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Veritas Software Corp. v. Comm'r and IP Transfer Pricing by U.S. Multinationals

2010 Emerging Issues 4982

Jennings and Sweigart on the Impact of Veritas Software Corp. v. Comm'r on Intellectual Property Transfer Pricing by U.S. Multinationals

By Robert Jennings and Elizabeth Sweigart

November 24, 2010

SUMMARY: IP management is a critical issue which U.S. multinationals face in managing their global supply chain yet the development, structuring, alignment and cost allocation processes are not given the full tax consideration they deserve until after an issue has arisen. In *Veritas Software Corp. v. Comm'r*, we see how the IRS is pursuing transfer pricing cases related to IP and the dangers of using purely economic modeling in the context of tax law.

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ARTICLE: Editor's Note: In an Action on Decision (AOD) [IRB No. 2010-49], the Internal Revenue Service (Service) announced that it does not acquiesce in the result or reasoning of the opinion issued by the Tax Court in *Veritas Software Corp. v. Commissioner*. The AOD with respect to *Veritas* contains a fulsome repudiation of the decision of the Tax Court, defending the platform contribution concept (referred to in the AOD as "the foundation for future development" and "R&D rights") and the aggregation approach presented to the court and set forth in Temporary Regulations, setting the stage for future battles with taxpayers.

Summary. As companies develop and expand internationally, the stress on the global supply chain increases. Often overlooked is a key component in the supply chain - intellectual property (IP) development, alignment and structuring. In light of the recent decision by the U.S. Tax Court in *Veritas Software Corporation v. Commissioner*, 133 T.C. No. 14 (2009), U.S. multinationals should give careful consideration to the manner in which their IP is created, held and paid for. The research and development (R&D) process must be coordinated with corporate tax, legal and accounting teams for companies to maximize the value derived and minimize potential enterprise risk - both in terms of protecting the intellectual capital and avoiding costly tax adjustments and penalties.

Company History. Veritas Software Corporation was originally established in 1982 as Tolerant Systems. Significant financial distress forced the company to change its strategy, changing its product focus to electronic data management and storage and adopting the name Veritas in 1989. As a young company, Veritas invested heavily in research and development programs designed to create software that was compatible with multiple computer systems, specifically, Windows, UNIX and Linux.

Growth of an International IP Portfolio. Through both organic growth and strategic acquisitions, Veritas

expanded its intellectual property portfolio and product lines. Notable partners during Veritas's early years included AT&T and IBM. Purchases and alliances - including the acquisition of Advanced Computing Systems Corporation and the storage management software business of Seagate - expanded Veritas's product offerings and positioned the company as a leader in the electronic data storage market. In mid-2005, Veritas was acquired by Symantec Corporation, an online security specialist, in a deal valued at approximately \$11 billion.

An Inconvenient Supply Chain. As with many companies whose growth outpaces their ability to integrate infrastructure from multiple acquisitions and organic development, in 1999 Veritas found itself with a highly inefficient supply chain, particularly with respect to its operations in non-U.S. markets. Prior to 2000 Veritas had concentrated on creating a sales and service presence outside of the U.S., but had no local manufacturing operations. Of Veritas's global work force of 3,000 personnel, only about one tenth was employed outside of North America in 1999.

With Europe, the Middle East and Africa (EMEA) as well as the Asia Pacific and Japan (APJ) markets offering tremendous opportunities for international growth, Veritas's management decided to move forward with plans to establish manufacturing and development operations in these key markets. Based on an evaluation of the cost of labor, employment laws, work force quality, and tax considerations, Ireland was selected as the headquarters for the company's expansion into EMEA and APJ.

Cost Sharing Arrangement. In January 1999, the company established Veritas Software Holding, Ltd. (VSHL), an Irish corporation, as a wholly owned subsidiary of the U.S. parent. In August 1999 Veritas Software International, Ltd. (VSIL) was incorporated as a resident of Ireland and a wholly owned subsidiary of VSHL. Effective November 3, 1999, Veritas assigned to VSHL and its subsidiaries (collectively, Veritas Ireland) all of the U.S. company's existing sales agreements with European-based sales subsidiaries. Also effective on that date, Veritas, Veritas Ireland and others of the company's subsidiaries entered into an Agreement for Sharing Research and Development Costs (RDA), and Veritas US and Veritas Ireland entered into a Technology License Agreement (TLA).

Under the TLA, Veritas Ireland would pay royalties to its U.S. parent. As is customary in these types of arrangements, the TLA included initial royalty rates, as well as an amount to be prepaid for the covered IP (i.e., a lump-sum buy-in payment). Under the TLA, the parties were able to "adjust the royalty rate prospectively or retrospectively as necessary so that the rate will remain an arm's-length rate." In fulfillment of the agreement, Veritas received \$6.3 million from Veritas Ireland in 1999. In 2000 Veritas Ireland paid Veritas \$166 million representing the balance of the lump-sum buy-in payment. The buy-in payment was subsequently reduced to \$118 million in 2002, as was permissible under the agreement.

Veritas's determination of arm's-length charges was made under the comparable uncontrolled transaction (CUT) method. Treas. Reg. § 1.482-4(c)(2)(ii). Under this method, the arm's-length nature of the amount charged is determined by reference to the amount charged in transactions involving the same or substantially similar intangibles under the same or substantially similar circumstances, terms and conditions between unrelated parties.

IRS Examination and Subsequent Litigation. Following an examination of Veritas's 2000 and 2001 U.S. Federal income tax returns, the IRS issued a notice of deficiency based on its own expert economist's report. The notice made a \$2.5 billion allocation of income to the U.S. parent and determined tax deficiencies of \$704 million and \$54 million, and I.R.C. Section 6662 penalties of \$281 million and \$22 million, relating to 2000 and 2001, respectively. Veritas petitioned the Tax Court seeking redetermination of the deficiencies and penalties. Over the 1-1/2 years, the IRS abandoned its original report and expert and selected a new expert whose report reduced the original lump-sum buy-in payment to \$1.675 billion, and the parties settled issues relating to stock-based compensation, technical support services, and Section 6662 penalties. Trial began on July 1, 2008, nearly two years to the day after Veritas's petition.

Although significant time during the trial was devoted to explanations of the calculation of the discount rate, determination of the useful life of the intangibles, and the application of the weighted average cost of capital (WACC) derived under the capital asset pricing method (CAPM), the court noted in its decision that the IRS's "determination

began to unravel with the parties' pretrial stipulations of the settled issues." Once the IRS and Veritas settled with respect to the arm's-length value of the RDA, the Tax Court noted, "as a practical and legal matter respondent [the IRS] was forced to justify the \$1.675 billion allocation by reference only to the preexisting intangibles." However, on reaching this settlement, the IRS was bound under Treas. Reg. § 1.482-7(g)(2), which limits the buy-in payment to *preexisting* intangibles. That is, the crux of the IRS expert's analysis - that the buy-in payment should reflect not just the preexisting intangibles but also the income attributable to future products resulting from the RDA - was rendered moot. The IRS had stipulated away that issue.

Despite what the court described as "an extensive stipulation process, a lengthy trial, the receipt of more than 1,400 exhibits, and the testimony of a myriad of witnesses," its decision in favor of Veritas hinged on the testimony of the IRS's replacement expert, testimony that was notable for its "numerous concessions and capitulations."

The IRS's expert, John Keith Hatch, Ph.D., is widely regarded as the pioneer of microfinance and an economic genius with respect to his creation of the village banking methodology. His work, particularly the founding of the non-profit Foundation for International Community Assistance (FINCA), has been cited as one of the great humanitarian acts of the 20th Century. Dr. Hatch's ability as an economist was not in question. The issue with his work and testimony arose because he made a purely economic argument disregarding applicable law, in which he had neither training nor experience and which IRS trial counsel did not address; this is an all too frequent refrain in transfer pricing related disputes.

The takeaway here is that trial counsel must work extensively with their client's expert, no matter how brilliant the expert, to acquaint the expert with the legal issues in the case, in advance of commissioning a report and before discovery begins.

A Tax Exercise. The determination of the value of an intangible is a subjective exercise involving numerous variables and qualitative measures aimed at producing a quantitative result. A tax valuation is like a contractor's bid or a skating judge's score - an expert's best guess carried to four decimal places. In this case, the issue came down to an interpretation of Treasury Regulations and their application to the facts and circumstances of the transaction. Dr. Hatch's report was flawed because it was an economic analysis unencumbered by the law. *Veritas* was a painful and expensive lesson for the IRS: Regardless of the intelligence or pedigree of an expert witness, you cannot employ subjective measures to arrive at a desired answer without regard to the relevant law, especially when it is your own legislative regulations that are involved.

As the IRS had settled the issues surrounding the RDA, the court noted that "as a practical and legal matter" the IRS could justify its revised lump-sum buy-in payment of \$1.675 billion "by reference only to the preexisting intangibles." In a vain effort to avoid their own regulations, the IRS's position, as expressed in the report and testimony of Dr. Hatch, resorted to the use of language and positions in Temporary Treas. Reg. Sections 1.482-1T through 1.482-9T, 74 *Fed. Reg.* 349 (Jan. 5, 2009), which the court noted "were promulgated 10 years after the transaction and 5 months after the trial." Despite the court's repeated comments that these Temporary Regulations post-dated the transaction, the IRS and its expert did not correct the positions taken or the references made to the Temporary Regulations in their amended filings. Said the court: "Taxpayers are merely required to be compliant, not prescient."

Conclusion and Lessons Learned. It was the business success of Veritas Ireland that solidified the case for the taxpayer. The Tax Court wrote:

"In sum, VERITAS Ireland prospered, not because VERITAS US simply spun off a portion of an established business and transferred valuable intangibles, but because VERITAS Ireland employed aggressive salesmanship and savvy marketing, successfully developed the EMEA and APJ markets, and co-developed new products that performed well in those markets."

Thus the allocations made by the IRS were deemed by the court to be arbitrary, capricious and unreasonable.

Both corporate and consulting counsel (and especially trial counsel) should take note of *Veritas*. The court's decision highlights that even when dealing with a highly subjective area - here, the valuation of intellectual property - relevant law and regulations trump pure economic modeling and financial forecasting.

Choosing a favorable answer and working backwards to arrive at it is a failing strategy. Neither taxpayers nor the government can manipulate the facts and circumstances or the law to suit a desired result. The IRS's arguments stemmed not from a disagreement with the manner in which the prescribed law and regulations were applied, but from a dislike of the ultimate answer. Thus the initial adjustments as proposed by the IRS were extraordinarily high compared to the result of the taxpayer's analysis.

Those experts whose work underpinned the IRS's case were not licensed to practice tax law, even at the enrolled agent level and, given their arguments and positions throughout, were not adequately supervised by those who were. Considering the tremendous responsibility and accountability required by attorneys, certified public accountants and enrolled agents in the practice of tax, it would be wise for both taxpayers and the IRS to ensure that those professionals outside of Circular 230's reach on whom they rely for critical analyses are properly trained and supervised. The woodshed is trial counsel's best friend.

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Implications of Canal Corp. v. Comm'r for U.S. Taxpayers and Their Advisors

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Jennings, Sweigart and Patel on the Implications of Canal Corp. v. Comm'r for U.S. Taxpayers and Their Advisors

By Robert Jennings, Elizabeth Sweigart and Reena Patel

October 29, 2010

SUMMARY: *Canal Corp. v. Comm'r*, 2010 U.S. Tax Ct. LEXIS 25 (T.C. Aug. 5, 2010), has serious implications for U.S. taxpayers and their advisors, especially regarding the issuance of tax opinions requiring a high degree of certainty. Fundamental points of the case as to advisor independence and economic substance are important for in-house counsel and external advisors to grasp in mitigating enterprise risk that often accompanies complex transactions.

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ARTICLE: Summary. A recent decision for the Government in *Canal Corp. v. Comm'r*, 2010 U.S. Tax Ct. LEXIS 25 (T.C. Aug. 5, 2010), highlights the continued focus by the Government on advisor independence and objectivity as well as the significance of substance over form, in the context of tax-advantaged transactions. On its face, the leveraged partnership structure designed by investment advisors, and reinforced by a tax opinion prepared by the taxpayer's third-party accounting firm, was found to be contrived. However, it is not the technical points of the case that are significant as much as the lessons to be gained from the dicta in the case. When providing a tax opinion with a high degree of certainty, the advisor's independence-both actual and perceived-is a key consideration in evaluating the persuasive value of the opinion in a judicial forum. It is unclear to what extent by extension this maxim will be true in administrative forums as well; only time will tell. In this case, the court's ruling that the taxpayer placed unreasonable reliance on its accounting firm's opinion cost the taxpayer nearly \$37 million in substantial-underreporting penalties, third party "should" level opinion notwithstanding. While a particularly egregious example, this case demonstrates the court's laser-like focus on economic substance over form and the importance of acknowledging and dealing with conflicts of interest-real or perceived.

Company Background. Canal Corporation, formerly known as Chesapeake Corporation ("Taxpayer", "Chesapeake") was a Virginia corporation organized as a corrugated paper manufacturer in 1918. In the late 1990s, the industry experienced major restructuring and consolidation as the capital intensive nature of the business favored large companies with the level of resources necessary to sustain its business and compete successfully.

Responding to the changing market, Chesapeake turned to producing specialty packaging-primarily for perfumes and other luxury items-and moved away from commercial tissue production. By exiting the commercial tissue business, Chesapeake had to choose between selling or liquidating its largest subsidiary, Wisconsin Tissue Mills, Inc. ("WISCO"). Georgia Pacific ("GP"), an unrelated third party prominent in the industry, expressed interest in purchasing

WISCO to complement its existing product lines. Chesapeake hired Salomon Smith Barney ("Salomon") and PricewaterhouseCoopers ("PwC") to recommend tax-efficient restructuring plans for WISCO's tissue business. PwC was to be paid a fixed fee of \$800,000 for tax advice and issuance of a formal opinion on the transaction. Chesapeake's Board of Directors expressly conditioned closing the transaction upon receipt of a "should"-level opinion from PwC that the transaction would not be currently taxable. A "should"-level opinion is the highest level of comfort PwC offers to a client that the position taken by a taxpayer will succeed on the merits.

The Transaction. Salomon and PwC advised Chesapeake to enter into a leveraged partnership with GP. WISCO contributed assets approximating \$775 million to a new joint venture, Georgia-Pacific Tissue LLC ("LLC"), in exchange for a 5 percent membership (partnership) interest. GP contributed assets approximating \$376.4 million to LLC in exchange for the remaining 95 percent membership interest. On the same day as both the contributions, LLC borrowed \$755.2 million from Bank of America ("BOA") and immediately transferred the loan proceeds to WISCO as a special cash distribution. GP guaranteed payment of the BOA loan and WISCO agreed to indemnify GP for any principal payments (but not interest payments) GP might have to make as guarantor on the BOA loan.

On its timely-filed consolidated 1999 Federal Income Tax Return, Chesapeake reported the transaction on Schedule M and reported \$377,092,299 book gain and no corresponding tax gain. Chesapeake did not treat the indemnity obligation as a liability, whether fixed or contingent, for accounting purposes because management determined there was no more than a remote chance Chesapeake would have to pay on the indemnity.

The Court's Ruling. The court ruled in agreement with the Commissioner that the transaction, taken as a whole, constituted a "disguised sale" per 26 USC § 707(a)(2)(B), and thus did not qualify for tax deferral in 1999. Chesapeake argued that the exception to the disguised sale rules for debt-financed transfers under Treas. Reg. § 1.707-5(b)(1) applied because WISCO bore the economic risk of loss on LLC's liability to the bank through the indemnity agreement. Although a true indemnification contract generally does result in the economic risk of loss, following Treas. Reg. § 1.752-2(b)(3)(i), the court invoked the Anti-Abuse rules in Treas. Reg. § 1.752-2(j). The court held that WISCO's indemnity agreement gave no real protection to GP and lacked "economic substance." The indemnity lacked substance because (1) GP did not require WISCO to indemnify BOA as well as GP, (2) the indemnity only covered principal and not interest, (3) the indemnity did not require WISCO to maintain a certain net worth, (4) GP would have to first proceed against LLC's assets before demanding indemnification, and (5) if WISCO did have to pay on the indemnity, WISCO would receive a proportionately increased interest in the LLC.

Accuracy-Related Penalty. The court also had to decide if this transaction and the resulting underpayment of tax was a 26 USC § 6662 substantial understatement of income, or if the reasonable cause exception in 26 USC § 6664(c)(1) applied. If the taxpayer shows that there was reasonable cause for, and that the taxpayer acted in good faith with respect to, the applicable underpayment, the penalty is excused. The specific facts and circumstances in each case determine good faith and reasonableness. Selecting a competent tax advisor and providing relevant information generally shows good faith. But, as courts have repeatedly held in the past, it is unreasonable for a taxpayer to rely on the same tax advisor that actively planned the transaction; that is an inherent conflict of interest. [*Mortensen v. Comm'r*, 440 F.3d 375, 387 (6th Cir. 2006), *affg.* T.C. Memo 2004-279; *Pasternak v. Comm'r*, 990 F.2d 893 (6th Cir. 1993), *affg.* *Donahue v. Comm'r*, T.C. Memo 1991-181; *Neonatology Assocs, P.A. v. Comm'r*, 115 T.C. 43 (2000), *affd.* by 299 F.3d 221 (3d Cir. 2002).]

A Conflict of Interest. Chesapeake's tax advisor, PwC, was involved in drafting the operating agreements and indemnity agreement. PwC also researched and wrote the tax opinion. For its services, PwC received a flat fee of \$800,000, instead of billing its standard hourly rates for work performed, payable and contingent upon the closing of the joint venture transaction. Chesapeake's directors conditioned closing of the transaction on receiving at closing a "should"-level opinion regarding tax deferral from PwC. According to the court, Chesapeake's draft opinion (the final opinion was not produced at trial) was not only "littered with typographical errors, disorganized and incomplete," but was also "riddled with questionable conclusions and unreasonable assumptions." Further, despite the high level of assurance given, the court noted the opinion "had no case law or Code authority" cited as support for the conclusion.

When asked in open court how the opinion could be authored without substantial authority, the drafter, David Miller, a non-practicing attorney, responded that it was "what Chesapeake requested." Based on the facts and circumstances presented, the court ruled that Chesapeake's reliance on the opinion issued by PwC was unreasonable and lacked good faith, and held Chesapeake liable for accuracy-related penalties in 26 USC § 6662.

Lessons for Tax Practitioners

Lesson 1: Be Independent. There is a long-standing belief that choosing a "Big 4" accounting firm buys an insurance policy. In *Canal Corp.*, the court indicates that this confidence may not be founded in the face of an "obvious conflict of interest."

However, the court did not state that all taxpayers should require a second opinion on every tax issue, nor did the court establish a single objective method to meet the "good faith" and "reasonable reliance" standards. Instead, the court made clear that taxpayers should not rely on an advisor "tainted by an inherent conflict of interest the taxpayer had reason to know of." Chesapeake clearly was aware of the possible conflict of interest created by the flat fee compensation for the desired level of opinion, that PwC would be paid only if the deal closed, and that Chesapeake would not close the deal without PwC's "should" opinion. Moreover, the court expressed concern as to the objectivity and independence of PwC given that it was involved in structuring the transaction and drafting many of the underlying agreements to facilitate the transaction. Interestingly, the court does not mention the role of the investment advisor in the planning and orchestration of the transaction. On these facts, PwC lacked the merest appearance of independence. PwC's obvious conflict of interest should have been a red flag to Chesapeake's management and board of directors.

Independence is proven by facts and circumstances-there are not, and cannot be, objective standards to measure whether an advisor is independent from its client in every conceivable permutation. Because of this inherent subjectivity, the onus is on management and the board of directors to exercise sound business judgment. Taxpayers and their advisors must recognize that an outsider's perception of the transaction is as important as its substance. Conflicts of interest-whether real or perceived-must be addressed proactively.

Lesson 2: Rely on Authoritative Sources. Before a tax advisor issues a formal opinion of any kind, especially the highest level of assurance as in this case, the advisor must do a thorough review of the facts and circumstances, as well as provide substantial authoritative support for any position taken. While binding on the Government, Revenue Procedures and Rulings do not carry the force of law. Beware of reliance upon non-authoritative sources; do not try to make them fit a particular case. If no substantial authority exists for a formal opinion, advisors must clearly convey to the client the key assumptions and the inherent risks. Documentation is crucial. Records-whether in the form of notes of informal discussion, e-mails or memoranda-are essential to establish the independence of the advisor and the integrity of the opinion.

Lesson 3: Tell the Same Story-Book vs. Tax Treatment. Pay careful attention to inconsistent book versus tax treatment of a transaction. Chesapeake's treatment of the transaction as a sale for book purposes without the same treatment for tax purposes raised an immediate red flag. Clearly there are circumstances where such a result is warranted; but each transaction should be examined carefully where there is divergent treatment particularly in the context of acquisitions and divestitures.

Lesson 4: Always Remember-Substance Over Form. The leveraged partnership structure was a ruse from the outset, as it lacked both sufficient non-tax business purpose and economic substance. Similar structures have survived the court's scrutiny, and may do so now. The issue is ultimately one of substance: Was WISCO really on the hook for anything? And was PwC acting as an advisor, providing objective, responsible advice, or acting as an insurer, taking the premium upfront in return for bearing the risk the structure would not withstand scrutiny?

When looking for a tax structuring solution, the tendency is to start with the desired answer, in this instance achieving tax deferral, and work backwards. Tax planning decisions must be based on facts and circumstances, not the

latest tax guidance fad. As seen in *Schering-Plough Corp. v. United States*, 651 F. Supp. 2d 219 (D.N.J. 2009), the paper facts may appear legitimate, but without economic substance and non-tax business purpose, no expert witness or financial model can make the transaction survive rigorous examination.

Key Takeaways. Attempting to fit the facts and circumstances to advantageous but ultimately irrelevant guidance puts the taxpayer and the advisor in peril, although the attempt may reduce short-term friction between taxpayer and advisor. On occasion, the best advice in-house counsel and external advisors can give is "No." Winning the battle of substance over form requires careful business and economic planning and execution-not just a flat-fee third-party opinion.

For trial counsel, there are three important takeaways from this case.

1. Documents are Important. Why would you let a rough, illiterate draft of the most important document in the case into evidence? The original, fully signed PwC opinion was the cornerstone of the entire transaction. No opinion, no deal. So where was the original opinion? The court pointedly referred only to a draft. Hint to trial counsel-the best evidence rule is alive and well.

2. Find Substance Where You Can. The key to the defense was the real economic risk to the indemnitor. What were the BOA loan terms? Was the loan a fully-collateralized sham? Were the loan terms commercially reasonable? Was the BOA loan in fact a bridge loan, short-term, to tide GP over until it could raise permanent financing? Was there a real capital-markets risk, that the principal would come due before alternative financing could be placed, so guarantor and indemnitor were really at risk? Was the loan term so short that the interest risk was small compared to the principal risk? Was the loan term so short that requirement for WISCO maintaining its net worth was less a concern than would be for permanent, long-term financing?

3. Witness Preparation is Not a Luxury. It is a necessity. Prior to his giving testimony in open court, who prepared Mr. Miller, the author of the opinion? When he testified that he gave the opinion because it was what Chesapeake requested, trial counsel should have smiled sweetly and contemplated a prolonged vacation. When assailed by demands for authorities to support his position, Miller should have had a better answer. Complex, innovative transactions cannot be done by rule of thumb. Very often there are no precedents; in complex transactions, we boldly go where no one has gone before. Turning to the flat fee, which was clearly a consideration in the court's decision, was it PwC's practice to provide "should"-level opinions on a flat fee? The myth of hourly billing cannot be debunked too often; years of specialized knowledge, acquired at great labor, has a worth that cannot be measured by how long it took the possessor thereof to write down an answer. Hours are not fungible. Talk to the witness. Make the witness talk. Ask pointed questions. The woodshed is the trial lawyer's best friend.

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Amended France -- U.S. Income Tax Treaty in Effect

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Amendments to France -- U.S. Income Tax Treaty Take Effect

By Sanford J. Davis, Mitchell R. Kops and William J. Kambas

October 28, 2010

SUMMARY: A new France-U.S. income tax treaty protocol eliminates withholding tax on intercompany dividends from 80 percent-owned subsidiaries and on royalties paid for the use of intellectual property; imposes stricter Treaty benefit qualification requirements; adds mandatory dispute arbitration; expands required information exchanges; and clarifies resident status of partnerships, fiscally transparent entities, and certain French investment vehicles.

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ARTICLE: INTRODUCTION

On July 20, 2009 the French Senate adopted a bill to ratify a protocol (the "Protocol") to the 1994 U.S. France income tax treaty (last amended in 2004) (the "Treaty"). On September 9, 2009 President Obama delivered the Protocol to the U.S. Senate for advice and consent.

The Protocol, which was signed by both countries on January 13, 2009, would modify the Treaty in several respects. The most significant changes to the existing Treaty are:

- (i) Elimination of withholding tax on intercompany dividends from 80%-owned subsidiaries;
- (ii) Elimination of withholding tax on all royalties paid for the use of intellectual property;
- (iii) Imposition of stricter requirements for companies to qualify for Treaty benefits;
- (iv) Addition of mandatory arbitration when the competent authorities are in disagreement;
- (v) Expansion of required exchanges of information; and
- (vi) Clarification on resident status of partnerships, fiscally transparent entities, and certain French investment vehicles.

Once ratified by both countries, and after exchange of instruments and entry into force, the Protocol will become effective in three stages:

(i) First, the new withholding tax provisions will apply as of January 1 of that year.

(ii) Next, the mandatory arbitration provisions will apply beginning on the date that the Protocol enters into force.

(iii) Finally, the balance of the Protocol will apply on the first day of the calendar year following the year the Protocol enters into force.

ANALYSIS

Withholding Rates: The Protocol lowers withholding tax rates for certain items of income for certain taxpayers, as set forth in the summary table, below:

Treaty

Protocol

I. Dividends

Individuals

- 15% rate
- Unchanged

Intercompany

- 5% rate for dividends if recipient company owns 10% or more of voting stock of dividend paying company and latter is a resident of the US
- 5% rate for dividends if recipient company owns 10% or more of capital of the dividend paying company and latter is a resident of France
- The 5% rate is unchanged for inter-company investments of at least 10% (and up to 79.9%) (see below)
- Zero withholding if recipient French company has owned 80% or more of the dividend paying company voting stock for 12 months and meets certain LOB tests, if such company is a resident of the US
- Zero withholding if recipient US company has owned 80% or more of dividend paying company capital for 12 months and meets certain LOB tests, if such company is a resident of France

RIC or SICAV

- 15% rate
- Unchanged

REIT

- 15% if any one of the following 3 REIT tests are not met: (i) the owner holds a 10% or smaller REIT interest, (ii) the dividend is paid with respect to a class of public REIT stock and the owner holds not more than 5% of any class of REIT stock, or (iii) the owner holds 10% or less of REIT stock and the REIT is diversified.

- Provides default rate of 30% if applicable REIT tests not met
- Applies identical tax treatment to French SIICs, and SPPICAVs

II. Interest

- 15% rate

- Unchanged

III. Royalties

- No withholding on copyright of literary, artistic, or scientific work, any cinematographic film, any sound or picture recording, or any software
- 5% rate on patent, trademark, design or model, plan, secret formula or process
- Zero withholding on all royalties

Limitations on Benefits: The Protocol imposes significantly stricter limitations on benefits ("LOB") rules, generally following the 2006 US Model Tax Treaty, to bring the Treaty in conformity with other recent US tax treaties. In this regard, the Protocol limits treaty benefits to companies that satisfy one of the following five standards:

(1) **Publicly Traded Company.** The company's principal class of shares must be regularly traded on one or more recognized exchanges. In addition, the shares must primarily be traded on a treaty-recognized exchange in the country of residence or, for French companies, any European Union ("EU") exchange identified in the Treaty, and, for US companies, any exchange in North America identified by the Treaty. Alternatively, the company's primary place of management and control must be in the country in which the company is resident.

(2) **Subsidiary of a Publicly-Traded Company.** At least 50% of the aggregate voting power and value of the shares (and at least 50% of any disproportionate class of shares) must be owned directly by five or fewer companies qualifying for the publicly-traded test. In cases of indirect ownership, each intermediary entity must be resident in either the US or France.

(3) **Treaty Country Resident Shareholders Satisfy Ownership and Base Erosion Tests.** For at least half the tax year, (i) at least 50% of the aggregate voting power and value of the shares of the company (and at least 50% of any disproportionate class of shares) must be owned (directly or indirectly) by residents of the country in which the company is resident; and (ii) less than 50% of the company's gross income is paid or accrued (directly or indirectly) to persons eligible for benefits under the Treaty in the form of payments that are tax deductible in the residence country (but not including arm's-length payments in the ordinary course of business for services, tangible property, or certain interest payments).

(4) **Seven or Fewer Equivalent Beneficiaries Own 95% of Vote and Value.** At least 95% of the aggregate voting power and value of the shares of the company (and at least 50% of any disproportionate class of shares) must be owned, directly or indirectly, by seven or fewer "equivalent beneficiaries" (the term "equivalent beneficiaries" includes any resident of an EU member state or NAFTA country provided that such person would be entitled to treaty benefits for that country and does not otherwise fail an applicable LOB provision).

(5) **Active Trade or Business In Residence Country.** A company actively engaged in trade or business in its country of residence (either directly or through sufficiently owned subsidiaries) will receive Treaty benefits limited to income connected with the applicable trade or business. If the income is derived through a related party then the business conducted in the residence country must be substantial in relation to the business conducted in the source country, based on the facts and circumstances of each case. This test does not apply to managing investments for one's own account.

Finally, the LOB article also contains an "anti-triangular" provision under which Treaty benefits for income attributable to a permanent establishment ("PE") in a third country require that the combined tax of the residence country and the PE country equal 60% or more of the tax payable in the country of residence (if the income were not attributable to the PE).

Mandatory Arbitration: The Protocol imposes new mandatory arbitration that applies if the competent authorities are unable to reach agreement under the Mutual Agreement procedure. However, the mandatory arbitration provision only applies if: (a) tax returns have been filed in one of the Contracting States for the tax years at issue; (b) the competent authorities do not agree it is not suitable for determination by arbitration; and (c) all concerned persons agree not to disclose to any other person any information received during the arbitration proceedings.

Mandatory arbitration is a new addition to US tax treaties generally (e.g. Belgium, Germany, as well as in the recent Protocol with Canada).

Residency: The Protocol contains entirely new provisions relating to the residence of partnerships and fiscally transparent entities (i.e., taxed only at the owner level). It also clarifies that certain French investment entities are automatically characterized as residents of France.

First, payments made from the US to certain French "qualified partnerships," a concept added by the Protocol, will be treated as payments received by a resident of France only if such income is included currently in the taxable income of partners who are French residents. A "qualified partnership" is a partnership that meets all four of the following conditions: (i) that has its place of effective management in France; (ii) that has not elected to be taxed in France as a corporation; (iii) the tax base of which is computed at the partnership-level for French tax purposes; and (iv) each shareholder, associate, or other member is liable for tax in France on their share of partnership profits.

Second, the Protocol adds a look-through rule to apply to fiscally transparent entities. Income, profit, or gain derived through a fiscally transparent entity for local tax purposes is classified as income of a resident of that country provided and to the extent that (i) the entity was formed under the laws of either contracting state (or of a third state if that third state has an exchange-of-information agreement in place with the contracting state from which the payment was made) and (ii) the item is treated under the tax law of such contracting state as income, profit or gain of a resident. In addition, the Protocol (amending the Miscellaneous Provisions of the Treaty) adds a provision that allows France to tax income derived through a fiscally transparent entity that has its place of effective management in France.

Lastly, the Protocol expands the types of French investment vehicles automatically defined as residents to include *societes d'investissement immobilier cotee* (SIIC) and *societes de placement a preponderance immobiliere a capital variable* (SPPICAV). However, despite the fact that SIICs and SPPICAVs are characterized as residents, they must also meet the eligibility rules contained in the Protocol's LOB article.

Exchange of Information: The Protocol contains a new Exchange of Information provision, generally consistent with the 2006 US Model Income Tax Treaty, that requires each party to supply any requested information, even if such information is held by a bank, other financial institution, nominee or person acting in an agency or fiduciary capacity or it relates to ownership interests in an entity.

First, the new withholding tax provisions (Dividends and Royalties) will apply for amounts paid or credited as of January 1 of the year in which the Protocol enters into force. Since the Protocol was entered into force on December 23, 2009, the withholding tax provisions apply retroactively for the entire 2009-year.

Second, the mandatory arbitration provisions are apply beginning on December 23, 2009, the date that the Protocol entered into force.

Third, the balance of the Protocol will apply on the first day of the calendar year following the calendar year in which the Protocol enters into force. In other words, since the Protocol entered into force December 23, 2009, it took full force and effect as to all provisions on January 1, 2010.

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To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

RELATED LINKS: For further insight, see

- 3-41 Rhoades & Langer, U.S. Int'l Tax'n & Tax Treaties § 41.03

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2010 Italy -- U.S. Income Tax Treaty in Effect

2010 Emerging Issues 5378

2010 Italy -- U.S. Income Tax Treaty Provisions in Effect

By Sanford J. Davis, Mitchell R. Kops and William J. Kambas

October 28, 2010

SUMMARY: On March 3, 2009, after nearly 10 years of deliberation, the Italian Parliament authorized ratification of the U.S.-Italy income tax treaty and protocol that were signed on August 25, 1999 (the "New Treaty"). The New Treaty then entered into force on December 16, 2009 and took effect generally for tax years starting on or after January 1, 2010. The New Treaty contains a number of important changes to the 1984 Treaty, as outlined here.

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ARTICLE: The New Treaty between Italy and the US took effect in two phases - first the new withholding tax provisions apply for payments made or credited on or after February 1, 2010. The balance of the New Treaty provisions became effective as of January 1, 2010 - fully supplanting the existing treaty signed in 1984 (the "1984 Treaty").

Withholding Rates: The New Treaty generally provides for lower withholding tax rates on dividends, interest, and royalties than those under the 1984 Treaty, as set forth in the summary table, below:

U.S.-Italy Treaty Withholding Tax Rates

1984 Treaty

New Treaty

I. Dividends

Individuals

- 15 percent rate
- 15 percent rate

Intercompany

- 5 percent rate if recipient company owns 50 percent or more of dividend paying company voting stock (provided paying company does not receive more than 25 percent of gross income from dividends and interest)
- 10 percent rate if recipient company holds 10 percent or more of voting stock
- 5 percent rate if company owns 25 percent or more of dividend-paying company voting stock

RIC

- No RIC specific provision
- 15 percent rate

REIT

- No REIT specific provision
- 15 percent if either -- (i) the owner holds a 10 percent or smaller REIT interest, (ii) the dividend is paid with respect to a class of public REIT stock and the owner holds not more than 5 percent of any class of REIT stock, or (iii) the owner holds 10 percent or less of REIT stock and the REIT is diversified.
- 30 percent default rate if no test met

II. Interest

- 15 percent rate
- 10 percent rate

III. Royalties

- 5 percent rate -- copyright of artistic, literary, or scientific work
- 8 percent rate -- motion pictures and films, tapes or other means of reproduction used for radio or television broadcasting
- 10 percent rate -- in other cases
- 0 percent rate -- copyright of literary, artistic or scientific works (with some exceptions)
- 5 percent rate -- computer software or industrial, commercial, or scientific equipment
- 8 percent rate -- all other cases

Intercompany dividends eligible for the lowest 5 percent withholding rate under the New Treaty will apply to companies that own at least 25 percent of the voting stock of the dividend paying company in lieu of a "50 percent or more" ownership threshold under the 1984 Treaty. The New Treaty also leaves behind the additional passive income limitation under the 1984 Treaty that not more than 25 percent of the gross income of the paying company be from dividends and interest (other than subsidiaries or interest derived in the conduct of a financing business). However, one negative effect of the reduction of the ownership threshold for the 5 percent withholding rate is that intercompany dividends paid on stock interests ranging between 10 percent and 24.99 percent of the voting stock will be taxed at a 15 percent rate (instead of a 10 percent rate that applies under the 1984 Treaty).

Another change impacting dividends that the New Treaty provides a flat 15 percent rate on all U.S. Regulated Investment Company (RIC) dividends and a 15 percent or 30 percent rate in the case of Real Estate Investment Trust (REIT) dividends depending on characteristics of the holder and REIT. In contrast, the 1984 Treaty has no provisions specifically directed to dividends paid by RICs or REITs.

The New Treaty taxes interest income at a 10 percent withholding rate in comparison to the 15 percent rate of the 1984 Treaty. The New Treaty also exempts interest with regard to sales of goods, services and certain equipment.

The New Treaty also relaxes the taxation of royalties as it (i) applies a 0 percent tax rate to royalties from a copyright of literary, artistic or scientific work (with some exceptions), (ii) reduces the withholding rate on royalties for the use of computer software and tangible personal property to 5 percent (from 10 percent and 7 percent under the 1984 Treaty, respectively) and (iii) reduces the highest royalty withholding tax rate to 8 percent (from a 10 percent rate under the 1984 Treaty).

On the whole, while the New Treaty withholding tax provisions are not as generous as the zero withholding rate approach of some U.S. treaties, the rate reductions should help advance U.S.-Italian cross-border business and flows of capital.

Branch Profits Tax: The New Treaty authorizes a 5 percent U.S. branch profits tax ("BPT") on earnings

repatriated from the U.S. by an Italian corporation doing business in branch form in the U.S. -- i.e., a second-level tax on top of the 35 percent U.S. corporate tax on net income. This provision is significant since to date U.S. Treasury regulations exempt Italian corporations doing business in the U.S. from imposition of the BPT, which was enacted after the 1984 Treaty. The U.S. BPT rate of 5 percent will place U.S. branch operations of Italian corporations in the same position as U.S. subsidiaries of Italian parent corporations. So long as Italy does not tax branch profits, this area continues to be a one-way street (although the New Treaty expressly permits Italy to impose a similar branch profits tax at 5 percent).

Post-Employment Compensation and Severance: The New Treaty expressly permits taxation by one contracting state of lump-sum payments or severance payments in respect of employment performed within such state but received after a change of residence to the other treaty state. This new provision is an exception to the general treaty rule that pensions and post-retirement employment income are taxable only by the treaty state of residence at the time of receipt.

Limitations on Benefits: Limitation on benefit ("LOB") provisions will apply to limit treaty benefits of companies, consistent with other modern U.S. income tax treaties, on the basis not only of tax "residence" (which is the only test under the 1984 Treaty) but also upon satisfaction of stock ownership and income base erosion tests. Italy's decision in March 2009 to ratify LOB provisions effectively yields to the U.S. Senate's condition embedded in its November 5, 1999 consent to ratification that LOB provisions will be the sole anti-abuse safeguard - this effectively eliminates the "main purpose" (a subjective) test of tax avoidance originally sought by Italy and resolves an impasse over the appropriate anti-abuse protection.

The New Treaty LOB stock ownership test is satisfied if either (i) the company's shares in the classes representing 50 percent of the voting power and value are regularly traded on a recognized stock exchange, (ii) at least 50 percent of each class of shares is owned directly or indirectly by five or fewer companies that meet the foregoing public trading test, or (iii) resident persons otherwise entitled to treaty benefits own at least 50 percent of each class of shares and the company satisfies a base erosion test requiring that less than 50 percent of its gross income for the taxable year be paid or accrued as deductible payments to persons who are not residents of either treaty country.

U.S. Foreign Tax Credits For IRAP Taxes: In a compromise regarding the availability of U.S. foreign tax credits for the Italian regional tax on production activities the New Treaty provides a "partial credit" reflecting the concern that the regional tax on production is a hybrid between a value-added tax and a tax based on "net" income.

Grandfathering Provision: Taxpayers can elect to apply the 1984 Treaty for 12 additional months. That is, there is one year where the New Treaty can overlap the 1984 Treaty. The grandfathered year begins from the date on which applicable provisions of the New Treaty become effective. Therefore, if more beneficial withholding tax rate results are available under the 1984 Treaty, taxpayers can apply them through February 1, 2011. Similarly, if provisions of the 1984 Treaty other than the withholding tax rates are more beneficial to a taxpayer, then such provisions (i.e., the balance of the New Treaty) can be deferred until January 1, 2011.

RELATED LINKS: For further insight, see

- 3-41 Rhoades & Langer, U.S. Int'l Tax'n & Tax Treaties § 41.03

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Bilski v. Kappos: A New Chapter in Tax Strategy Patentability

2010 Emerging Issues 5359

Marvin Petry on *Bilski v. Kappos: A New Chapter in Tax Strategy Patentability*

By Marvin Petry

October 25, 2010

SUMMARY: *Bilski v. Kappos*, 130 S. Ct. 3218 (U.S. 2010) has given significant clarity to the status of tax strategy patents. However, desires for greater clarity on patentability could be ill-advised. Many tax practitioner concerns seem to involve a misunderstanding of the term "business method patents." An understanding of *State St. Bank & Trust Co. v. Signature Fin. Group*, 149 F.3d 1368 (Fed. Cir. 1998) and other cases leading to *Bilski* is essential.

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ARTICLE: *Bilski v. Kappos*, 130 S. Ct. 3218 (U.S. 2010) has given significant clarity to the status of tax strategy patents. To understand why this is so, one must start with an analysis and clear understanding of *State St. Bank & Trust Co. v. Signature Fin. Group*, 149 F.3d 1368 (Fed. Cir. 1998) as well as cases leading up to the *Bilski* Supreme Court decision.

The *State Street* Decision and Its Fundamental Significance

In *State Street*, the Court of Appeals for the Federal Circuit expanded and clarified that computer software covering a method of doing business (instead of accomplishing a purely physical phenomenon) was patentable. Unquestionably, at least with the benefit of hindsight, *State Street* was (unintentionally) a watershed event in the development of patentable subject matter. *State Street* itself was not all that significant. However, it became significant because of how it was intentionally or unintentionally misunderstood or mischaracterized. Prior to *State Street*, three principal cases, found the presence of patentable subject matter based on the existence of some scientific/computer application. n1 *State Street* itself was consistent with those cases, finding patentability on a method which related to computer software.

State Street became important for reasons which go beyond its actual holding. First, the computer software *did* involve a business method. Second, the Court concluded (possibly dicta, as it was not truly necessary to its decision) that the "business method" exception to patentability was ill conceived. It did so not because it wished to open any floodgates to the business method/tax strategy patents which followed thereafter, but because the Court simply felt it necessary or desirable to explain that in its view "since its inception, there was never in reality a true self-standing business method exception to patentability". Rather, in its view, "business methods" were simply words which were used to represent the application of other general legal principles. It noted in the decision that in virtually all of the cases

which rejected claims based on the "business method" exception there were other reason for rejecting the claims.

Viewed somewhat differently, since *State Street* the term "business method" patents seems to have encompassed, at least in the most general and simplistic sense, two groups of subject matter.

1. Computer software and other physical or scientific subject matter, was no doubt intended by the *State Street* Court to be considered as patentable subject matter; and

2. Essentially abstract ideas, absent any scientific aspect, i.e., pure mental steps, which *State Street* never condoned as patentable subject matter.

Tax strategy patents are often described as patents relating to tax planning which fall into either of these two groups. However, the more enlightened tax practitioners and pending legislation seem to understand this dichotomy by differentiating between unacceptable tax strategy patents directed to pure mental steps and acceptable tax strategy patents relating to or including computerized applications.

After *Statestreet*, the evolution of (1) patents in general with claims directed purely to method steps and (2) as a subset thereof, tax strategy patents which are essentially mental steps, proceeded along parallel paths, unaided by meaningful and judicial interpretation until the *Bilski* Federal Circuit and U.S. Supreme Court decisions.

Judicial Developments Leading up to, and including, *Bilski*

The current status of tax strategy patents is essentially defined by the recent Supreme Court decision of *Bilski v. Kappos*, 130 S. Ct. 3218 (U.S. 2010). In developments leading up to *Bilski*, the Court of Appeals for the Federal Circuit, had just recently decided in *In re Comiskey*, 554 F.3d 967 (Fed. Cir. 2009) that the pure mental step abstract, method claim presented to it in that case did not constitute patentable subject matter. However, *Comiskey* did not answer the critical question of just where the line should be drawn in the spectrum between, at one end, claims clearly having technological or scientific subject matter including computer software and at the other end pure mental steps, which *Comiskey* held not patentable subject matter. The Federal Circuit had recently decided in *In re Nuijten*, 500 F.3d 1346 (Fed. Cir. 2007) that a claim directed to signals embedded in with information allowing them to place digital watermarks on electronic data files was not patentable subject matter.

It was in this context that the Federal Circuit held in *In re Bilski*, 545 F.3d 943 (Fed. Cir. 2008) (1) that the pure mental step claim in the subject patent was an unpatentable abstract idea, and (2) that patentability of claims including method steps would turn largely on (1) its ties to a machine or apparatus or (2) its ability to transform an article into a different state or thing (the so-called machine or transformation test).

The issue at the Federal Circuit in which concerned patentable subject matter of a process claim, was whether it satisfied the transformation branch of the machine or transformation test. Transformation of an article includes transformation of electronic signals representing a physical object or substance, but does not include as a patent-eligible transformation a step of gathering or deriving data. Also, specifically mentioned as not being a patent-eligible transformation, are steps which simply manipulate public or private legal obligations or relationships, business risks or other such abstractions because they are not physical objects or representations of physical objects. The essential objection to such process steps which do not satisfy the machine/transformation test is that they are considered to preempt all applications of the underlying unpatentable fundamental principle, i.e., the mathematical formula, the law of nature or the abstract idea. Nor is such a process claim which fails the machine/transformation test saved by insignificant post-solution steps, such as using a general purpose computer.

The U.S. Supreme Court did two things in *Bilski*. First, it ruled, as generally anticipated, that the claim presented therein, since it included only method steps, was an abstract idea which did not constitute patentable subject matter. Second, the Court addressed the Federal Circuit Court's machine or transformation test (i.e., the Federal Circuit's line in the spectrum between purely physical inventions at one end and purely method steps at the other end) by saying that by

drawing the line, i.e., at the machine/transformation, the Federal Circuit was incorrect. Instead, the Court held that the line should be drawn somewhere between a "machine or transformation" standard and the abstract idea end of the spectrum. The Court stated that the "machine or transformation" test is not the sole test for what constitutes patentable subject matter.

The Supreme Court did not rule on exactly what does constitute patentable subject matter, instead stating that, "the court therefore need not define further what constitutes a patentable "process" beyond pointing to the definition of the term provided in § 101(b) and looking to the guideposts in *Benson*, *Flook* and *Diehr*.² And nothing in today's opinion should be read as endorsing interpretations of § 101 that the Court of Appeals for the Federal Circuit has used in the past", citing *State Street*. The Supreme Court further stated that "in disapproving an exclusive machine - or - transformation test, we by no means foreclose the Federal Circuit's development of other limiting criteria that further the purpose of the Patent Act and are not inconsistent with this text."

Bilski seems, once and for all, to have ended the tax practitioners' concern with tax strategy patents because it conclusively rejects tax strategy patents which were of significant concern, those that involve pure method steps, and this favorable conclusion is in no way minimized by the fact that the case leaves standing the possibility of tax strategy patents involving scientific principles such as computer software since those types of patents should stand and fall with patents in all other subject matters which involve some mental steps, i.e., the machine or transformation test or other test to be determined in the future. Stated differently, if a tax strategy patent involves a sufficient level of scientific material, including computer software, which would support patentability in general, such claims should not be treated differently just because they involve tax strategies.

Beyond the Courts

Apart from the judicial system, the Internal Revenue Service, Congress and the tax bar have raised concerns with respect to tax strategy patents. As explained in the following section of this article, and based essentially on *Bilski*, the underlying reasons for these concerns no longer exist.

The Internal Revenue Service, concerned that some tax preparers may be fooled into thinking that a "patented" tax strategy bears the government's seal of approval, has made it clear that just because the United States Patent and Trademark Office has granted a patent on a tax strategy, that has no bearing on its legitimacy under the tax laws. The U.S. Patent and Trademark Office does not have a strong voice one way or the other on the subject of tax strategy patents. If the relevant case law is that tax strategy patents meet the standards of patentability, in the absence of legislation to the contrary, they are obligated to issue the patents. On July 27, 2010, the Patent and Trademark Office issued interim guidelines for the examiners to follow in determining subject matter eligibility under *Bilski*. These can be found on the Patent and Trademark Office website at www.uspto.gov.

Congress has introduced several bills which, in one way or another, essentially negate tax strategy patents. The two bills pending at the present time include HR 2584 which would amend the patent statute, 35 U.S.C. Section 101, to state explicitly that a patent may not be obtained for a tax planning method. This bill defines a tax planning method as a plan, strategy, technique, or scheme that is designed to reduce, minimize or defer, or has, when implemented, the effect of reducing, minimizing, or deferring, a taxpayer's tax liability, but does not include the use of tax preparation software or other tools used solely to perform or model mathematical calculations or prepare tax or information returns. Another bill, HR 1265 is part of the Stop Tax Haven Abuse Act. The portion of this bill applicable to patent tax strategies includes a provision similar to HR 2584 but uses the term "tax planning invention" for the type of patents which are barred under 35 U.S.C. Section 101. For the most part, these current bills replaced similar bills which did not advance past the 110th Congress.

The Treasury has proposed regulations which would make any planning method using a patentable tax strategy a reportable transaction by a participating taxpayer under IRC Section 6010 or by a tax advisor under IRC Section 6111.

The Section of Taxation of the American Bar Association and the American Institute of Certified Public Accountants both oppose tax strategy patentability. The principle underlying this position is the public policy concern that allowing patents on strategies for complying with any law or regulation creates an exclusivity on interpreting the law.

Summary: Favorable Resolution of the Tax Strategy Patent Concern

The concerns of tax practitioners regarding ostensibly unacceptable tax strategy patents, i.e., those directed purely to mental steps, is over. It is a virtual certainty that no new such patents will issue. In fact, in all 13 decisions of the Patent Office Board of Appeals since *Bilski*, the Board has rejected purely method step patents in every case. Further, such patents that have already issued in all likelihood cannot be enforced. For clarity, tax strategy patents which involve scientific principles, including software, should never have been considered unacceptable because true innovation may lie in those scientific principles, including computer software, such that they should be treated like all other patents involving some mental steps, i.e., they should not be singled out and the inventors thereof should not be denied rewards for their innovation in the same way that inventors are rewarded in all other fields of endeavor.

Continuing concerns by tax practitioners since *Bilski* do not appear to fully appreciate the judicial system in general and the patent law judicial system in particular. Most importantly, *Bilski* is important not just because its holding with respect to pure mental step patents is the law of the land, but also because it ended years of uncertainty which allowed evolution of the tax strategy patents and the concerns which they raised.

The continuing concerns post-*Bilski* appear to fall into two categories. The first category involves things that have happened in the past and an uncertainty as to whether they will continue in the future. Some commentators note that prior tax strategy litigations have been settled but without sufficient clarity. A litigant perceiving that he will lose simply wants to get out in the most expeditious way. What is important is that in none of the settlements did the owner of a mental step tax strategy patent walk away with a victory and a patent declared valid. Concerns have been raised regarding the large number of patent applications filed at the U.S. Patent Office and issued and the fact that there are classes and subclasses directed to tax strategy patents. First, it is unclear how many of the patent applications on file and listed in the classes and subclasses involve pure tax strategy mental steps as opposed to patents with potentially legitimate scientific material including computer software. Second, the U.S. Patent and Trademark Office will go forward in its decision making by following the *Bilski* decision.

The other category involves looking forward. An often expressed criticism of *Bilski* is that it did not provide greater clarity as to how much scientific material, including computer software in a claim having some method steps is enough to satisfy the subject matter requirements of § 101. These commentators expressed concern that because of the Supreme Court's approach, some tax strategy patents, particularly those involving scientific principles or computer software, may yet issue.

All such criticisms regarding the lack of clarity in the Supreme Court's decision appear to be wide of the mark. First, as discussed above, when it comes to tax strategy patents involving scientific principles or computer software, any commentator that feels that such tax strategy patents must not exist is simply wrong. If a "tax strategy patent" includes scientific material or computer software, then under all generally accepted principles of our patent law, that inventor should be entitled to a patent for his innovation in the same manner that all other inventors in all other fields with the accepted level of innovation is entitled to a patent.

And as for a desire that the Court should have set out a definite definition of what does constitute patentable subject matter, I would describe that result as nothing short of horrifying. The Supreme Court does not have sufficient knowledge or information to rule on what may be the most important patent law question in history. In this context they did the only correct thing; defer that question for development by future cases.

Many concerns by tax practitioners have seemed to involve their misunderstanding of the term "business method

patents". Taking one commentator's estimation that there are 15,000 business method patents, it is probable that far less than one percent of them are tax strategy patents whether of the acceptable kind including scientific material or computer software or of the purely mental step kind. Commentators who decry the existence of business method patents are erroneously directing their concern to a large universe of perfectly good patents when instead they should accept the continued validity of business method patents in general and direct their concern to mental step tax strategy patents (or accept the premise herein that the continued viability of that minuscule portion of the business method patent subset is no longer of concern).

Finally, given the resolution of tax strategy patent concern by *Bilski*, there is no longer a need for legislation of the type described above to negate tax strategy patents. To the extent that commentators seek legislation for clarity, that is a very unlikely result. Instead, tax legislation is more likely to have an opposite effect. As noted above, clarity can only come in the way that the Supreme Court said it should, by essentially percolating up from future lower court cases. Legislation also often has very undesirable unintended consequences of reaching beyond its intended scope, thus placing in doubt the validity of many perfectly acceptable patents with subject matter around the fringes of any such legislation. These issues are best resolved by courts, not by unintended results of legislation, litigation involving expensive issues of congressional intent, and the like.

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n1 *In re Chakrabarty*, 571 F.2d 40 (C.C.P.A. 1978); *Diamond v. Diehr*, 450 U.S. 175 (U.S. 1981); *In re Alappat*, 33 F.3d 1526 (Fed. Cir. 1994)

n2 *Gottschalk v. Benson*, 409 U.S. 63 (U.S. 1972); *Parker v. Flook*, 437 U.S. 584 (U.S. 1978); *Diamond v. Diehr*, 450 U.S. 175 (U.S. 1981)

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IRC Section 1031 and Phantom Income: Can Property With No Equity Be Exchanged?

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USC Gould School of Law 2010 Tax Institute: IRC Section 1031 and Phantom Income: Can Property With No Equity Be Exchanged?

By Louis Weller

August 19, 2010

SUMMARY: Like-exchanges under IRC Section 1031 (*26 USCS 1031*) are an important arrow in the quiver of tax planners. However, the collapse and ongoing weakness of the real estate market has highlighted risks associated with Section 1031 transactions, as well as impediments to their use. This article examines one topic arising from recent activities: the potential to defer "phantom" gains from foreclosures of property where debt exceeds basis.

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ARTICLE: Introduction

Like-exchanges under Internal Revenue Code Section n1 1031 (*26 USCS 1031*) continue to represent an important arrow in the quiver of tax planners. However, the collapse and ongoing weakness of the real estate market over the past several years has highlighted certain risks associated with the implementation of IRC § 1031 transactions, as well as impediments to their use. This article examines one such topic arising from recent activity in the like-kind exchange world: the potential to defer "phantom" gains associated with foreclosures of property where debt exceeds basis.

The Issue

When a foreclosed property is transferred and the debt on such property exceeds the transferor's basis and the fair market value, the transfer results in gain, or potentially a combination of gain and cancellation of indebtedness income. If nonrecourse debt is discharged in the transfer, the amount of debt is treated as the amount realized on such transfer, resulting in a gain equal to debt exceeding basis. n2 Alternatively, if the debt that was discharged in the transfer was recourse, the amount of the debt up to the fair market value of the property is treated as the amount realized on the transfer, resulting in gain while the amount of debt discharged which exceeds the fair market value of the property results in income from the cancellation of indebtedness under IRC § 61(a)(12) (*26 USCS 61(a)(12)*). n3

IRC § 1031 (*26 USCS 1031*) allows for the deferral of realized gain, but it does not avoid recognition of income from the cancellation of indebtedness under IRC § 61(a)(12) (*26 USCS 61(a)(12)*). When a parcel of property is subject to debt equal to or in excess of its fair market value, then such property has no "equity". The issue for practitioners is whether IRC § 1031 applies to defer gain resulting from foreclosure or voluntary transfer of property having no equity?

A Technical Cause for Concern

IRC § 1031 deals with the exchange of property. Property is still owned by a transferor, regardless of debt that encumbers it. Nothing in IRC § 1031 suggests that equity is required; the analysis of gain or loss realized, recognized or deferred involves an analysis of amounts realized and transferred in an exchange.

However, some practitioners have raised a concern arising from the incorporation of a cross reference to IRC § 357(d) 26 USCS 357(d) within IRC § 1031 26 USCS 1031. IRC § 1031(d) 26 USCS 1031(d) cross references IRC § 357(d) 26 USCS 357(d) with respect to making a determination of whether a party to an exchange has assumed the debt of the taxpayer, creating "mortgage boot." IRC § 357(d)(2) 26 (USCS 357(d)(2)) limits the amount of a nonrecourse debt that is deemed assumed by a transferee to the extent assets securing the debt are retained by the transferor.

In 2003 the Internal Revenue Service issued an advance notice of proposed regulations ("the Notice") that it was considering addressing in connection with the amount of a liability a transferee is treated as assuming under the rules of IRC § 357(d) . n4

The Notice discusses various issues arising under the rule that nonrecourse debt is considered assumed by the transferee of any property securing the debt, even when the transferor retains other property also securing the same debt, in the absence of an agreement by the transferor to satisfy some or all of the liability. The Notice posits various scenarios when a transferor retains some or even all of the assets securing a nonrecourse debt but through operation of the presumptions built into the statute, the transferee is treated as assuming the debt or at least an amount of the debt that exceeds the value of property it receives. The Notice suggests that the IRS might consider adopting rules limiting the amount of nonrecourse debt a transferee is deemed to assume on receipt of property securing the debt to the property's value when the transferor remains potentially liable to satisfy the same debt due to retention of other property also serving as collateral for the same debt. This could mean that any additional debt from which a transferor is released constitutes cancellation of indebtedness income, not an amount realized, in the bifurcated manner applicable to recourse debt foreclosure cancellation. n5

The Notice specifically mentions the relevance of IRC § 357(d) 26 USCS 357(d) to IRC § 1031 26 USCS 1031 and requests public input on whether possible changes on the rules governing debt assumption under IRC § 357(d) should also apply for purposes of the other Code provisions that "specifically invoke section 357(d) as well as other provisions that do not specifically invoke section 357(d) ."

Some practitioners have suggested that this Notice implies that the IRS will impose a fair market value limitation on the amount of a nonrecourse debt that is regarded as boot for IRC § 1031 purposes and that any recognition caused by debt in excess of value cannot be deferred under IRC § 1031.

However, no proposed regulations were issued in the wake of REG 10018-01. Where a property securing a nonrecourse debt is transferred to a lender and the transferor retains no other property serving as collateral for the debt, there is no authority supporting the view that the entire debt isn't viewed as an amount realized, and thus boot in a like-kind exchange. Further bifurcation of nonrecourse debt for purposes of IRC § 1031 boot analysis is inconsistent with the *Tufts* principle that the entire amount of nonrecourse debt discharged on a transfer represents an amount realized.

In addition, there is always (well, almost always) property having a positive intrinsic value being transferred in any foreclosure notwithstanding lack of net equity. IRC § 1031 boot rules treat transfer of that intrinsic value as consideration given in the exchange and treat the transferee's mortgage assumption as receipt of consideration with the only special characteristic being the more favorable boot offset rule applicable to debt boot than to cash boot. n6 No published authority suggests this regime is affected by the relationship of value to debt under existing rules.

The Real Problems: Mechanics and Economics

Assuming no technical limitation on the qualification of property encumbered by debt equal to or in excess of its value to be exchanged under IRC § 1031, the real problems are:

1. Converting a foreclosure into an exchange, and
2. Acquiring sufficient replacement property when there are no funds coming from relinquished property equity.

A direct swap of properties prior to a foreclosure transfer of an exchanger's relinquished property should be subject to IRC § 1031, but this will be highly unusual.

A deferred exchange will likely involve a qualified intermediary ("QI") in order to satisfy the exchange requirement of IRC § 1031. Under Treas. Reg. § 1.1031(k)-1(g)(4), the QI is deemed to be the taxpayer's exchange counterparty (i.e. the accommodation acquirer of relinquished property and replacement property) only if the QI actually acquires title to these or is assigned the taxpayer's right to sell the relinquished property and purchase the replacement property. In the latter case, the QI need not acquire title. n7

In a foreclosure, there may not be a relinquished property contract to assign to the QI. A deed in lieu of foreclosure will typically involve an agreement between the owner-borrower and the lender which is the equivalent to a sales contract. In these cases it may be possible to assign an owner's rights to a QI prior to transfer of property to the lender. It may be helpful to negotiate some consideration payable by the lender on the transfer that can be received by a QI, in the usual fashion associated with a deferred exchange.

Non-judicial and judicial foreclosures involving trustee auctions do not give rise to contracts other than the original loan documentation. In such situations, it appears to be necessary to deed the property to the QI prior to a foreclosure sale in order to satisfy the exchange requirement. Many QIs are not willing to take title to assets, limiting the available number of QI candidates for these transactions.

Creating the Deferral.

Boot netting rules require payment of cash or assumption of debt secured by replacement property in amount equal to or exceeding debt boot realized on foreclosure to effect full deferral. This typically means need to invest 5-10% additional equity to purchase highly leveraged replacement property. Where the cost of replacement is less than the foreclosed debt, gain may be recognized but this may be acceptable if there are available passive activity losses or NOLs to offset, so the taxpayer needs to determine how much foreclosed debt to "cover" with replacement from an IRC § 1031 exchange.

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n1 All references to "Code", "IRC" or "Section" are to the Internal Revenue Code of 1986, as amended.

n2 *Tufts v. Commissioner*, 461 U.S. 300 (1983).

n3 Treas. Reg. § 1.1001-2(c) ex. 8; *Rev. Rul. 90-16*, 1990-1 CB 12.

n4 REG 100818-01, February 24, 2003.

n5 See *Rev. Rul. 90-16*, 1990-1 CB 12.

n6 See, e.g. Treas. Reg. § 1.1031(d)-2 example 2.

n7 Virtually all deferred exchanges are completed using "direct deeding" in which the QI receives assignments of contract rights but not title to property.

RELATED LINKS: For the full text of the conference paper, see

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Like Kind Exchange Failures and What to Do About Them

2010 Emerging Issues 5274

USC Gould School of Law 2010 Tax Institute: Like Kind Exchange Failures and What to Do About Them

By Louis Weller

August 19, 2010

SUMMARY: Like-exchanges under IRC Section 1031(26 USCS 1031) represent an important tool for tax planners. However, recent events have highlighted risks associated with the implementation of these transactions, as well as impediments to their use. One such risk is the consequence of actual or feared failure of a qualified intermediary to deliver on its promise to acquire replacement property for a taxpayer.

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ARTICLE: Like-exchanges under Internal Revenue Code section n1 1031 continue to represent an important arrow in the quiver of tax planners. However, recent events have highlighted certain risks associated with the implementation of these transactions, as well as impediments to their use. One such current risk, which is explored in more depth in this article, is the consequence of actual or feared failure of a qualified intermediary to deliver on its promise to acquire replacement property for a taxpayer.

Security of Funds in Section 1031 Like Kind Exchanges

The vast majority of modern § 1031 exchanges utilize the safe harbor from constructive receipt of boot authorized by Treasury Regulations § 1.1031(k)-1(g)(4), employing a third party known as a qualified intermediary ("QI"). In this construct, the QI replaces a "cooperating buyer" of relinquished property or "cooperating seller" of replacement property as the taxpayer's exchange counterparty and is tasked to hold proceeds from the sale of relinquished property ("Exchange Funds") during the period until the subsequent purchase of replacement property (the "Exchange Period").

While anyone who is not a "disqualified person" with respect to the exchanger can serve as QI, in modern practice, an industry of professional QIs has arisen. n2 These commercial QIs perform several functions in addition to simply acting as an exchange counterparty and holding funds; they supply basic forms of exchange documentation, accept assignment of the obligation to transfer and receive property, and participate in closing both disposition of relinquished properties and acquisition of replacement properties. They also frequently provide information about the requirements imposed by § 1031, although they generally disclaim any responsibility for providing tax advice to their clients. The paramount obligation of a QI in a § 1031 transaction is to hold Exchange Funds during the Exchange Period and timely deliver them to acquire replacement property. If the QI fails to meet this fundamental duty for any reason, the exchanger's transaction will likely fail to achieve the deferral offered by § 1031. More importantly, as some exchangers

have discovered in recent years, a QI's failure to adequately protect Exchange Funds can result in permanent loss of sale proceeds. Since the Exchange Period may extend for a maximum of 180 days (other than in the event of a Presidentially declared disaster), any delay in completing acquisition of replacement property may make a valid § 1031 exchange impossible to complete.

There are several reasons why a QI may fail to meet its obligation to deliver Exchange Funds to a replacement property closing:

1) The QI may have placed the Exchange Funds in an illiquid investment, which causes them to be unavailable at the appointed time. This is apparently the case with the recent case of LandAmerica 1031 Exchange Services, Inc., which disclosed in a letter to clients that it was unable to meet liquidity demands when it could not access funds invested in Auction Rate Securities upon the collapse of the ARS marketplace. n3 Many exchangers have reasonably assumed that their Exchange Funds are always placed in highly liquid, highly secure vehicles such as money market accounts. However, virtually no state or federal regulation governs how or where a QI is obligated to hold Exchange Funds.

2) Similarly, Exchange Funds can be lost if they are simply misappropriated by an unscrupulous QI or diverted to fund other business activities of the QI or its owners. n4

3) Another incorrect assumption among exchangers is that QIs themselves, perhaps like other depository institutions, are state-chartered, highly regulated, or subject to licensure. In fact, until a very short time ago, QIs were largely unregulated on how they operated.

Steps to Protest Against Losing Exchange Funds

The first way to avoid losing Exchange Funds via QI failure is to research potential QIs. Many attorneys or advisors who are not QIs, or who may be excluded from being a QI, may be able to make a referral to a reputable QI. Exchangers may also choose QIs with whom they have a prior relationship or because the QI is affiliated with a known bank or title company. These are sensible starting points. The following are some basic safeguards for Exchange Funds:

1) Exchangers should insist that their Exchange Funds are maintained in a bank account separate from the QI's own operating funds. Exchangers should also consider whether to require that their funds be placed in an account separate from those holding other exchanger funds. An exchanger can also request that a separate account in the name of the QI be set up to require dual signatures (one taxpayer, one QI) in order to disburse funds. The Internal Revenue Service ("IRS") is reportedly working on guidance specifically sanctioning this format. The exchanger should insist on receiving monthly statements from this account. With the increased rate of bank failures in recent years, Exchangers should be aware that the failure of a bank or depository institution used to hold Exchange Funds can cause a QI to become unable to deliver Exchange Funds to the replacement property closing. Unlike more traditional bank deposit accounts, Exchange Funds may or may not be protected by FDIC insurance depending on where the Exchange Funds are held. Further, FDIC insurance may not be a complete safeguard against losing Exchange Funds. n5

2) Exchangers should also be mindful of protections against both QI malfeasance and QI errors. Some QIs offer the protection of a fidelity bond that insures against losses resulting from dishonest acts such as embezzlement, conversion, theft, or fraud. A fidelity bond will typically protect the taxpayer against these types of acts committed by the QI's employees and partners, but the size of the fidelity bond may be limited. Accordingly, taxpayers should be aware of whether the fidelity bond maintained by their QI can protect against their full potential losses. Many QIs maintain "errors and omissions" insurance. This type of insurance can protect a taxpayer against losses resulting from negligence or error on the part of the QI. Again, the size of this policy may be limited, so exchangers should be cognizant of the coverage their QI offers. Some QIs even go as far as to advertise that they subject themselves to regular audits of their business procedures.

The deferred exchange regulations also offer two structural mechanisms to provide security for Exchanger Funds:

the qualified escrow or the qualified trust. n6 While the regulations refer to use of these as security for performance of the actual transferee of the exchanger's relinquished property to complete a deferred exchange, as in the *Starker* n7 case, the devices can clearly be used to secure the performance of a QI. This will typically be preferable to continuing involvement of the relinquished property buyer in the transactions.

The Qualified Escrow Account

In a qualified escrow, the Exchange Funds are held in a third-party escrow account. Neither the exchanger nor a disqualified person can be the escrow holder. n8 Such an account makes the escrow holder a "dual agent" of (i) the exchanger and (ii) the party depositing funds. This could be the relinquished property buyer but is most often a QI, to avoid any need for the exchanger to seek post-closing cooperation from the relinquished property buyer. Taxpayers must remember that the escrow arrangement is not a substitute for a QI, since it does not itself create a separate exchange counterparty with whom the exchanger conducts its trade. To qualify under the safe harbor, the qualified escrow agreement must expressly limit the exchanger's rights to pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account. n9

Since the escrow holder must be a party separate from the two parties to the escrow, qualified escrows are typically organized with a licensed escrow company or a bank as escrow holder. Use of an escrow with an institutional escrow holder should provide assurance that exchange funds remain available to complete an exchange, provided that the second party to the escrow cooperates by giving instructions to the escrow holder to disburse funds. While the funds cannot be accessed for non-exchange purposes by the second party, the continued viability of both the escrow agent and the exchange counterparty (whether relinquished property buyer or QI) is necessary for successful completion of the exchange. n10

The Qualified Trust

A qualified trust requires the transfer of assets to a third party trustee under a trust instrument. Similar to a qualified escrow, Exchange Funds can be held in a qualified trust as long as the trustee is not a disqualified person and as long as the exchanger's right to receive or benefit from the funds is limited. n11 The key difference between a qualified trust and a qualified escrow is that a trustee is regarded as legal owner of trust assets while an escrow holder is not owner of escrowed assets but merely holds them in an agency capacity. Due to this distinction, some advisers believe that, in the case of protecting against a potential QI bankruptcy, a qualified trust may provide better protection than a qualified escrow against claims on the segregated funds by unsecured creditors of the QI.

In *PLR 201030020* the IRS ruled that the same entity, in this case a bank, could act as both a QI and trustee of a qualified trust in the same exchange without thereby becoming a disqualified person under the Regulations.

Changing QIs Midstream in a § 1031 Transaction: Risks and Rewards

Under Treas. Reg. § 1.1031(k)-1(g)(4), the QI has two basic functions: serving as exchange counterparty and preventing constructive receipt.

First, via a written exchange agreement, the QI acts as exchange counterparty, to create an "exchange" where the relinquished property buyer will not directly serve as the counterparty as in the manner of Crown Zellerbach Corporation in the original *Starker* cases. n12 Rather than requiring the relinquished property buyer to complete the acquisition of replacement property, the QI safe harbor transforms the QI into the exchange counterparty by virtue of QI's deemed receipt and transfer of the relinquished and replacement properties. This fiction created by the QI safe harbor is critical because in order for IRC § 1031 to apply a taxpayer must be deemed to swap relinquished for replacement property. Absent the application of the QI safe harbor, IRC § 1031 does not normally apply to the sale of relinquished property followed sometime later by purchase of replacement property where the relinquished property buyer has not participated in both transactions.

The second basic function of QI is to prevent exchangers from being deemed to be in actual or constructive receipt of Exchange Funds, which would result in sale, rather than exchange, treatment. This function is the one that most advisors focus on. By deeming the QI to be independent of the taxpayer, i.e. not the taxpayer's agent for income tax purposes, Exchange Funds held by the QI are not deemed to be held by the taxpayer. The QI safe harbor focuses on this aspect in its requirements that the taxpayer not be entitled to obtain direct or indirect benefit of Exchange Funds for non exchange purposes during the pendency of the exchange. These are the so-called "(g)(6)" conditions, found in Treas. Reg. § 1.1031(k)-1(g)(6).

Because the QI safe harbor grants dispensation from potential IRS challenge that a taxpayer is in receipt of Exchange Funds held by its QI, failure to strictly comply with all its requirements creates a risk that the QI safe harbor's benefits won't be available. Where a taxpayer grows uncomfortable with a QI, it may consider a change prior to the end of the Exchange Period. Changing QIs in the middle of a like kind exchange creates two tax concerns, one associated with each of the functions served by the QI.

The first tax risk is the issue of whether the taxpayer has undertaken an "exchange" under IRC § 1031 if it receives replacement property from a different party than the one to whom the taxpayer transferred relinquished property. Arguably, when one QI is substituted for another, this is no different than if the exchanger sold relinquished property to one party and bought replacement property from another. This is precisely the scenario the QI safe harbor is intended to avoid.

Second, since the definition of a QI under the Safe Harbor involves one party doing four things: (1) acquiring and (2) transferring relinquished property and (3) acquiring and (4) transferring replacement property, substituting one QI for another would result in neither of these parties satisfying the definition. Failure to be considered a "qualified intermediary" for purposes of the QI safe harbor could mean that both the exchange counterparty and constructive receipt protection elements are lost.

In *PLR 200908005*,¹³ the IRS ruled that if three qualified subchapter S subsidiaries (collectively the "QSubs") acting as QIs converted to C corporations upon the transfer of their stock to a new owner, thus becoming new entities for tax purposes, they would not be considered new or different QIs for purposes of the QI safe harbor. The IRS held that a change in the QSubs' tax identity alone would not cause their exchanger customers to lose the benefit of the QI safe harbor with respect to like-kind exchanges where relinquished property had been sold but replacement property had not been acquired.

The ruling appears to rely on the fact that the state law identities of the QSubs would remain the same, since they remained the same corporate entities for non-tax purposes. Accordingly, after the change in ownership, the QSubs would continue to be bound by their original exchange agreements and continue to operate in the same manner as before. Even though it was represented that the business operations of the QSubs would not change, the principles expressed in *PLR 200908005* may also apply where the QI legal entity stays the same but the business operations of the QI are altered. This rationale would appear to provide guidance in other fact patterns. For example, what would be the consequences of a change in management at the QI? In this case, similar to *PLR 200908005*, the exchange and assignment agreements entered into by the QI entity would remain in effect, so the same legal party would serve throughout an exchange as counterparty and as holder of exchange funds. What if the exchanger requires its initial QI to set up a separate entity to function as QI solely for that exchanger?

Does a midstream change of ownership of the QI prejudice pending exchanges? Thus, should taxpayers consider use of a single owner limited liability company to function as QI for their exchanges under agreements giving the taxpayer power to require transfer of the membership interests in the QI to a different party that is not a disqualified person under Treas. Reg. § 1.1031(k)-1(k)? While modifying exchange agreements after initiation of an exchange to provide this type of right might be viewed as impermissible, creation of the right at the outset appears it may not constitute a violation of any of the elements of the QI safe harbor.

Can application of the QI safe harbor continue to apply if the QI legal entity changes but the QI's business operations remain the same? This could occur if the initial QI merges into or is acquired by an outside entity that intends to continue its operations. In a merger or acquisition where the original QI is not the surviving party, the QI entity's tax (and legal) status will likely terminate. Continued application of the QI safe harbor may turn on precisely what type of entity took on the continued operations. In *PLR 201030020* the IRS ruled that when a bank subsidiary QI merged into its parent bank, the parent could succeed to the status of QI on pending exchanges commenced by the subsidiary. This conclusion was based, in part, on provisions of banking law that provided that every type of property, contractual right and rights and interests as a "trustee, executor, administrator...and in every other fiduciary capacity" of the subsidiary were transferred to and vested in the parent by virtue of the merger. ⁿ¹⁴ Since the IRS had already concluded that a surviving corporation can complete an exchange started by a disappearing corporation when the mid-exchange transaction between them is a reorganization subject to IRC § 381(a), arguably the same principle's application to mid-exchange QI reorganizations seems quite appropriate. ⁿ¹⁵ It is not clear, however, whether the same result will apply should applicable state law not mirror the express provisions of federal banking law relating to the succession of a parent to rights and obligations of its merged subsidiary.

With its focus on continuity of business operations and legal form, neither *PLR 200908005* nor *PLR 201030020* can be read to assure taxpayers that the IRS believes the QI safe harbor would continue to apply if the both the QI legal entity and business operations are changed during the exchange period. However, given a choice between creating tax risk that the QI safe harbor will be lost and accepting business risk that Exchange Funds will be trapped inside a failed QI's bankruptcy proceeding, it is hard to conclude that it will be better to bear the tax risk of a failed exchange than the economic risk of lost proceeds.

Under the circumstances, there are several other practical steps an exchanger can take to help avoid triggering gain during the Exchange Period due to an unanticipated change in the identity of a QI. Exchangers should be aware of who ultimately owns the QI with whom they intend to do business. Exchangers may want to avoid dealing with a QI that is at risk for being bought or sold as part of a larger merger. Exchangers might consider asking for covenants in exchange agreements that restrict the ability of the QI to substantially alter its business operations during the Exchange Period. Exchangers should resist standard form exchange agreements that afford the QI the ability to resign without the consent of exchanger for virtually any reason deemed worthy by the QI. Many of these provisions state that QI will transfer funds to another entity that would qualify as a QI under the QI safe harbor. Exchangers should suggest that such provisions be limited to circumstances where the exchanger is in default or has breached the exchange agreement.

Possible Taxpayer Responses to QI Failures

Exchangers who have lost (or stand to lose) their exchange funds to a bankrupt QI or cannot access them in time to complete a deferred exchange during the normally allowable 180 day Exchange Period can face the dual indignity of not only losing their exchange funds but of potentially having to recognize gain on their relinquished property. Several approaches that may provide varying degrees of relief from gain triggered by a QI theft or bankruptcy are considered below.

IRS Administrative Relief

On March 5, 2010 the Internal Revenue Service issued *Rev. Proc. 2010-14* ⁿ¹⁶ addressing the tax consequences of losses suffered by taxpayers who are the victims of QI default. Fundamentally, this guidance institutes a modified form of installment sale treatment for taxpayers whose like-kind exchanges fail due to a QI default occurring on or after January 1, 2009, but taxpayers who suffered losses on transactions occurring prior to that date are able to file amended returns subject to limitations on credit or refund claims.

Under *Rev. Proc. 2010-14* when a QI defaults on its obligation to acquire replacement property to complete a taxpayer's exchange and "becomes subject to a bankruptcy or receivership proceeding," the taxpayer is not treated as being in actual or constructive receipt of relinquished property sales proceeds and must recognize gain from disposition

of the relinquished property only as required under a safe harbor "gross profit ratio method." Under this method, the taxpayer reports gain only as cash or property payments are received from the QI or its bankruptcy estate (referred to as a "payment attributable to the relinquished property") except where debt retired, assumed or taken subject to on disposition of relinquished property exceeded the taxpayer's adjusted basis in the property, as is the case with other installment sales under IRC § 453. A payment attributable to the relinquished property does not include satisfied debt unless debt relief exceeds basis. The formula to be utilized defines gain recognized as being equal to the product of any payment attributable to the relinquished property times a gross profit ratio, which ratio is created by dividing "gross profit" by "contract price." Gross profit is defined as being the

"selling price" of the relinquished property minus its adjusted basis and selling price equals the amount originally realized on the sale of the relinquished property unless a lower amount is specified in court order by end of year in which payment received. Thus, where a taxpayer begins to receive payments from a QI prior to the year when the taxpayer's ultimate recovery

amount from the QI is fixed, the original relinquished property sales amount will be used to establish the gross profit ratio. The contract price is simply the selling price minus satisfied debt not in excess of basis.

Rev. Proc. 2010-14 provides additional rules relating to losses attributable to failed exchanges and to imputed interest arising by reason of application of the installment sale regime. A loss deduction is allowed for actual losses (where selling price is less than adjusted basis) and for gain incorrectly recognized in a prior year. However, loss deductions are not available if sum of (i) payments received plus (ii) satisfied debt exceeds adjusted basis, even where a taxpayer suffers an economic loss by receiving less cash from the failed QI than was received on sale of the relinquished property.

Further, imputed interest rules apply to the deemed installment sale under either IRC §§ 483 or 1274, but for purposes of imputing interest, the taxpayer is treated as selling relinquished property on the date of confirmation of the bankruptcy plan rather than on the original date of conveyance and closing of the sale of relinquished property to the actual buyer. If the taxpayer receives all payments from the defaulting QI within a six-month period from the date payments commence, no interest is imputed. Where a property transfer results in recapture under IRC §§ 1245 and 1250, *Rev. Proc. 2010-14* provides that the recapture rule will not apply to gain until the taxable year in which gain is recognized. This treatment differs and is more lenient than the treatment of ordinary income recapture under IRC §§ 1245 and 1250 provided by IRC § 453(i) for installment sales generally.

To illustrate its provisions, *Rev. Proc. 2010-14* contains several examples. In Example 2, a taxpayer (B) attempts to exchange 8 blackacre (having \$160x fair market value; \$90x adjusted basis and subject to a \$60x mortgage using a QI. On sale of the relinquished property in year 1, after satisfying the debt the QI holds \$100x of exchange proceeds. The QI then files for bankruptcy while B's exchange is pending. In year 2, the bankruptcy court approves a \$70x distribution to B to satisfy all claims, payable \$35x in year 2 and \$35x in year 3. B's overall gain is thus \$40x (\$130x -- \$90x). B recognizes no gain in year 1 because no payment attributable to the relinquished property is received. The selling price of relinquished property is \$130x -- the sum of (i) \$70x (maximum cash payment as of end of year 2 (because of Court order) plus (ii) \$60x debt. The contract price of the relinquished property is \$70x (\$130x selling price minus \$60x debt). The gross profit ratio is 40/70 (gross profit/contract price). Thus, gain recognized in year 2 and 3 is \$20 per year (\$35 x 40/70). Even though B has suffered a \$30x economic loss by ultimately receiving \$70x of the \$100x sales proceeds, no loss is allowed for tax purposes because payments exceed basis.

In Example 3, the facts are the same as Example 2 except B's adjusted basis is \$40x instead of \$90x. Now B is deemed to have received a payment of \$20x in year 1 (to the extent of debt (\$60x) in excess of basis (\$40x). Selling price is now \$160x (no court order is in effect at the end of year 1), contract price is \$120x (selling price minus \$40x of debt not in excess of basis) and gross profit ratio is 100% (120/120). Thus, gain recognized in year 1 is \$20x (\$20 x 100%) and gain recognized in years 2 and 3 is \$35x per year. Again, despite the economic loss, no loss allowed for tax purposes because payments exceed basis. While *Rev. Proc. 2010-14* provides welcome relief from premature taxation to

taxpayers who are caught up in QI failures, it leaves some questions open. "QI default" is narrowly defined in this guidance as bankruptcy or receivership. It is not clear that simple theft or other types of default will give rise to application of the relief rule. Further, *Rev Proc 2010-14* requires that for relief to be available, failure to complete the like kind exchange must be due "solely" to QI default. What if a combination of events prevents the § 1031 exchange? For example, assume QI enters bankruptcy on day 46 of the taxpayer's exchange, emerges on day 120 with 100% of taxpayer's exchange proceeds, but the taxpayer has missed the deadline to close on replacement property due to contractual language in the purchase agreement. Is this a condition "solely due" to the QI default? What if the taxpayer never receives any payments? Can the safe harbor still apply?

Despite these questions, the guidance provided by *Rev. Proc. 2010-14* has generally been favorably received by taxpayers and their advisors as reflecting a reasonable approach to the problems arising for taxpayers who have suffered from QI default.

Involuntary Conversion

The potentially most taxpayer favorable, but also perhaps least viable remedy, would be to treat losses from a bankrupt or otherwise insolvent QI as an involuntary conversion subject to deferral under IRC § 1033(a)(2). Section 1033 provides that gain realized pursuant to an involuntary conversion of property into money as a result of theft may be deferred if the taxpayer acquires property that is similar or related in service or use within two years of the first gain realized on the conversion. The replacement period arguably would not start running until the exchanger received cash proceeds (from a bankruptcy court or otherwise) in excess of relinquished property basis unless the debt retired on sale of the relinquished property exceeded the taxpayer's basis. n17

If viable, an exchanger would also be able to fully defer gain by acquiring replacement property with a value equal to any amount eventually received (plus debt retired on the sale) rather than the full (and almost certainly higher) value of their relinquished property. An exchanger could also acquire replacement property without engaging another QI, because IRC § 1033 does not require use of a QI. While the consequences of an involuntary conversion under IRC § 1033 are highly appealing, the viability of the § 1033 approach seems doubtful.

It is unclear whether a taxpayer who willingly disposes of property and causes sale proceeds to be directed to a QI at the outset of a deferred exchange suffers an involuntary conversion of the relinquished property when at some subsequent time the exchange funds are lost or become inaccessible due to a QI failure. Arguably, even if a theft, the involuntarily converted asset is the exchange funds, not the relinquished property. In that case, IRC § 1033 would not likely defer the gain triggered on the original disposition of the relinquished property, which had occurred previously. Section 1033 does not provide a benefit for the involuntary conversion of cash.

A recent decision by a U.S. bankruptcy court involving a high profile QI bankruptcy seems inconsistent with the conclusion that QI bankruptcy results in a theft of exchangers' assets. In *Millard Refrigerated Services, Inc. v. LandAmerica 1031 Exchange Services, Inc.*, n18 a Bankruptcy Court held, consistent with prior rulings, that exchange funds placed with a QI were property of the estate of the QI for bankruptcy purposes. Millard argued unsuccessfully that its exchange funds, held in a segregated bank account by LandAmerica 1031 Exchange Services ("LES"), were held in trust for its benefit under the terms of their exchange agreement.

The bankruptcy court held that neither the terms of the exchange agreement nor the QI safe harbor created a trust arrangement. The exchange agreement provided that LES maintain exclusive control of the exchange funds (presumably in order to comport with the QI safe harbor). More importantly, the parties had not expressly created any type of qualified trust arrangement. As a result of *Millard*, it may be difficult for exchangers, absent a qualified trust arrangement, to assert they have an interest in Exchange Funds that were subsequently misappropriated by a QI.

Even if the relinquished property is deemed to be the converted asset and the exchanger is deemed to own its Exchange Funds while held by QI via the creation of a qualified trust arrangement or otherwise, it is unclear whether a

subsequent bankruptcy would constitute a "theft" for purposes of applying IRC § 1033.

Even when Exchange Funds are undeniably stolen, it is unclear whether IRC § 1033 would provide relief if the asset subject to the involuntary conversion is the Exchange Funds, not the relinquished property. In light of *Millard*, it is unclear whether the exchanger has an interest in the converted asset. If the exchanger does not have an interest in the Exchange Funds then the QI, if it is respected as an entity separate from its owners, and not the exchanger, may have suffered the conversion.

Favorable Characterization of Losses

If less than the full amount of exchange proceeds are recovered, individual exchangers may obtain some relief due to a favorable characterization of losses. Under *Rev. Proc. 2010-14*, tax losses as a result of a QI defalcation offset gain from the relinquished property sale but are not otherwise recognized except to the extent basis exceeds received (cash plus debt relief). There are several ways losses could be characterized depending on the exchanger's facts and circumstance. The discussion below assumes that the exchanger is an individual property owner or a member of a pass-through entity. Any losses sustained by corporate exchangers simply offset gains elsewhere and may give rise to net operating losses if net losses exceed net gains.

If the losses are sustained as a result of a QI theft of all Exchange Funds, the appropriate characterization may be as a theft loss under IRC § 165(e). Theft losses give rise to an ordinary deduction in the year of discovery and can be carried forward or back as net operating losses. ⁿ¹⁹ The critical benefit associated with theft loss treatment is that the exchanger need not be in a real estate trade or business in order to achieve this characterization and losses offset both capital gain and ordinary income. Recent guidance on Madoff-type Ponzi schemes has allowed favorable treatment of losses from such schemes, not subjecting such losses to IRC § 165(h) limitations or itemized deduction limits of IRC §§ 67 and 68. ⁿ²⁰ Application of these rules requires finding of a criminal fraud or embezzlement by the QI.

If no theft loss treatment available but the exchanger is treated as being engaged in a real estate business and the relinquished property was used in that business, QI default losses might give rise to business bad debts under IRC § 166(a). The most common example of this is an individual exchanger with one or more active rental properties. Under IRC § 165(a) and (c)(1), business bad debts give rise to ordinary losses and can be carried forward or back as net operating losses.

If relinquished property was held purely for investment by an individual exchanger not otherwise in the real estate business, such as non-rented raw land held for appreciation, then the appropriate characterization of the tax loss may be as a non-business bad debt loss under IRC § 166(d). This is generally the least favorable tax treatment. Non-business bad debts give rise to capital losses, which can offset current year capital gains and up to \$3,000 of ordinary income annually. ⁿ²¹ Unused capital losses may be rolled forward to offset future capital gains and but only up to \$3,000 of ordinary losses. ⁿ²² Unused capital losses cannot be carried back to prior years, so if gain on a property disposition occurs in a year prior to the year of a loss realization, a significantly negative timing mismatch between income and deduction can occur. Even where there is a same year offset of relinquished property gain if the property has any tax basis the exchanger will have tax losses in excess of what is necessary to offset the gain from the relinquished property. If these excess tax losses are large enough it may take the exchanger years to utilize the excess losses.

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n1 All references to "Code", "IRC" or "Section" are to the Internal Revenue Code of 1986, as amended.

n2 See Treas. Reg. § 1.1031(k)-1(k).

n3 See *In re LandAmerica Financial Group, et. al.*, United States Bankruptcy Court for E.D. Virginia, Richmond Division, Case 08-35994.

n4 See e.g. *In re the 1031 Tax Group, LLC*, United States Bankruptcy Court, S.D.N.Y., Case 07-11448.

n5 While the existence of FDIC insurance for an account holding Exchange Funds does provide some measure of security, the total Exchange Funds may exceed the FDIC insurance limits (currently \$250,000). While the existence of Exchange Funds is at least partially insured when FDIC insurance exists, the strict time requirements on a § 1031 transaction can pose a practical obstacle for the successful completion of a § 1031 transaction. The Exchange Period must end in 180 days, so even if Exchange Funds are within the FDIC limit, any delay in receiving funds from the FDIC upon a depository institution failure could make it impossible to complete an exchange on time.

n6 Treas. Reg. § 1.031(k)-1(g)(3).

n7 *Starker v. U.S.*, 602 F.2d 1341 (9th Cir 1979).

n8 See Treas. Reg. § 1.1031(k)-1(k).

n9 See Treas. Reg. § 1.1031(k)-1(g)(3)(ii).

n10 The selection of a qualified escrow holder should require the same due diligence as choosing a QI, since failure of the escrow holder is likely to doom an exchange as surely as failure of a QI.

n11 See Treas. Reg. §1.1031(k)-1(g)(3)(iii).

n12 *Starker v. U.S.*, 602 F.2d 1341 (9th Cir 1979).

n13 *PLR 200908005* (February 20, 2009).

n14 Citing 12 U.S.C. 215(a)(e).

n15 See *PLR 200151017* (December 21, 2001); *PLR 9850001* (December 11, 1998).

n16 2010-12 IRB 456.

n17 IRC §1033(a)(2)(B)(i).

n18 51 B.R. 148 (Bankr. E.D.VA 2009).

n19 IRC § 165(e).

n20 *Rev. Rul. 2009-9*, 2009-4 I.R.B. 735.

n21 IRC § 1211(b).

n22 IRC § 1212(b).

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Disposition of Less than the Whole: The Need to Identify the Securities Sold

2010 Emerging Issues 5272

Andrew W. Singer on Disposition of Less Than the Whole: The Need to Identify the Securities Sold

By Andrew W. Singer

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SUMMARY: Beginning in January, 2011, brokers required to report the gross proceeds from customers' stock sales also must report the adjusted basis of stock sold and whether gain or loss on the sale is long-term or short-term. The Energy Improvement and Extension Act of 2008 amended IRC Section 6045 to impose the new basis and holding period reporting requirements, affecting compliance when less than all of the holdings in a specific security is sold.

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ARTICLE: Beginning January 1, 2011, brokers previously required to report to the Internal Revenue Service the gross proceeds from sales of stock by their customers are also required to report the adjusted basis of the stock sold and whether gain or loss on the sale is long-term or short-term. n1 The Energy Improvement and Extension Act of 2008, which amended 26 USCS § 6045 (IRC Section 6045) to impose the new basis and holding period reporting requirements, also changed certain of the substantive basis rules so that brokers could more easily comply with the new reporting requirements, especially when the customer sells less than all of his holdings in a specific security. If only a part of the total investment is sold, it becomes necessary to identify the lot from which the securities were sold in order to fix gain or loss. Identification is also important in determining the holding period of the securities, and thus whether capital gain or loss is long- or short-term.

The First-In, First-Out Default Method

If the taxpayer is unable adequately to identify the lot from which the securities were sold, regulations provide that the sale is deemed to be of those securities acquired first, n2 irrespective of the manner in which the securities were acquired n3 or the time at which the securities were placed in a particular account. n4

There are, however, certain instances in which the earliest-acquired securities in a total holding will not be considered the ones sold. If the securities are held in a number of depositories or accounts, and the taxpayer can identify the depository or account from which delivery has been made, the first-in, first-out rule will be applied solely with respect to the securities in the particular depository. n5 In addition, if it can be shown that it would have been impossible to sell the first-acquired securities, as the same were held as collateral, these securities can be disregarded when applying the first-in, first-out rule. n6

Normally, the date of purchase or actual acquisition by the taxpayer is the controlling date for purposes of the first-in, first-out rule, but this is not always so. Securities acquired by specific bequest from a decedent are deemed acquired on the date of death, even if distribution is delayed. n7 Securities acquired in satisfaction of a residuary legacy are subject to one of two relation-back rules. If the taxpayer receives securities which the decedent owned, the applicable date is the date of death; if he receives securities purchased by the executor, it is the date of purchase. n8 Stock acquired by reason of a stock dividend or stock split should be considered as acquired on the same date as the stock with respect to which the dividend or split is made.

Interesting treatment is afforded stock acquired through the exercise of rights. The time of acquisition is the date of exercise. However, if rights issued with respect to different lots of stock are exercised at the same time, any sale of less than the total shares of stock so acquired is treated as having been made from stock acquired through the exercise of rights issued in respect of the earliest-acquired lots. n9

The "Adequate Identification" Method

The first-in, first-out rule will not be applied if the lot from which the stock is sold is adequately identified by the taxpayer. n10 Effective identification may be achieved in a number of ways, but it is clear that the absence of adequately kept records showing acquisition dates and prices, and, where feasible, certificate numbers, will severely hamper, if not render impossible, adequate identification.

[i] Identification Through Actual Delivery

Proper identification is effected when it is shown that a particular certificate representing shares of stock purchased on a certain day, at a certain price, is delivered to the transferee in settlement of the transaction. n11 Except as discussed below, certificate-delivery identification will govern the transaction even though the taxpayer intended to sell a different lot, and so instructed his broker. n12

[ii] Identification by Broker's Confirmation

Where the taxpayer sells or transfers stock left in the custody of a broker or other agent, adequate identification is achieved if the taxpayer specifies to the custodian the particular lot from which the stock is to be sold or transferred and, within a reasonable time thereafter, receives from the custodian written confirmation of these instructions. n13 The regulations currently require that the taxpayer's specification be made at the time of the sale or transfer, but this requirement will be deemed satisfied as long as lot identification is made by the time the shares are delivered to the purchaser. n14

When identification is made by broker confirmation the taxpayer's intention prevails; unlike identification by actual delivery, a mistake in delivery on the part of the taxpayer's broker or other agent will not affect the result. n15 Identification by broker confirmation is equally acceptable for isolated sales of stock, sales made pursuant to a systematic plan of liquidation, n16 sales of stock held in margin accounts, n17 and sales of bonds. n18 When the taxpayer sells or transfers a "book-entry security," *i.e.*, certain government securities issued in the form of an entry made on the records of a Federal Reserve Bank, n19 adequate identification by broker confirmation requires written instructions from the taxpayer (as well as a written confirmation) and the specification of a unique lot number, determined in accordance with a prescribed procedure, that identifies the lot containing the securities being sold or transferred. n20

[iii] Identification by Fiduciaries

A trustee, executor, or administrator can make adequate identification of stock not held by a custodian if, at the time of a sale or distribution, the fiduciary specifies in writing, in the books and records of the trust or estate, the particular stock sold or distributed. n21 Where stock is distributed to a beneficiary rather than sold, the fiduciary has the additional requirement of furnishing the distributee with a written document indicating the particular stock

distributed to him. n22 Stock so identified will be considered the stock sold, transferred or distributed even though stock certificates from a different lot are actually delivered to the purchaser, transferee, or distributee. n23

The Average Cost Method

Regulations currently allow a taxpayer who sells less than all his stock in a regulated investment company (sometimes called a "RIC" or "mutual fund") n24 to determine the basis of the shares sold under the average cost method. In general, average cost is determined by dividing the aggregate basis of the taxpayer's shares in the RIC by the aggregate number of shares held. The average cost so determined is then multiplied by the number of shares sold to arrive at the aggregate basis of those shares. n25

The 2008 amendments to Section 1012 of the Internal Revenue Code make important changes to these rules. Beginning in 2011, the average cost method may be used to determine the basis not only of RIC stock but, in addition, any corporate stock acquired after December 31, 2010 in connection with a dividend reinvestment plan ("DRP"). n26 Second, average basis for any eligible stock must be elected on an account-by-account basis beginning January 1, 2012. n27 Finally, in the absence of an election to the contrary, the average basis of shares of any RIC or DRP stock acquired before January 1, 2012 must be determined separately from RIC or DRP shares acquired after that date, whether or not such shares are held in separate accounts. n28

The Treasury Department and Internal Revenue Service have proposed changes to the average cost regulations to reflect the 2008 amendments to Section 1012 (the "proposed regulations"). n29 The provisions of the current regulations as well as the proposed regulations are discussed below.

[i] Eligibility for the Average Cost Method

In permitting the use of the average cost method for stock in a regulated investment company, current regulations prescribe four requirements: (1) the RIC shares must be left by the taxpayer in a custodial account maintained for the acquisition or redemption of RIC shares; n30 (2) the shares must have been purchased or otherwise acquired at different prices or bases; n31 (3) the account in which the shares are held must not contain shares acquired by gift if the basis of the gifted shares in the hands of the donor exceeds the fair market value of such shares at the time of gift unless the taxpayer files a statement electing to use such fair market value as the basis of the gifted shares in computing average basis; n32 and (4) the taxpayer must file an election to use the average cost method in an income tax return (including a timely filed amended return) for the first taxable year for which the taxpayer desires the election to apply, which election may only be revoked with the Commissioner's prior written consent. n33

Under the 2008 amendments to Section 1012, and the proposed regulations interpreting those amendments, the basis of corporate stock acquired after December 31, 2010 in connection with a dividend reinvestment plan ("DRP") may also be determined under the average cost method. n34 A DRP is statutorily defined as an arrangement under which dividends are reinvested in stock identical to the stock with respect to which the dividends were paid. n35 The proposed regulations further require that the arrangement or plan be in writing and that at least 10 percent of every dividend be reinvested in identical stock. n36 A DRP is allowed to hold stock on which no dividends have ever been declared or paid as well as stock on which the issuer has ceased paying dividends, may reinvest a different percentage of dividends with respect to different stocks, and may be administered either by the issuer of the stock or by a non-issuer. n37 Apart from these definitional provisions, the proposed regulations treat DRP stock acquired after December 31, 2010 in the same manner as RIC stock. n38

Beginning in 2012, the 2008 amendments and the proposed regulations change the rules for electing and calculating the average cost of RIC and DRP shares that are "covered securities" as defined in 26 USCS § (g)(3) (IRC Section 6045(g)(3)) of the Code. In general, covered securities include shares in a RIC or DRP purchased in a brokerage or other custodial account on or after January 1, 2012, regarding which the broker or custodian is responsible for reporting to the Internal Revenue Service the taxpayer's adjusted basis, gain or loss, and holding period when the shares

are sold. n39

To assure that brokers have the information necessary to calculate the taxpayer's basis and holding period when RIC or DRP "covered securities" are sold or otherwise transferred, the proposed regulations provide that the taxpayer's election to use average cost must be made by notifying the broker or other custodian of the account in which the shares are held that the taxpayer desires to use the average cost method with respect to such shares. n40 The notice must be in writing but can be given "by any reasonable means." n41 The average cost election is effective only for sales or other dispositions occurring in the account after the taxpayer provides such notification and applies only to identical RIC or DRP stock in the particular account for which the election is made. n42 An election to use the average cost method for RIC or DRP shares in one account neither requires nor allows the taxpayer to use the average cost method for shares of identical RIC or DRP stock held in a different account; a separate election must be made for each account in which RIC or DRP stock is held. n43 Thus, if a taxpayer notifies Broker A of her election to use the average cost method to determine the basis of eligible covered securities in the account, but thereafter transfers the securities to an account with Broker B, the election filed with Broker A is of no further effect and the taxpayer's right to use the average cost method with respect to those securities depends on her filing a similar notification with Broker B prior to sale. n44

Shares of stock in a RIC or DRP acquired prior to January 1, 2012, and shares considered non-covered securities for any other reason, are treated as if held in a separate account from shares of identical RIC or DRP stock acquired on or after January 1, 2012 that meet the definition of covered securities. n45 The taxpayer may still elect to use the average basis method for all RIC shares or DRP shares acquired after December 31, 2010, whether the shares are covered or non-covered securities, but an election to use average basis for non-covered securities will not apply to shares of identical stock in the same account classified as covered securities, and vice-versa. n46 Moreover, if separate elections are made for covered and non-covered securities, the average bases covered and non-covered securities must be computed separately. n47

An irrevocable "single account election" can be made to treat all shares of identical RIC or DRP stock in an account as covered securities, requiring that the broker report adjusted basis and holding period information on the sale of every share of the RIC's or DRP's stock in the account, regardless of date of purchase. n48 The single account election cannot be made by the taxpayer, however. It can only be made by the RIC or DRP which maintains the account or accounts in which the taxpayer's stock is held, or by the broker which holds RIC or DRP stock as a nominee for the taxpayer, n49 by "clearly noting it [the election] on its books and records." n50 The election may be made at any time, may be made for one or more taxpayers for which the RIC, DRP or broker maintains an account, and for one or more stocks held for a given taxpayer. n51 The single account election applies to all identical shares of RIC or DRP stock for which the taxpayer elects to use the average cost method, but only if the electing RIC, DRP or broker has accurate basis information with respect to all such stock. n52

The proposed regulations provide that a taxpayer who makes an election to use the average cost method may revoke that election with retroactive effect by so notifying the custodian of the account, by any reasonable means, within one year after the election is made (or a longer period if the period is extended by the custodian or other agent), but only if no stock covered by the election has been sold out of the account prior to the notification of revocation. n53 Once RIC or DRP covered securities have been sold out of the account, any change from the average cost method elected for that account is a change in method of accounting that can only be prospective in effect, and requires the consent of the Commissioner under prescribed procedures. n54

[ii] Computation of Basis and Holding Period

The average cost regulations currently permit the taxpayer to choose either of two methods of determining the average cost of a share of stock. Under the "double-category method," all shares in an account at the time of each sale or transfer of stock are divided into two categories, one for shares then having a holding period of more than one year (the "more-than-one-year" category), and the other for all shares having a holding period of one year or less (the "one-year-or-less" category). n55 The taxpayer is allowed to specify the category out of which shares are sold, and the

basis of each share in that category is then computed by dividing the aggregate basis of all shares in that category by the number of shares in the same category. n56 The determination of average basis under the second method, the "single-category method," is made without regard to the holding period of the shares involved. Instead, average basis is computed by aggregating the cost or other basis of all shares in the account at the time of transfer or sale, and then dividing such total basis by the number of shares in the account. n57 While taxpayers are permitted to use different average cost methods for different RICs, the regulations require that the same method be used with respect to all of the taxpayer's accounts that hold shares in the same RIC. n58

The proposed regulations would eliminate the double-category method, leaving the single-category method as the only valid method for determining average cost. n59 Taxpayers presently using the double-category method would be required to switch to the single-category method in calculating the basis of shares sold, exchanged or otherwise disposed of after the date the proposed regulations are published as final regulations in the Federal Register. n60 Further, taxpayers holding stock of the same RIC (or DRP) in more than one account are no longer required to use average costing in all such accounts or none; average cost may be elected for RIC stock held in one account but not for stock in the same RIC held in a different account. n61

Under the single-category method, the holding period of shares sold is determined under the first-in, first-out method. n62 The proposed regulations apply the same methodology. n63 Thus, if an account holding shares of identical RIC stock contains 100 shares held for more than one year and 100 shares held for one year or less, and the taxpayer sells 50 of the shares, all 50 would be deemed to have been held for more than one year. n64

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n1 See 26 USCS § 6045(g) (IRC § 6045(g)).

n2 Treas Reg § 1.1012-1(c)(1); Prop Treas Reg 1.1012-1(c)(1). Although the Regulation refers to stock, it is expressly made applicable to bonds by Treas Reg § 1.1012-1(c)(6). It applies as well to "when issued" securities, IT 3858, 1947-2 CB 71, and to noncertificate shares. *Hall v Commr*, 92 TC 1027 (1989).

n3 *Curtis v Helvering*, 101 F2d 40 (2d Cir 1939) (shares acquired by gift prior to the purchase of additional shares of the same security were the ones charged under the first-in, first-out rule). *Cf Helvering v Campbell*, 313 US 15 (1941).

n4 *Forrester v Commr*, 32 BTA 745 (1935).

n5 See 26 USCS § 1012(c)(1) (IRC § 1012(c)(1)) which, as amended by The Energy Improvement and Extension Act of 2008, explicitly provides that "the basis conventions prescribed by the regulations," including

the first-in, first-out rule, "shall be applied on an account by account basis." See also *Bancitaly Corp v Commr*, 34 BTA 494, 507-508 (1936). Compare *Canelo v Commr*, 41 BTA 713, 729-730 (1940), where the taxpayer maintained a number of separate margin accounts maintained by the taxpayer with the same broker were who combined for the purpose of applying the first-in, first-out rule because the broker had combined the accounts for the purpose of computing margin requirements, and the taxpayer "himself treated the several accounts...as if they constituted but one single account" by frequently transferring securities and credit balances from one account to another the accounts had to be considered as one for the purpose of applying the first-in, first-out rule. *Canelo v Commr*, 41 BTA 713 (1940).

n6 GCM 8426, IX-2 CB 92 (1930). See also *Millikan v Commr*, 83 F2d 213 (2d Cir 1936).

A deposit of shares in escrow under an agreement constituting an assignment of shares is a transfer of those shares for purposes of the first-in, first-out rule. *Malkan v Commr*, 54 TC 1305 (1970), acq 1971-1 CB 3.

n7 *Helvering v Campbell*, 313 US 15 (1941).

n8 *Id*; *Helvering v Gambrill*, 313 US 11 (1941).

n9 GCM 11743, XII-2 CB 31 (1933).

n10 Treas Reg § 1.1012-1(c)(1); Prop Treas Reg § 1.1012-1(c)(1). See also *Rev Rul 72-415*, 1972-2 CB 463, prescribing a procedure for adequately identifying shares sold when the taxpayer holds shares acquired in more than one lot at different times or for different prices.

n11 Treas Reg § 1.1012-1(c)(2). A numerical matching of shares purchased and sold is not the equivalent of actual delivery. *Beran v Commr*, TC Memo 1980-119.

n12 *Ibid*. The Supreme Court reached this result in *Davidson v Commr*, 305 US 44 (1938). The taxpayer in that case instructed his broker to sell, and a bank holding the stock to deliver, shares which he had purchased in 1929 at an approximate cost of \$50 a share. The bank erred and delivered shares which had been acquired in earlier years for about \$4 a share. The Court, in holding that the actual fact of delivery controlled over the taxpayer's intention, denied the taxpayer's contention that an adequate identification was achieved by his instructions to the broker and bank, and that the bank's mistake should in no way change the result. In contrast,

the taxpayer in *Kluger Associates, Inc v Commr*, 69 TC 925 (1978), *affd* 617 F2d 323 (2d Cir 1980), was required to use the first-in, first-out method when the certificate delivered did not represent the shares identified as sold by the taxpayer.

n13 Treas Reg § 1.1012-1(c)(3)(i). Similarly, adequate identification will be achieved when a taxpayer holds a single stock certificate representing stock from different lots and sells a part of the stock represented by the certificate through a broker or other agent, if the taxpayer specifies to the broker or other agent the particular stock to be sold and receives a written confirmation of such specification from the broker or other agent within a reasonable time thereafter. Treas Reg § 1.1012-1(c)(3)(ii). If the taxpayer does not sell through a broker but deals directly with the purchaser, adequate identification is made if the taxpayer maintains his own written record of the particular stock he intended to sell. *Id.* Where the transfer is of a "book-entry security," i.e., certain government securities issued in the form of an entry made on the records of a Federal Reserve Bank, proper identification is made by specifying the unique lot number which the taxpayer has assigned to the lot containing the securities being transferred. Treas Reg § 1.1012-1(c)(7).

n14 In Rev Rul 67-436, 1967-2 CB 266, the Internal Revenue Service held that an adequate identification made by the taxpayer at the time of delivery, occurring within four days of the date of sale, timely satisfied the requirement that identification of the stock sold be made at the time of sale or transfer. Treasury and the Internal Revenue Service have proposed adding a new paragraph (8) to Treas Reg § 1.1012-1(c) that would make explicit (consistently with *Rev Rul 67-436*, which would become obsolete) that an identification is timely if the taxpayer identifies the lot from which the shares are sold or transferred no later than the earlier of the settlement date or the time for settlement required by SEC rules. Prop Treas Reg § 1.1012-1(c)(8). A standing order or instruction for the specific identification of stock would also be treated as a timely specification. In addition, Prop Treas Reg § 1.1012-1(c)(9) would clarify that a written confirmation of the taxpayer's instructions from a broker or other custodian can be made in electronic format. The proposed regulations, like the current regulations, do not specify a particular mode by which the taxpayer's instructions should be conveyed to the custodian; communication can be made orally, in writing, or by any other reasonable method. See Dept of the Treasury, "Basis Reporting by Securities Brokers and Basis Determination for Stock; Proposed Rules," 74 *Fed Reg* 67010.

n15 Treas Reg § 1.1012-1(c)(3)(i).

n16 *Rev Rul 61-97*, 1961-1 CB 394.

n17 *Helvering v Rankin*, 295 US 123 (1935).

n18 Treas Reg § 1.1012-1(c)(6).

n19 See Treas Reg § 1.1012-1(c)(7)(iii)(a); Prop Treas Reg § 1.1012-1(c)(7)(iii)(a).

n20 To adequately identify lots from which book-entry securities are sold, the taxpayer must assign lot numbers in numerical sequence to successive purchases of securities of the same loan title (series) and maturity date, although securities of the same loan title (series) and maturity date which are purchased at the same price on the same date may be included within the same lot. Treas Reg § 1.1012-1(c)(7)(i). The unique lot number from which the securities are sold may be specified either in the taxpayer's written instructions or, in the case of a taxpayer in whose name the book entry by the Federal Reserve Bank is made, in a list of lot numbers with respect to all book-entry securities on the books of the Federal Reserve Bank sold or transferred on that date by the taxpayer, provided such list is mailed to or received by the Federal Reserve Bank on or before its next business day. *Id.* The requirement that the taxpayer receive a written confirmation is satisfied if the taxpayer is furnished with a written advice of transaction by the Federal Reserve Bank or the person through whom the taxpayer sells or transfers the securities, which advice must specify the amount and description of the securities sold or transferred and the date of the transaction. Treas Reg § 1.1012-1(c)(7)(ii)(a); Prop Treas Reg § 1.1012-1(c)(7)(ii).

n21 Treas Reg § 1.1012-1(c)(4)(i). Proposed regulations clarify that when the trust or estate's stock is sold through a broker or other agent, the trustee, executor or administrator may adequately identify the lot from which the shares are sold by using the broker's confirmation method. Prop Treas Reg § 1.1012-1(c)(4)(i)(c).

n22 Treas Reg § 1.1012(c)(4)(ii).

n23 Treas Reg § 1.1012(c)(4).

n24 A "regulated investment company" is defined for this purpose as any domestic corporation (other than a personal holding company as defined in section 542) which meets the limitations of section 851(b) and Treas Reg § 1.851-2, and which is registered at all times during the taxable year under the Investment Company Act of 1940. Treas Reg § 1.1012-1(e)(5). Regulated investment companies are the subject of Ch 12.

n25 Treas Reg § 1.1012-1(e)(1).

n26 See 26 USCS § 1012(d) (IRC § 1012(d)).

n27 See 26 USCS § 1012(c)(1) (IRC § 1012(c)(1)).

n28 See 26 USCS § 1012 (c)(2) (IRC § 1012(c)(2)).

n29 See Dept of the Treasury, "Basis Reporting by Securities Brokers and Basis Determination for Stock; Proposed Rules," 74 Fed Reg 67010, 67025-67029 (Dec 17, 2009).

n30 Treas Reg § 1.1012-1(e)(1)(i)(a).

n31 Treas Reg § 1.1012-1(e)(1)(i)(b).

n32 Treas Reg § 1.1012-1(e)(1)(ii).

n33 Treas Reg § 1.1012-1(e)(6). The taxpayer's election to use average cost applies to all of the taxpayer's shares in the RIC, whether held in a single account or separate accounts. It does not, however, apply to accounts in which the taxpayer holds shares of gifted RIC stock the basis of which was greater than the stock's fair market value at the time of the gift, unless the taxpayer has filed a statement agreeing to use the lower fair market value as the gifted stock's basis in calculating average cost. See Treas Reg § 1.1012-1(e)(1)(ii).

n34 Stock acquired "in connection with" a DRP includes not only stock purchased with reinvested dividends but also the initial purchase of stock in the DRP, transfers of identical stock into the DRP, and additional periodic purchases of identical stock in the DRP. See 26 USCS § 1012(d)(4)(B) (IRC § 1012(d)(4)(B)); Prop Treas Reg § 1012-1(e)(6)(ii).

n35 26 *USCS* § 1012 (d)(4)(A) (IRC § 1012(d)(4)(A)). The proposed regulations define "identical stock" as stock having the same Committee on Uniform Security Identification Procedures ("CUSIP") number. Prop Treas Reg § 1.1012-1(e)(4). Dividends declared before or pending a merger, consolidation, spinoff or similar corporate action and subsequently paid and reinvested in shares of stock in the successor entity or entities are considered reinvested in identical stock even though the CUSIP number of the successor entity's stock may be different. Prop Treas Reg § 1.1012-1(e)(6)(iii). On the other hand, shares of corporate stock in a dividend reinvestment plan are not "identical" to shares of stock in the same corporation that are not in a dividend reinvestment plan, even though both have the same CUSIP number. Prop Treas Reg § 1.1012-1(e)(4).

n36 Prop Treas Reg § 1.1012-1(e)(6)(i).

n37 Prop Treas Reg § 1.1012-1(e)(6)(i).

n38 Thus, to be eligible to use the average cost method, shares of stock acquired in connection with a DRP, like RIC stock, must be left in an account with a custodian or agent, Prop Treas Reg § 1.1012-1(e)(1)(i), the account must contain identical stock acquired at different prices or bases, Prop Treas Reg § 1.1012-1(e)(1)(ii), the account may not include gifted stock the basis of which in the hands of the donor is higher than its fair market value at the time of the gift unless the taxpayer files a statement agreeing to use the lower fair market value as the gifted stock's basis, Prop Treas Reg § 1.1012-1(e)(8); and the taxpayer must make an election to apply the average cost method in the manner specified in the proposed regulations. See Prop Treas Reg § 1.1012-1(e)(9). If the taxpayer withdraws from a DRP, or the plan administrator terminates the plan, the basis of each share of stock received by the taxpayer from the DRP will be the same as the average cost basis of such stock immediately before the withdrawal or termination, but the distributed stock is no longer considered acquired in connection with a dividend reinvestment plan and the taxpayer may not continue to use the average cost method with respect to such stock. Prop Treas Reg §§ 1.1012-1(e)(6)(iv) and 1.1012-1(e)(7)(v).

n39 Under IRC § 6045(g)(3), a "covered security" is defined as any "specified security" acquired on or after the "applicable date" if the security was (1) acquired through a transaction in the account in which such security is held or (2) was a covered security in another account and was transferred into the account in which it is presently held with a statement providing details regarding the customer's basis and holding period in the security. A "specified security" means, among other things, any share of stock in a corporation, IRC § 6045(g)(3)(B)(i), including a share of stock in a RIC or stock acquired in connection with a DRP. Although the "applicable date" for most corporate stock is January 1, 2011, in the case of any stock "for which an average basis is permissible" (namely, RIC and DRP stock), the applicable date is deferred to January 1, 2012. 26 *USCS* § 6045(g)(3)(C)(ii) (IRC § 6045(g)(3)(C)(ii)). The proposed regulations merely restate the statutory definition of a "covered security," see Prop Treas Reg 1.6045-1(a)(15), but in addition define a "non-covered security" as a security that is not a "covered security." Prop Treas Reg 1.6045-1(a)(16). RIC or DRP stock, although acquired by the taxpayer in an account on or after January 1, 2012, could nevertheless be a non-covered security under certain circumstances; namely, if the stock was transferred from another account in which the stock was a "non-covered security," or the stock was transferred from another account unaccompanied by a statement,

ordinarily required by 26 *USCS* § 6045A) (IRC § 6045A), containing the adjusted basis and holding period of the stock. See Prop Treas Reg § 1.6045-1(a)(15)(iv) and Treas Reg § 1.1012-1(e)(10)(iv), Example 5.

n40 Prop Treas Reg § 1.1012-1(e)(9)(i). For RIC or DRP shares that are covered securities, this replaces the previous procedure under which an election to use average cost is made by filing a statement with the taxpayer's return for the year in which the election first applies. However, the proposed regulations continue to require that the election to use the average cost method be made with the taxpayer's income tax return if the RIC or DRP stock to which the election relates is a noncovered security. Prop Treas Reg § 1.1012-1(e)(9)(ii).

n41 Prop Treas Reg § 1.1012-1(e)(9)(i).

n42 Prop Treas Reg § 1.1012-1(e)(9)(i). If, for example, a taxpayer holds shares of two different RICs in the same account, the broker may be notified to use average cost to determine basis in the shares of one of the RICs and a different method of determining the basis of shares in the other RIC. Prop Treas Reg § 1.1012-1(e)(10)(iv), Example 2.

n43 A taxpayer may use the average cost method for RIC or DRP stock in one account and a different basis determination method for identical stock in a different account, even if both accounts are held with the same broker. Prop Treas Reg § 1.1012-1(e)(10)(i); Prop Treas Reg § 1.1012-1(e)(10)(iv), Example 1. This contrasts with the current rule that an election to use average cost for RIC or DRP stock in one account applies as well to all other accounts in which identical stock is held, a rule the proposed regulations would continue to apply, however, to RIC or DRP shares sold or otherwise disposed of before January 1, 2012. Prop Treas Reg § 1.1012-1(e)(10)(ii).

n44 See Prop Treas Reg § 1.1012-1(e)(2)(ii). If the taxpayer does not validly elect a method for determining the basis of RIC or DRP stock held in a brokerage or other custodial account before selling such stock from the account, basis will be determined using the broker's default method. Prop Treas Reg § 1.1012-1(e)(2)(i). Accordingly, if in the above example Broker B uses first-in, first-out as its default method, and does not receive notification to use average cost or another method for determining the basis of the transferred RIC or DRP shares, the basis of those shares will be determined under Broker B's first-in, first-out default method and not under the average cost method that the taxpayer elected when the shares were held by Broker A. Note that while, in the absence of taxpayer instructions to the contrary, brokers must use the first-in, first-out method as their default method for purposes of determining the basis of most customer securities, in the case of stock for which the average cost method of determining basis is permissible (*viz*, RIC or DRP stock), brokers may choose any permissible method as the default method, including average cost. See 26 *USCS* § 6045(g)(2)(B)(i)(I) and (II) (IRC § 6045(g)(2)(B)(i)(I) and (II)); Prop Treas Reg § 1.1012-1(c)(1).

n45 Suppose, for example, that on March 1, 2014, a taxpayer transfers inherited stock in a RIC to a brokerage account in which the taxpayer also holds shares in the same RIC that were purchased in the account on or after January 1, 2012. Since inherited stock is not "acquired through a transaction in the account in which such security is held," IRC § 6045(g)(3)(A)(i), the inherited RIC shares are non-covered securities that are deemed held in a separate account from the purchased RIC shares which are covered securities. See Prop Treas Reg 1.1012-1(e)(10)(iv), Example 5.

n46 Recall that the procedure for electing the average cost method is different depending on whether the RIC or DRP shares are non-covered securities (election made with tax return) or covered securities (election made by notifying broker). See Prop Treas Reg §§ 1.1012-1(e)(9)(i) and (ii).

n47 See Prop Treas Reg § 1.1012-1(e)(10)(iv), Example 4.

n48 IRC § 1012(c)(2)(B); Prop Treas Reg § 1.1012-1(e)(11). The single account election may be made at any time. Prop Treas Reg § 1.1012-1(e)(11)(iv). Once made, the single account election applies to all identical stock the taxpayer later acquires in the same account that is a covered security. Prop Treas Reg § 1.1012-1(e)(11)(iii). However, if identical stock that is a noncovered security (for example, inherited stock) is subsequently transferred into the account, it will be treated as held in a separate account unless the RIC, DRP or broker makes another single account election to treat such stock as a covered security. See Prop Treas Reg §§ 1.1012-1(e)(11)(iii) and 1.1012-1(e)(11)(vi), Example 4.

n49 Prop Treas Reg § 1.1012-1(e)(11)(i). The taxpayer must be notified by the RIC, DRP or broker making the single account election that the election has been made and that, as a consequence, all identical RIC or DRP stock in the account will be treated as covered securities regardless of when acquired. Prop Treas Reg § 1.1012-1(e)(11)(v). The taxpayer has the right to receive a copy of the books and records maintained by the RIC, DRP or broker which reflect that a single account election has been made with respect to his account. Prop Treas Reg § 1.1012-1(e)(11)(iv).

n50 Prop Treas Reg § 1.1012-1(e)(11)(iv). The books and records must reflect the date of the election; the taxpayer's name, account number, and taxpayer identification number, the stock subject to the election, and the taxpayer's basis in the stock.

n51 Prop Treas Reg §§ 1.1012-1(e)(11)(ii) and (iv).

n52 Prop Treas Reg §§ 1.1012-1(e)(11)(i) and (ii). Stock for which accurate basis information is unavailable may not be included in the single account election and must be treated as held in a separate account. Prop Treas Reg § 1.1012-1(e)(11)(ii).

n53 Prop Treas Reg § 1.1012-1(e)(9)(iii).

n54 Prop Treas Reg § 1.1012-1(e)(9)(iv).

n55 Treas Reg § 1.1012-1(e)(3)(i).

n56 Treas Reg § 1.1012-1(e)(3)(ii).

n57 Treas Reg § 1.1012-1(e)(4)(i).

n58 Treas Reg § 1.1012-1(e)(2).

n59 The Explanation given in the preface to the proposed regulations states that elimination of the double category method resulted from public comments that the method was "not widely used" and could create "problems...when shares are transferred between accounts that use different methods." See Dept of the Treasury, "Basis Reporting by Securities Brokers and Basis Determination for Stock; Proposed Rules," *supra*, 74 *Fed Reg* at 67016.

n60 Prop Treas Reg § 1.1012-1(e)(7)(iii).

n61 See Prop Treas Reg § 1.1012-1(e)(10)(i). However, the taxpayer must apply IRC § 1091 and the associated regulations (dealing with wash sales of substantially identical securities in computing average basis regardless of whether the stock or other security disposed of and the stock acquired are in the same account or in different accounts. By contrast, in applying the basis reporting rules imposed on brokers by the 2008

amendments to IRC § 6045(g), the wash sale provisions need not be taken into account by the broker unless the transactions occur in the same account with respect to identical securities. IRC § 6045(g)(2)(B)(ii).

n62 Treas Reg § 1.1012-1(e)(4)(ii).

n63 Prop Treas Reg § 1.1012-1(e)(7)(ii).

n64 *Id.*

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Exclusions from Property Tax Change in Ownership Rules in California

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USC Gould School of Law 2010 Tax Institute: Exclusions from Property Tax Change in Ownership Rules in California

By Peter B. Kanter and Richard S. Kinyon

August 17, 2010

SUMMARY: California Constitution Article XIII A, enacted by Proposition 13, limits real property tax to one percent of a property's "full cash value," plus certain outstanding "bonded indebtedness." California property is assessed at factored "base year value" or current fair market value, whichever is less. Transfers between spouses, domestic partners, parents to children, and grandparents to grandchildren are exclusions from change in ownership rules.

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ARTICLE: I. Introduction

Shortly after the passage of Proposition 13, Proposition 8 was passed by California voters. Proposition 8 added the additional limitation that in no event should property be assessed in any year at an amount above its current fair market value. Thus, in California today, property is generally assessed at the lesser of (1) its factored "base year value" and (2) its current fair market value.

The California Legislature enacted temporary implementation statutes that were generally effective for one year after Proposition 13 was passed, during which time the Legislature planned to consider and draft more permanent statutory provisions to carry out Article XIII A. The California State Board of Equalization (hereinafter the "SBE") promulgated regulations under the temporary statutes, including regulations on the term "change in ownership." To aid the Legislature in drafting more permanent legislation, a Task Force on Property Tax Administration (hereinafter the "Task Force"), including representatives of the government and taxpayers, was appointed to make recommendations to the Legislature concerning the implementation of Article XIII A. The Task Force issued a report which formed the basis of the current statutory scheme. n1

The general definition of "change in ownership" envisioned by the Task Force is set forth in California Revenue and Taxation Code Section 60. n2 It provides: ***"change in ownership" means a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest.*** The Legislature also enacted several statutory provisions that follow R&TC § 60, which provide examples of particular types of transactions that either fall under the definition of "change in ownership" or are excluded from it. n3

Notably, the California Supreme Court in *Pacific Southwest Realty Co. v. County of Los Angeles* n4 has ruled that

the general definition of what constitutes a change in ownership contained in R&TC § 60 is the overarching rule that must be met for any transaction to be deemed a change in ownership under Proposition 13. The court held that the statutory provisions that follow R&TC § 60 are merely examples of types of transactions that will, in most cases, meet that definition or are excluded from it. ***However, when there is a conflict between one of the exemplary provisions and Section 60, the court ruled, the overarching definition contained in Section 60 must govern over the specific examples in the provisions that follow.***

The exemplary statutory provisions, however, govern in most cases to determine whether a transaction has triggered a change in ownership. The SBE has also promulgated regulations implementing Article XIII A of the constitution and the related statutory provisions. n5

This Emerging Issues Analysis will examine specific exclusions from change in ownership rules under California's Constitution. This includes transfers between spouses and domestic partners, transfers between parents and children, and transfers from grandparents to grandchildren.

II. Exclusions from Change in Ownership

There are several specific exclusions from change in ownership that have been added to the California Constitution, Article XIII A, and in order for a transfer that otherwise meets all three prongs of Section 60's overarching test to not be a change in ownership, an exclusion must be found in Article XIII A itself. That is, the legislature does not have the authority to add any exclusions to the change in ownership rule of Section 60 that are not found in the California Constitution. The following exclusions have been provided in Article XIII A, and statutory provisions implementing these constitutional exclusions:

A. Interspousal Transfers

Article XIII A, Section 2(g) of the California Constitution provides that for purposes of determining whether a "purchase" or "change in ownership" of real property has occurred, those terms shall not include the purchase or transfer of real property between spouses since March 1, 1975, including, but not limited to, all of the following:

(1) Transfers to a trustee for the beneficial use of a spouse, or the surviving spouse of a deceased transferor, or by a trustee of such a trust to the spouse of the trustor.

(2) Transfers to a spouse that take effect upon the death of a spouse.

(3) Transfers to a spouse or former spouse in connection with a property settlement agreement or decree of dissolution of a marriage or legal separation.

(4) The creation, transfer, or termination, solely between spouses, of any co-owner's interest.

(5) The distribution of a legal entity's property to a spouse or former spouse in exchange for the interest of the spouse in the legal entity in connection with a property settlement agreement or a decree of dissolution of a marriage or legal separation.

R&TC § 63 provides almost identical provisions to the California Constitution, and further provides that its own provisions override "any other provision in this chapter."

18 CCR 462.220 provides as follows:

Notwithstanding any other provision of Rules 460 through 471, a change in ownership shall not include any interspousal transfer, including, but not limited to:

(a) Transfers of ownership interests in legal entities,

(b) Transfers of ownership interests in legal entities resulting in one spouse obtaining control as defined in Section 64(c) of the Revenue and Taxation Code,

Example 1: Husband (H) owns a 30 percent ownership interest in a partnership and wife (W) owns a 30 percent ownership interest in the same partnership. W transfers her interest to H; H now owns a 60 percent ownership interest. There is no change in ownership.

(c) Transfers of ownership interests in legal entities by "original co-owners" which would otherwise be cumulated or counted for purposes of Section 64(d) of the Revenue and Taxation Code.

Example 2: Spouses H and W are "original coowners" of a partnership; each originally owned a 50 percent partnership interest. They have previously each transferred a 10 percent interest to X and to Y, leaving H and W each with a 30 percent partnership interest. W transfers a 15 percent interest to H. Although cumulatively more than 50 percent has been transferred, there is no change in ownership.

(d) Transfers to a trustee for the beneficial use of a spouse, or the surviving spouse of a deceased transferor, or by a trustee of such a trust to the spouse of the trustor,

(e) Transfers which take effect upon the death of a spouse,

Example 3: H and W each own a 30 percent interest in General Partnership (GP). H and W transfer their respective partnership interests to the HW Revocable Trust. No change in ownership. Trust provides that upon the death of the first spouse: the assets of the deceased spouse, including partnership interests in GP, shall be distributed to "A Trust", and the assets of the surviving spouse, including partnership interests in GP, shall be distributed to "B Trust." Surviving spouse is the sole present beneficiary of both A Trust and B Trust. No change in ownership upon the death of the first spouse.

(f) Transfers to a spouse or former spouse in connection with a property settlement agreement, including post-dissolution amendment thereto, or decree of dissolution of a marriage or legal separation,

(g) The creation, transfer, or termination, solely between spouses, of any co-owner's interest, or

(h) The distribution of property of a corporation, partnership, or other legal entity to a spouse or former spouse having an ownership interest in the entity, in exchange for the interest of such spouse in the legal entity in connection with a property settlement agreement or decree of dissolution of a marriage or legal separation.

The interspousal exclusion has been construed very broadly. Practically any transfer between spouses, directly or indirectly, or to effectuate the dissolution of a marriage, will be excluded from a change in ownership.

B. Registered Domestic Partner Transfers

Transfers between registered domestic partners after January 1, 2000, are generally excluded from a change in ownership to the same extent as interspousal transfers. R&TC § 62(p) makes provisions similar to R&TC § 63 applicable with respect to transfers between registered domestic partners.

18 CCR 462.240(k) provides that any transfer of separate property inherited by a surviving domestic partner by intestate succession upon the death of a registered domestic partner does not constitute a change in ownership. n6

C. Parent-Child and Grandparent-Grandchild Transfers

Certain parent-child and grandparent-grandchild transfers are also excluded from changes in ownership. n7 However the parent-child exclusion (and presumably the grandparent-grandchild exclusion as well) will not apply to transfers of interests in legal entities that would cause a change in control over the legal entity. n8

Article XIII A, Section 2(h)(1) of the California Constitution provides that for purposes of determining whether a "purchase" or "change in ownership" of real property has occurred, those terms shall "not include the purchase or transfer of the principal residence of the transferor in the case of a purchase or transfer between parents and their children, as defined by the Legislature, and the purchase or transfer of the first one million dollars (\$1,000,000) of the full cash value of all other real property between parents and their children, as defined by the Legislature. This subdivision shall apply to both voluntary transfers and transfers resulting from a court order or judicial decree."

Article XIII A, Section 2(h)(2) of the California Constitution provides as follows:

(A) Subject to subparagraph (B), . . . the exclusion established by paragraph (1) [relating to Parent-Child transfers] also applies to a purchase or transfer of real property between grandparents and their grandchild or grandchildren, as defined by the Legislature, that otherwise qualifies under paragraph (1), if all of the parents of that grandchild or those grandchildren, who qualify as the children of the grandparents, are deceased as of the date of the purchase or transfer.

(B) A purchase or transfer of a principal residence shall not be excluded pursuant to subparagraph (A) if the transferee grandchild or grandchildren also received a principal residence, or interest therein, through another purchase or transfer that was excludable pursuant to paragraph (1). The full cash value of any real property, other than a principal residence, that was transferred to the grandchild or grandchildren pursuant to a purchase or transfer that was excludable pursuant to paragraph (1), and the full cash value of a principal residence that fails to qualify for exclusion as a result of the preceding sentence, shall be included in applying, for purposes of subparagraph (A), the one million dollar (\$1,000,000) full cash value limit specified in paragraph (1).

R&TC § 63.1 defines "a purchase or transfer between parents and their children," "the purchase or transfer of the first one million dollars (\$1,000,000) of the full cash value of all other real property . . . between parents and their children," and a qualified "purchase or transfer of real property . . . between grandparents and their grandchild or grandchildren." That section is applicable "[n]otwithstanding any other provision of this chapter [relating to Change in Ownership and Purchase] for which a claim is filed pursuant to this section."

R&TC § 63.1(a)(1)(B) provides that a purchase or transfer of a principal residence from a foster child to his or her biological parent is treated as a change in ownership if the child previously received the residence, or interest therein, from a foster parent through a purchase or transfer that was not treated as a change in ownership.

R&TC § 63.1(a)(3)(A) provides that in determining whether "all of the parents of that grandchild or those grandchildren, who qualify as the children of the grandparents, are deceased as of the date of purchase or transfer," a son-in-law or daughter-in-law of the grandparent who is a stepparent of the grandchild is disregarded.

R&TC § 63.1(b)(1) provides that "principal residence" means a dwelling that is eligible for a homeowners' or disabled veterans' residence exemption in the name of the eligible transferor, but includes "only that portion of the land underlying the residence that consists of an area of reasonable size that is used as a site for the residence."

R&TC § 63.1(b)(2) provides that the \$1,000,000 exclusion applies separately to each eligible transferor with respect to all purchases by and transfers to eligible transferees of real property, other than the principal residence, of that eligible transferor. However, the exclusion does not apply to any property in which the transferor's interest was received through a transfer or transfers excluded from change in ownership under either Section 62(f) (relating to the creation or transfer of a joint tenancy interest if the transferor, after the creation or transfer, is one of the joint tenants as provided in Section 65(b)) or Section 65(b), unless the transferor qualifies as an original transferor under Section 65(b). Furthermore, in the case of any such purchase or transfer involving two or more eligible transferors, the transferors may elect to combine their separate \$1,000,000 exclusions; and upon making that election, the combined amount of their separate exclusions applies to any property jointly sold or transferred by the electing transferors, provided that the amount of the full cash value of real property of any one eligible transferor excluded under this election may not exceed the amount of the transferor's separate unused exclusion on the date of the joint sale or transfer.

R&TC §§ 63.1(c)(1) and (2) provide, in part, that the date of any transfer between parents and their children, or grandparents and their grandchildren, under a will or by intestate succession, is the date of the decedent's death. This also applies to a transfer under a revocable trust, as provided in 18 CCR 462.160(b)(2).

R&TC § 63.1(c)(3) provides, in part, as follows:

The term "child" or "children" includes a stepchild of the parent or parents and the spouse of that stepchild while the relationship of stepparent and stepchild exists, and it is deemed to exist until the marriage on which the relationship is based is terminated by divorce, or if the relationship is terminated by death, until the remarriage of the surviving stepparent.

The term "child" or "children" also includes the spouse of a child, and it is deemed to exist until the marriage of the child and his or her spouse is terminated by divorce, or if the child dies, until his or her surviving spouse remarries.

The term "child" or "children" does not include someone adopted after reaching age 18 or a child born of the parent or parents if the child has been adopted by someone else.

The term "child" or "children" also includes a foster child of a state-licensed foster parent if the child was not adopted by the foster parent or parents because of a legal barrier before the child aged out of the foster care system. The relationship between a foster child and foster parent is deemed to exist until terminated by death of either party, but a transfer that occurs as a result of death will be treated as a transfer between a parent and child.

The term "transfer" includes any transfer of the present beneficial ownership of property through the medium of an inter vivos or testamentary trust.

18 CCR 462.240 provides as follows:

The following transfers do not constitute a change in ownership:

...

(g) Any transfer, occurring on or after January 1, 1983, of an eligible dwelling unit from a parent(s) or legal guardian(s) to a minor child or children or among minor siblings, or to a trust for the sole benefit of such persons, resulting from a court order or judicial decree due to the death of one or both of the partners. An 'eligible dwelling unit' means the dwelling which was the principal place of residence of the minor child or children prior to the transfer and remains such after the transfer.

(h) Any transfer of property to a disabled child or ward, whether minor or adult, or to a trust for the sole benefit of such person, upon the death of a parent or guardian pursuant to Section 62(n) of the Revenue and Taxation Code.

In Letter to Assessors No. 2008/018 from the California State Board of Equalization, dated February 29, 2008, which superseded several previous Letters to Assessors, the SBE provided 52 questions and answers relating to parent-child transfers and 17 questions and answers relating to grandparent-grandchild transfers. Letter No. 2008/018 also mentions that in order to grant either exclusion, the county assessor must receive a claim form and it discusses the deadlines for filing those forms and the effective dates of the exclusions.

D. Base-Year Value for Persons Over 55 Years of Age

Article IIIA, Section 2 provides in part as follows:

(a) . . . [T]he Legislature may provide that, under appropriate circumstances and pursuant to definitions and procedures established by the Legislature, any person over the age of 55 years who resides in property that is eligible for the homeowner's exemption under subdivision (k) of Section 3 of Article XIII and any implementing legislation may

transfer the base year value of the property entitled to exemption, with the adjustments authorized by subdivision (b), to any replacement dwelling of equal or lesser value located within the same county and purchased or newly constructed by that person as his or her principal residence within two years of the sale of the original property. For purposes of this section, "any person over the age of 55 years" includes a married couple one member of which is over the age of 55 years. For purposes of this section, "replacement dwelling" means a building, structure, or other shelter constituting a place of abode, whether real property or personal property, and any land on which it may be situated. For purposes of this section, a two-dwelling unit shall be considered as two separate single-family dwellings. This paragraph shall apply to any replacement dwelling that was purchased or newly constructed on or after November 5, 1986.

In addition, the Legislature may authorize each county board of supervisors, after consultation with the local affected agencies within the county's boundaries, to adopt an ordinance making the provisions of this subdivision relating to transfer of base year value also applicable to situations in which the replacement dwellings are located in that county and the original properties are located in another county within this State. For purposes of this paragraph, "local affected agency" means any city, special district, school district, or community college district that receives an annual property tax revenue allocation. This paragraph shall apply to any replacement dwelling that was purchased or newly constructed on or after the date the county adopted the provisions of this subdivision relating to transfer of base year value, but shall not apply to any replacement dwelling that was purchased or newly constructed before November 9, 1988.

The Legislature may extend the provisions of this subdivision relating to the transfer of base year values from original properties to replacement dwellings of homeowners over the age of 55 years to severely disabled homeowners, but only with respect to those replacement dwellings purchased or newly constructed on or after the effective date of this paragraph.

(b) The full cash value base may reflect from year to year the inflationary rate not to exceed 2 percent for any given year or reduction as shown in the consumer price index or comparable data for the area under taxing jurisdiction, or may be reduced to reflect substantial damage, destruction or other factors causing a decline in value.

R&TC § 69.5(a) provides in part that notwithstanding any other provision of law, any person over 55 years of age (or any severely and permanently disabled person), who resides in property that is eligible for the homeowner's exemption may transfer the base year value of that property to any replacement dwelling of equal or lesser value that is located within the same county and is purchased or newly constructed by that person as his or her principal residence within two years of the sale by that person of the original property, provided that the base year value of the original property may not be transferred to the replacement dwelling until the original property is sold. Any county may allow the base year value of property located in another county to be transferred to a replacement dwelling in its county.

E. Certain Other Transfers

R&TC § 62 provides in part that certain transfers are not considered a change in ownership. In addition to those referred to above, a change of ownership does not include:

(b) Any transfer for the purpose of perfecting title to the property.

(c) (1) The creation, assignment, termination, or reconveyance of a security interest; or (2) the substitution of a trustee under a security instrument.

...

(l) Any transfer, that would otherwise be a transfer subject to reappraisal under this chapter, between or among the same parties for the purpose of correcting or reforming a deed to express the true intentions of the parties, provided that the original relationship between the grantor and grantee is not changed. R&TC § 62.

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n1 See Report of the Task Force on Property Tax Administration to the Assembly Revenue and Taxation Committee, January 22, 1979 ("Task Force Report").

n2 All references to "R&TC" hereafter refer to the California Revenue and Taxation Code.

n3 See R&TC §§ 61 through 69.

n4 1 Cal. 4th 155 (1991).

n5 All references to "regulations" throughout this article refer to the regulations relating to Change in Ownership and New Construction in the California Code of Regulations, Title 18, Chapter 4, Article 4.

n6 This regulation was probably rendered obsolete and superseded by the much broader rule covering all transfers between domestic partners established under R&TC § 62(p), which was enacted after 18 CCR 462.240(k) was promulgated.

n7 Cal. Const. art. XIII A, § 2(h); R&TC § 63.1.

n8 See *Penner v. County of Santa Barbara*, 37 Cal. App. 4th 1672 (1995) (transfer of property in California by a parent to a limited partnership made up solely of the parent and her children constituted a change in ownership for assessment purposes, because the parent-child exemption is limited to transfers between natural persons and does not include transfers to or from legal entities).

RELATED LINKS: For a general overview of constitutional issues and policy concerns affecting real property taxation, see

■ 2-22 Bender's State Taxation: Principles and Practice 22.01

For discussion about real property transfers with property tax implications, see:

■ 2-20 Bender's State Taxation: Principles and Practice 20.04

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Marc A. Countryman on the Unified Loss Rule and Basis Reduction Rule

2010 Emerging Issues 5260

USC Gould School of Law 2010: Marc A. Countryman on the Unified Loss Rule: Basis Reduction Rule of Treas. Reg. § 1.1502-36(c)

By Marc A. Countryman

August 16, 2010

SUMMARY: In the second installment of a series of articles on the Unified Loss Rule, Marc A. Countryman discusses the second prong of the Unified Loss Rule under Treas. Reg. § 1.1502-36(c). The basis reduction rule of Treas. Reg. § 1.1502-36(c) is designed to prevent uneconomic stock losses caused by the investment adjustment system and promote the clear reflection of the group's income.

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ARTICLE: The basis reduction rule of Treas. Reg. § 1.1502-36(c) is designed to prevent uneconomic stock losses caused by the investment adjustment system and promote the clear reflection of the group's income. Under this rule, if after taking into account any applicable basis redeterminations required by Treas. Reg. § 1.1502-36(b), a transferred S share remains a loss share, then basis in the transferred share can be reduced (but not below the share's fair market value) by the lesser of the share's "disconformity" amount and the share's net positive investment adjustment. See also:

- USC Gould School of Law 2010: Marc A. Countryman on the Unified Loss Rule: Basis Redetermination Rule of Treas. Reg. § 1.1502-36(b) *2010 Emerging Issues 5257* and
- USC Gould School of Law 2010: Marc A. Countryman on the Unified Loss Rule: Attribute Reduction Rule of Treas. Reg. § 1.1502-36(d), *2010 Emerging Issues 5262*.

The basis reduction rule of Treas. Reg. § 1.1502-36(c) is designed to prevent uneconomic stock losses caused by the investment adjustment system and promote the clear reflection of the consolidated group's income. n1 If both the basis redetermination rule n2 and the basis reduction rule apply to a transfer of a loss share of S stock, the basis redetermination rule applies before the basis reduction rule. However, the basis reduction rule may apply to the transfer even if the basis redetermination rule does not apply to the transfer. Unlike the basis redetermination rule, which can only reallocate investment adjustments among shares, the basis reduction rule, if it applies, results in a permanent elimination of S stock basis. Thus, the basis reduction rule has the same effect as a loss disallowance rule. However, similar to its predecessor loss disallowance rules, the basis reduction rule can only eliminate loss-it cannot prevent investment adjustments from reducing or eliminating gain.

Basis Reduction Rule

If, after taking into account any applicable basis redeterminations required by Treas. Reg. § 1.1502-36(b), a transferred S share remains a loss share, then *M*'s basis in the transferred share is further reduced (but not below its value) by the lesser of (i) the share's "net positive adjustment" and (ii) the share's "disconformity amount." n3

The share's "net positive adjustment" is defined as the greater of zero and the sum of all investment adjustments reflected in the basis of the share at the time of the transfer, as provided in Treas. Reg. § 1.1502-36(b)(1)(iii), but expanded to include all adjustments specially allocated under Treas. Reg. § 1.1502-32(c)(1)(ii) (not just the special allocation under Treas. Reg. § 1.1502-32(c)(1)(ii)(B), as in the case of the basis redetermination rule). n4 Thus, here the definition of "net positive adjustment" includes all investment adjustments to the transferred loss share *except* the negative adjustment for distributions.

The share's "disconformity amount" is determined as of the time of the transfer and is defined as the excess, if any, of (a) *M*'s basis in the S share over (b) the share's "allocable portion" of S's "net inside attribute amount." n5 S's "net inside attribute amount" generally is the sum of (i) S's inside basis, money, net operating and capital loss carryovers, and deferred deductions, minus (ii) the amount of its liabilities. n6 With respect to a share of stock of a lower-tier member owned by S that is transferred in the transaction, S's basis in that share is its actual basis, adjusted to reflect any gain or loss recognized by S on the transfer of that share. A special rule is set forth in Treas. Reg. § 1.1502-36(c)(6) where one of S's assets is stock of a lower-tier member that is *not* transferred in the same transaction.

Example 1: Transferred lower-tier shares. In Year 1, *P* purchases all 5 shares of the stock of *S* from a nonmember for \$25. At the time of this purchase, *S*'s only asset is a patent worth \$25 and having a \$0 basis. Later in Year 1, *P* contributes \$50 to the capital of *S*. *S* uses that \$50 to purchase 2 of the 5 shares of *S1* stock from a nonmember, and *P* purchases the remaining 3 shares of the *S1* stock from the nonmember for \$75. Later in Year 1, *S1* sells its only asset (raw land with a value of \$125 and basis of \$0) to *X* in exchange for an *X* debt obligation with a value and basis of \$125, recognizing \$125 of gain. The \$125 gain recognized by *S1* results in a positive investment adjustment of \$25 to the basis of each of the 5 shares of *S1* stock (the \$125 of gain divided by the 5 outstanding shares of *S1* stock) and a positive investment adjustment of \$10 to the basis of each of the 5 shares of *S* stock (the \$50 aggregate positive investment adjustment to the 2 *S1* shares owned by *S* divided by the 5 shares of *S* stock owned by *P*). At the end of Year 1, *S*'s patent declines in value from \$25 to \$0. Thus, at the end of Year 1, (i) *P* owns all 5 shares of the stock of *S*, each of which has a value of \$10 and adjusted basis of \$25 (the quotient of (1) the sum of (a) the \$25 initial basis of the 5 *S* shares, plus (b) the \$50 capital contribution made by *P* to enable *S* to buy 2 of the 5 *S1* shares, plus (c) the aggregate \$50 positive investment adjustment tiering up from *S1*'s sale of its raw land, divided by (2) the 5 outstanding *S* shares); (ii) *S*'s only assets are its patent (value and basis of \$0) and 2 of the 5 outstanding shares of *S1* stock (having an aggregate value of \$50 and an aggregate basis of \$100); (iii) *P* owns the other 3 shares of *S1* stock (having an aggregate value of \$75 and aggregate basis of \$150); and (iv) *S1*'s only asset is an *X* debt obligation with a value and basis of \$125.

At the beginning of Year 2, *P* sells all 5 shares of the stock of *S* to *Y* for \$50, resulting in *S*'s departure from the *P* group. The departure of *S* from the *P* group results in a "transfer" of all 5 shares of *S1* stock owned by *S* and *P* under Treas. Reg. § 1.1502-36(f)(10)(i)(B) because *P* and *S1* are no longer members of the same group, and *S* and *S1* likewise are no longer members of the same group. As a result, the basis reduction rule of Treas. Reg. § 1.1502-36(c)(2) is first applied to the *S1* shares. n7 The "disconformity amount" of each *S1* share under Treas. Reg. §§ 1.1502-36(c)(4) and (5) is determined to be \$25 (the amount by which the \$50 basis of the share exceeds 1/5th of the \$125 inside basis of *S1*'s assets). The "net positive adjustment" of each *S1* share under Treas. Reg. § 1.1502-36(c)(3) likewise is \$25. Accordingly, the adjusted basis of each *S1* share is reduced by \$25 (from \$50 to its \$25 value) as a result of *S1*'s departure from the *P* group in Year 2.

The aggregate \$50 reduction in the basis of the two *S1* shares held by *S* resulting from the application of Treas. Reg. § 1.1502-36(c)(2) constitutes a noncapital, nondeductible expense that tiers up under Treas. Reg. § 1.1502-32 and

is reflected as a negative investment adjustment of \$10 to the basis of each of the 5 shares of S stock owned by P immediately before the sale of those shares to Y. This reduces the adjusted basis of each of the 5 S shares by \$10 from \$25 to \$15 (for an aggregate basis of \$75). As a result, unless a reduction in the basis of the S shares is required under Treas. Reg. § 1.1502-36(c)(2), P recognizes a \$25 capital loss on the sale of the 5 S shares to Y for \$50.

The "disconformity amount" with respect to each of the 5 S shares is determined under Treas. Reg. §§ 1.1502-36(c)(4) and (5) to be the excess of the \$15 basis of the S share over \$10 (1/5th of the \$50 aggregate basis of the 2 S1 shares held by S), adjusted to reflect any gain or loss (\$0 here) recognized on the "transfer" of those S1 shares. As such, the "disconformity amount" with respect to each of the 5 S shares is \$5 (an aggregate of \$25). The "net positive adjustment" with respect to each of the 5 S shares is determined under Treas. Reg. § 1.1502-36(c)(3) to be \$0 (the \$10 positive adjustment in Year 1 resulting from the sale of the S1 raw land minus the \$10 negative adjustment in Year 2 resulting from the \$50 reduction under Treas. Reg. § 1.1502-36(c)(2) to the 2 shares of S1 stock owned by S). Since the basis reduction amount with respect to each S share is the lesser of \$5 (the disconformity amount) and \$0 (the net positive adjustment), no reduction to the basis of the S shares is required under Treas. Reg. § 1.1502-36(c)(2). Accordingly, P is allowed a \$25 capital loss on the sale of the S stock to Y. n8

Determination of S's Net Inside Attribute Amount Where S Owns Non-Transferred Stock of Lower-Tier Subsidiaries

If a loss share of S stock is transferred while S owns a share of stock of a lower-tier subsidiary (S1) that is not transferred in the same "transaction," n9 S's net inside attribute amount is determined by tentatively reducing the basis of the S1 share by its "tentative reduction amount," defined as the lesser of the S1 share's net positive adjustment and its disconformity amount. n10 If S directly or indirectly owns nontransferred shares of stock of subsidiaries in multiple tiers, the tentative reduction is first applied to the stock of the subsidiary or subsidiaries at the lowest tier and then successively to the stock of subsidiaries in each higher tier that is a lower tier to S. n11

The tentative reductions at each tier are treated as noncapital, nondeductible expenses that tier-up under the principles of Treas. Reg. § 1.1502-32 and are reflected as negative adjustments to the basis of shares of higher-tier subsidiaries. To prevent the tentative reduction rule of Treas. Reg. § 1.1502-36(c)(6) from applying to shares to which Treas. Reg. § 1.1502-36(c) applies without regard to the tentative reduction rule, (i) the tentative reduction rule does not apply to a share of S1 stock that is transferred in the same transaction, n12 and (ii) the tentative reduction rule applies to shares of a subsidiary in a tier below S1 only to the extent such shares are lower-tier to a nontransferred share of S1 stock. n13

Example 2: Non-transferred lower-tier shares. The facts are the same as Example 1 above, except that at the beginning of Year 2, P sells only one (20%) of the 5 shares of S stock to Y for its \$10 value. At the time of this sale, (i) the adjusted basis of each S share is \$25, \$10 of which is a positive investment adjustment tiering up through the 2 S1 shares held by S as a result of the \$125 gain recognized in Year 1 on the sale of S1's raw land; (ii) the adjusted basis of each of the 5 S1 shares is \$50, \$25 of which is a positive investment adjustment resulting from the \$125 of gain recognized by S1 on the Year 1 sale of its raw land; (iii) the only assets owned by S at the time of the Year 2 sale are a patent (value and basis of \$0) and 2 shares of S1 stock (aggregate value of \$50 and aggregate basis of \$100); and (iv) the only asset owned by S1 is an X debt obligation with a value and basis of \$125.

Unlike Example 1, in which sufficient stock of S is sold to Y to cause the departure of S and S1 from the P group, here the sale of only 1 share of S stock results in the departure of neither S nor S1 from the P group. As a result, there is no "transfer" of any of the S1 shares, whether owned by S or P, pursuant to Treas. Reg. § 1.1502-36(f)(10)(i)(B). Accordingly, Treas. Reg. § 1.1502-36(c)(2) does not apply to cause a reduction in the basis of any of the S1 shares.

However, Treas. Reg. § 1.1502-36(c)(6) does apply to require a reduction in the basis of the 2 shares of S1 stock owned by S by the "tentative reduction amount" for purposes of determining the disconformity amount with respect to the transferred S share. The "tentative reduction amount" for each S1 share is the lesser of its net positive adjustment

and its disconformity amount. As indicated in Example 1 above, the net positive adjustment as well as the disconformity amount for each *S1* share is the same amount—\$25. Consequently, for purposes of determining *S*'s net inside attribute amount, the total basis of the 2 *S1* shares held by *S* is deemed to be \$50 (post-positive investment adjustment basis of \$100 less the \$50 aggregate "tentative reduction amount" for both shares). Therefore, the disconformity amount for the 1 share of *S* stock sold to *Y* is \$15 (adjusted basis of \$25 minus 1/5th of \$50).

Netting Gains and Losses

Under Treas. Reg. § 1.1502-36(c)(7)(i), the basis reduction to an *S* share otherwise required by the basis reduction rule is reduced by the amount of any gain or income recognized by members on the transfer of *S* shares if (i) the *S* shares are transferred in one transaction (including a series of steps pursuant to a single plan or arrangement), and (ii) the gain or income is taken into account as of the time of the transaction. n14

Disallowance of Economic Loss and Allowance of Non-Economic Loss

Unfortunately, the basis reduction rule of Treas. Reg. § 1.1502-36(c) does not always allow a deduction for true economic losses in subsidiary stock, and there are also cases in which a taxpayer is permitted to deduct a non-economic loss in subsidiary stock. These cases arise primarily as a result of the government's rejection of tracing as unadministrable and, as a practical matter, are unavoidable.

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n1 Treas. Reg. § 1.1502-36(c)(1).

n2 Treas. Reg. § 1.1502-36(b).

n3 Treas. Reg. § 1.1502-36(c)(2).

n4 Treas. Reg. § 1.1502-36(c)(3). Thus, any investment adjustments for noncapital, nondeductible expenses resulting from attribute reattribution that are specially allocated under Treas. Reg. § 1.1502-32(c)(1)(ii)(A) are taken into account under the basis reduction rule but not the basis redetermination rule.

n5 Treas. Reg. § 1.1502-36(c)(4). A share's "allocable portion" is defined in Treas. Reg. § 1.1502-36(f)(1) to have the same meaning as set forth in Treas. Reg. § 1.1502-32(b)(4)(iii)(B) (i.e., a vertical slice of *S*'s attributes). Each share within the same class will have an identical allocable portion, and if there are two or more classes of outstanding stock, *S*'s net inside attribute amount must be attributed to the various classes by taking into account the terms of each class and any other factors relating to the overall economic arrangement.

n6 Treas. Reg. § 1.1502-36(c)(5).

n7 The basis reduction rule is first applied to the *S1* shares because Treas. Reg. §§ 1.1502-36(a)(3)(ii)(A), (B), and (C) provide that the basis reduction rule is applied from the lowest-tier level of transferred loss shares to the highest tier.

n8 The \$25 capital loss allowed to *P* on the sale of the *S* stock after the basis reduction amount is computed is attributable to the decline in value of *S*'s zero-basis patent from its \$25 value when *S* joined the *P* group (which value was reflected in *P*'s initial \$25 basis in the *S* stock) to \$0. Thus, clearly this amount of the *S* stock loss in Example 1 is economic and, hence, is properly allowed after the basis reduction amount under Treas. Reg. § 1.1502-36(c) is determined. However, this is not always true.

n9 As defined in Treas. Reg. § 1.1502-36(f)(9).

n10 Treas. Reg. § 1.1502-36(c)(6)(i) and (ii).

n11 Treas. Reg. § 1.1502-36(c)(6)(iii).

n12 Under Treas. Reg. § 1.1502-36(f)(10)(i)(B), *S1* shares held by *S* are deemed transferred on the date *S* and *S1* are no longer members of the same group. For example, if *M* transfers sufficient *S* shares to cause *S* to leave the *M* group while *S* owns less than 80% of the *S1* shares, *S* is treated as transferring its *S1* shares because *S* and *S1* are not members of the same consolidated group immediately after the transaction. If an actual basis reduction to the *S1* stock is required under Treas. Reg. § 1.1502-32(c), that basis reduction will tier up as a noncapital, nondeductible expense and be reflected as a negative adjustment to the basis of the *S* shares under Treas. Reg. § 1.1502-32(b)(3)(iii)(B) and (c)(1)(iii). This will both reduce the net positive adjustments to the *S* stock and reduce *S*'s net inside attribute amount.

n13 Treas. Reg. § 1.1502-36(c)(6)(iv).

n14 Unlike the netting rules in prior loss disallowance rules, the gain or income does not have to be taken into account with respect to a disposition of S shares in the same class (e.g., common stock or preferred stock) as the loss share. This makes sense in light of the fact that the basis reduction rule does not discriminate based on the class to which a share belongs.

RELATED LINKS: For further information, see

■ 3-73A Taxation of Corps Filing Consolidated Returns § 73A.04

and

■ Lexis Explanation IRC Sec. 1502

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California's Property Tax Change in Ownership Rules Governing Legal Entities

2010 Emerging Issues 5261

USC Gould School of Law 2010 Tax Institute: California's Property Tax Change in Ownership Rules Governing Legal Entities

By Peter B. Kanter and Richard S. Kinyon

August 16, 2010

SUMMARY: California Constitution Article XIII A, enacted by Proposition 13, limits real property tax to one percent of a property's "full cash value," plus certain outstanding "bonded indebtedness." California property is generally assessed at factored "base year value" or current fair market value, whichever is less. This commentary examines change in ownership rules governing legal entities, as well as how to apply the control test and step transaction.

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ARTICLE: I. Introduction

Until the adoption of Proposition 13 in 1978, California, like most states, assessed property at its current fair market value for property taxation purposes. Proposition 13 enacted Article XIII A of the California Constitution entitled "Tax Limitation" and generally limits the tax on real property to 1% of the property's "full cash value," plus certain outstanding "bonded indebtedness." These additions to the tax rate for bonded indebtedness are relatively limited and generally do not exceed 0.25%, so the overall rate, which will vary by county and even by district within each county, is usually between 1.00% and 1.25%. "Full cash value" is defined as the assessed value of the property for the 1975 tax year, or its fair market value on the date of a later change in ownership or new construction. This so-called "base year value" assessment can be increased by no more than 2% per annum or the annual increase in the Consumer Price Index, whichever is less.

Shortly after the passage of Proposition 13, Proposition 8 was passed by California voters. Proposition 8 added the additional limitation that in no event should property be assessed in any year at an amount above its current fair market value. Thus, in California today, property is generally assessed at the lesser of (1) its factored "base year value" and (2) its current fair market value.

The California Legislature enacted temporary implementation statutes that were generally effective for one year after Proposition 13 was passed, during which time the Legislature planned to consider and draft more permanent statutory provisions to carry out Article XIII A. The California State Board of Equalization (hereinafter the "SBE") promulgated regulations under the temporary statutes, including regulations on the term "change in ownership." To aid the Legislature in drafting more permanent legislation, a Task Force on Property Tax Administration (hereinafter the

"Task Force"), including representatives of the government and taxpayers, was appointed to make recommendations to the Legislature concerning the implementation of Article XIII A. The Task Force issued a report which formed the basis of the current statutory scheme. n1

The general definition of "change in ownership" envisioned by the Task Force is set forth in California Revenue and Taxation Code Section 60. n2 It provides: ***"change in ownership" means a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest.*** The Legislature also enacted several statutory provisions that follow R&TC § 60, which provide examples of particular types of transactions that either fall under the definition of "change in ownership" or are excluded from it. n3

Notably, the California Supreme Court in *Pacific Southwest Realty Co. v. County of Los Angeles* n4 has ruled that the general definition of what constitutes a change in ownership contained in R&TC § 60 is the overarching rule that must be met for any transaction to be deemed a change in ownership under Proposition 13. The court held that the statutory provisions that follow R&TC § 60 are merely examples of types of transactions that will, in most cases, meet that definition or are excluded from it. ***However, when there is a conflict between one of the exemplary provisions and Section 60, the court ruled, the overarching definition contained in Section 60 must govern over the specific examples in the provisions that follow.***

The exemplary statutory provisions, however, govern in most cases to determine whether a transaction has triggered a change in ownership. The SBE has also promulgated regulations implementing Article XIII A of the constitution and the related statutory provisions. n5

This Emerging Issues Analysis will examine the change in ownership rules governing legal entities, including the legislative history pertaining to these rules, the general rules with respect to legal entities and the exceptions under those rules, how to apply the control test when there is an acquisition of control of the stock of a parent corporation that triggers a change in ownership of its "controlled" subsidiaries, and how the step transaction may be applied to find a change in ownership.

II. Legal Entities

A. Legislative History of the Change in Ownership Rules for Legal Entities

Among the most controversial and complex rules in the change in ownership area are those governing legal entities. The controversies generally revolve around the issue of whether a legal entity should be treated as a separate taxpayer ("separate entity" theory) or whether the property tax law should "look through" the entity to the beneficial owners of the property (*i.e.*, those who own the interests in the legal entity - the "ultimate control" theory).

The Task Force recommended that the legislature adopt the separate entity theory both because it seemed more consistent with general state law and because it would reduce administrative and enforcement problems. The change in ownership rules ultimately adopted by the Legislature in the Revenue and Taxation Code do not follow a uniform approach to legal entities. Instead, the rules vary with the particular situation, in some instances applying an "ultimate control" theory, and in others applying a "separate entity" theory.

B. The General Rules and the Broad Exceptions

There are two "general rules" with respect to legal entities, both of which have several exceptions.

General Rule No. 1: Transfers of real property between legal entities, or between a legal entity and those who own interests in the entity (*e.g.*, a partnership and its partners), *are* changes in ownership. n6

General Rule No. 2: Transfers of interests in legal entities (*e.g.*, transfers of corporate stock or interests in a partnership or LLC) *are not* changes in ownership of the real property owned by the legal entity. n7

Exceptions to General Rule No. 1: There are two broad statutory exceptions to the general rule that transfers of real property to or from a legal entity are changes in ownership:

R&TC § 62(a)(2) provides that no change in ownership arises from any transfer between an individual or individuals and a legal entity or between legal entities, which results solely in a change in the method of holding title to the real property and in which proportional ownership interests of the transferors and transferees, whether represented by stock, partnership interest, or otherwise, in each and every piece of real property transferred, remain the same after the transfer. n8

For example, suppose A owns Blackacre worth \$1,000 and B owns Whiteacre, which is also worth \$1,000. A and B form an equal general partnership. If A and B each transfer their properties to the partnership, both properties will be deemed to have a change in ownership and will be fully reassessed. On the other hand, if A and B had owned both Whiteacre and Blackacre as 50-50 tenants in common, and then transferred both properties into their 50-50 general partnership (or corporation or LLC)-as long as their interests in the entity were equal to their tenancy in common interests in the transferred properties, the transfer of the properties to the legal entity should not constitute a change in ownership.

R&TC § 64(b) provides that transfers of real property between or among corporations that are members of an "affiliated group" before an after the transfer, including transfers in the course of a tax-free reorganization under Section 368 of the Internal Revenue Code, will not cause a change in ownership. "Affiliated group" is defined as one or more chains of corporations connected through stock ownership with a common parent corporation if both of the following conditions are met:

(1) One hundred percent of the voting stock, exclusive of any shares owned by directors, of each of the corporations, except the parent corporation, is owned by one or more of the other corporations.

(2) The common parent corporation owns, directly, 100 percent of the voting stock, exclusive of any shares owned by directors, of at least one of the other corporations.

Exceptions to General Rule No. 2: There are also two broad statutory exceptions to the general rule that transfers of interests in a legal entity will not cause a change in ownership of real property owned by the legal entity:

R&TC § 64(c) provides that a change in ownership of all real property owned by a legal entity shall occur whenever any person or other legal entity obtains "direct or indirect ownership or control" over the real estate-owning legal entity. For corporations, control is defined as more than 50% of the voting stock in the corporation. For partnerships and limited liability companies, control is defined as more than a 50% interest in *both* profits and capital of the partnership or LLC. For other legal entities, control is defined vaguely as simply "more than 50% of the total ownership interest." n9

R&TC § 64(d) provides that a change in ownership of real property owned by a legal entity is triggered if the legal entity obtained the property in a prior transaction that was excluded from a change in ownership under Section 62(a)(2), and thereafter, cumulatively more than 50% of the ownership interests in the legal entity (labeled under Section 64(d) as "original co-owner interests") have been transferred.

For Example: Suppose B, C and D hold Whiteacre as equal tenants in common. They transfer Whiteacre to an LLC in which they each hold exactly one-third of the voting interests. Pursuant to R&TC § 62(a)(2) the transfer of Whiteacre to the LLC will be excluded from a change in ownership reassessment because the proportional ownership interests in Whiteacre remain identical. B later transfers her LLC interest to E. No change in ownership occurs because no one has obtained control over the LLC; however, B's transfer will count toward the 50% threshold set by section 64(d) for transfers of "original co-owner interests." If C then transfers more than half of his voting interest in the LLC, this will cause cumulatively more than 50% of the original co-owner interests in the LLC to have been transferred since it acquired Whiteacre in the Section 62(a)(2) excluded transaction, and it will thus trigger a change in ownership under

Section 64(d).

Interplay Between R&TC §§ 62(a)(2), 64(d), and 64(b): As stated above, only real property that has previously received the exclusion provided by R&TC § 62(a)(2) is subject to R&TC § 64(d)'s special rule regarding the transfer of more than 50% of original co-owners' interests in a legal entity. However, transfers of real property between two 100% wholly-owned corporate subsidiaries, or between a parent corporation and its wholly owned corporate subsidiary, could be excluded from a change in ownership under both R&TC § 62(a)(2) (as a transfer from one entity to another in which the proportional ownership interests in the transferee were identical to those in the transferor) and R&TC § 64(b) (as a transfer between two members of a corporate affiliated group). However, if a transaction would be excluded under both R&TC § 62(a)(2) and R&TC § 64(b), the latter will apply rather than the former, and thus, the real property will not be subject to R&TC § 64(d)'s original co-owner rule. n10

A change in ownership can occur even though the transaction is a tax-free reorganization for income tax purposes. However, the Code specifically provides that stock transfers do not trigger a change in ownership for transactions that involve tax-free corporate reorganizations among wholly affiliated corporations. R&TC § 64(b). Courts have held that the affiliation requirement must be met both before and after the reorganization. n11

C. Acquisition of Control Over a Parent Entity Trickles Down

The control test applies so that the acquisition of control of the stock of a parent corporation also triggers a change in ownership of its "controlled" subsidiaries. Thus, in *Title Insurance & Trust Co. v. County of Riverside*, n12 the California Supreme Court ruled that acquisition of control in a parent entity (*e.g.*, more than 50% of the voting stock of the corporation) caused a change in ownership of the real property held by any subsidiaries of that entity in which the parent held directly or indirectly a majority controlling interest. The court reasoned that R&TC § 64(c)'s adoption of the definition of "control" contained in R&TC § 25105—which defines "control" as direct *or indirect* ownership or control of more than 50% of the voting stock of a corporation—meant that obtaining a parent corporation's stock effected a change in ownership of property held by all lower-tier subsidiaries through acquisition of *indirect* control of those subsidiaries.

The control test of R&TC § 25105 (which has now been included directly in the text of R&TC § 64(c)) does not look up the corporate chain to the "ultimate ownership" of the corporations to determine whether the transaction has in substance resulted in the acquisition of control by a new taxpayer. n13

D. Step Transaction Doctrine

The courts have applied the step transaction doctrine in several cases to find that a change in ownership has occurred even though the taxpayer was able to establish that no change in ownership (or only a partial one affecting a fraction of the property) occurred at each step in a transaction. The most often cited case, *Shuwa Investments Corp. v. County of Los Angeles*, n14 involved a transaction in which the taxpayer (Shuwa) acquired 100% of a building in a series of steps that, had the step transaction doctrine not been applied, would have led to only a 50% reassessment. The court of appeal found that under all of the three traditional tests the courts have used to apply the step transaction doctrine—interdependence of steps, binding commitment, and end result—the transfer of the building to Shuwa would meet the test. Thus, the court found that 100% of the building was subject to reassessment. Notably, the court found that the existence of a business purpose for the structure of the transaction did not preclude application of the step transaction doctrine, at least when the business purpose was not mandated by government regulation.

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n1 See Report of the Task Force on Property Tax Administration to the Assembly Revenue and Taxation

Committee, January 22, 1979 ("Task Force Report").

n2 All references to "R&TC" hereafter refer to the California Revenue and Taxation Code.

n3 *See* R&TC §§ 61 through 69.

n4 1 *Cal. 4th* 155 (1991).

n5 All references to "regulations" throughout this article refer to the regulations relating to Change in Ownership and New Construction in the California Code of Regulations, Title 18, Chapter 4, Article 4.

n6 R&TC § 61(j); 18 CCR 462.180(a).

n7 R&TC § 64(a); 18 CCR 462.180(c).

n8 *See also* 18 CCR 462.180(b)(2).

n9 18 CCR 462.180(d)(1).

n10 *See* R&TC § 62(a)(2).

n11 *See Sav-on Drugs, Inc. v. County of Orange*, 190 *Cal. App. 3d* 1611 (1987) (forward triangular merger did not qualify); *Pueblos del Rio S. v. City of San Diego*, 209 *Cal. App. 3d* 893 (1989) (divisive reorganization did not qualify).

n12 48 Cal. 3d 84 (1989).

n13 See *Kraft, Inc. v. County of Orange*, 219 Cal. App. 3d 1104 (1990) (a "double reverse triangular merger," whereby two corporations became wholly-owned subsidiaries of a new parent corporation, constituted a change in ownership even for the corporation whose shareholders obtained majority control in the new parent corporation, since the new parent corporation had obtained "direct" control over both corporations in the transaction). See also *Twentieth Century Fox Film Corp. v. County of Los Angeles*, 223 Cal. App. 3d 1158 (1990) (acquisition of stock of a target corporation by a group of investors through a special purpose subsidiary constituted a change in ownership even though no single person or entity of the investor group owned more than 50% of the voting stock of the acquiring corporation).

n14 1 Cal. App. 4th 1635 (1991).

RELATED LINKS: For a general overview of constitutional issues and policy concerns affecting real property taxation, see

■ 2-22 Bender's State Taxation: Principles and Practice 22.01

For discussion about real property transfers with property tax implications, see

■ 2-20 Bender's State Taxation: Principles and Practice 20.04

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Marc A. Countryman on the Unified Loss Rule and Attribute Reduction Rule

2010 Emerging Issues 5262

USC Gould School of Law 2010: Marc A. Countryman on the Unified Loss Rule and Attribute Reduction Rule of Treas. Reg. § 1.1502-36(d)

By Marc A. Countryman

August 16, 2010

SUMMARY: In the final installment of a series of articles on the Unified Loss Rule, Marc A. Countryman discusses the third prong of the Unified Loss Rule under Treas. Reg. § 1.1502-36(d). The attribute reduction rule is designed to further single entity principles by preventing a subsidiary (or lower-tier subsidiaries of S) from using losses or deductions to the extent the group or its members have used or preserved a corresponding loss in S shares.

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ARTICLE: In the final installment of a series of articles on the Unified Loss Rule, the Author discusses the third prong of the Unified Loss Rule under Treas. Reg. § 1.1502-36(d). The attribute reduction rule of Treas. Reg. § 1.1502-36(d) is designed to further single entity principles by preventing a subsidiary (or lower-tier subsidiaries of S) from using losses or deductions to the extent the group or its members have used (or preserved for future use) a corresponding loss in S shares. If a transferred S share remains a loss share after the basis of the share is adjusted under all applicable rules, the attribute reduction rule of Treas. Reg. § 1.1502-36(d) may reduce the attributes of S (or a lower-tier subsidiary of S) to the extent they duplicate a net loss on shares of S stock transferred by members in one transaction. See also:

- USC Gould School of Law 2010: Marc A. Countryman on the Unified Loss Rule: Basis Redetermination Rule of Treas. Reg. § 1.1502-36(b), *2010 Emerging Issues 5257* and
- USC Gould School of Law 2010: USC Gould School of Law 2010: Marc A. Countryman on the Unified Loss Rule: Basis Reduction Rule of Treas. Reg. § 1.1502-36(c), *2010 Emerging Issues 5260*.

While the provisions of the basis redetermination and reduction rules under Treas. Reg. § 1.1502-36(b) and (c) are complex, their complexity pales in comparison to that of the attribute reduction rules under Treas. Reg. § 1.1502-36(d). In order to further single entity principles by preventing a subsidiary, S (or lower-tier subsidiaries of S) from using losses or deductions to the extent the group or its members (including former members) have used (or preserved for future use) a corresponding loss in S shares, Treas. Reg. § 1.1502-36(d) reduces the attributes of S (or a lower-tier subsidiary of S) to the extent they duplicate a net loss on shares of S stock transferred by members in one transaction.

n1 The attribute reduction rule applies only if the transferred S share remains a loss share after making all adjustments

to its basis under all applicable rules, including the rules in Treas. Reg. § 1.1502-36(b), (c) and (d)(5)(iii) (negative S stock basis adjustment to reflect attribute reduction amounts of lower-tier subsidiaries of S).ⁿ² In addition, unless the common parent affirmatively elects to reduce attributes under Treas. Reg. § 1.1502-36(e)(5), attribute reduction does not occur if the aggregate attribution reduction amount in the transaction is less than 5% of the value of the S shares transferred by members in the transaction.ⁿ³

As is true of the basis redetermination and reduction rules, most of the complexity of the attribute reduction rule results from the government's efforts to be fair to taxpayers and not exact more attribute reduction than is required to further the anti-loss duplication policies of the rules. An excellent example of this is the attribute reduction ordering rules of Treas. Reg. § 1.1502-36(d)(4) in which shorter-lived attributes (capital loss carryovers), absent a contrary election by the taxpayer, are reduced before longer-lived attributes (NOL carryovers and deferred deductions) are reduced.

Definition of Attribute Reduction Amount

Treas. Reg. § 1.1502-36(d)(3)(i) defines "attribute reduction amount" to be the *lesser of*:

- The "net stock loss" (defined in Treas. Reg. § 1.1502-36(d)(3)(ii) as the aggregate value over aggregate basis of all S shares, both gain and loss shares, transferred in the transaction), and
- S's "aggregate inside loss."

S's "aggregate inside loss" is the excess of (1) S's net inside attribute amount (as defined in Treas. Reg. § 1.1502-36(c)(5) but determined without regard to the tentative reduction rule of Treas. Reg. § 1.1502-36(c)(6) should S directly or indirectly own stock of one or more lower-tier subsidiaries),ⁿ⁴ over (2) the value of all outstanding shares of S stock.ⁿ⁵

Example 1: *Computation of attribute reduction amount-transfer of all S shares.* M owns all 100 shares of S stock (all common stock), with a \$2 basis in each share. S owns land with a basis of \$100, has a \$120 loss carryover, and has no liabilities. Each S share has a value of \$1. M sells 30 of the S shares to X for \$30. As a result of the sale, M and S cease to be members of the same group. Accordingly, all 100 shares of S are transferred.ⁿ⁶ M's transfer of the S shares is a transfer of loss shares and thus subject to the Unified Loss Rule.

There is no basis redetermination under Treas. Reg. § 1.1502-36(b) because there is no disparity among M's bases in the shares of S stock. In addition, no adjustment is required under the basis reduction rule of Treas. Reg. § 1.1502-36(c) because the net positive adjustment to the S shares is \$0. Thus, after the application of both of those rules, M's transfer of the S shares is still a transfer of loss shares. Accordingly, the transfer is subject to the attribute reduction rule of Treas. Reg. § 1.1502-36(d).

Under the attribute reduction rule, S's attributes are reduced by S's attribute reduction amount. S's attribute reduction amount is the lesser of (i) the net stock loss and (ii) S's aggregate inside loss. The net stock loss is the excess of the \$200 aggregate bases of the transferred shares over the \$100 aggregate value of the transferred shares, or \$100. S's aggregate inside loss is the excess of its \$220 net inside attribute amount (the sum of the \$100 basis in the land and the \$120 loss carryover) over the \$100 value of all outstanding S shares, or \$120. The attribute reduction amount thus is the lesser of (i) the \$100 net stock loss and (ii) the \$120 aggregate inside loss. Accordingly, the attribute reduction amount is \$100.ⁿ⁷

Example 2: *Computation of attribute reduction amount-transfer of less than all S shares.* The facts are the same as in Example 1, except that M sells only 20 S shares to X. M's sale of the 20 S shares is a transfer of loss shares and therefore is subject to the Unified Loss Rule.ⁿ⁸

No adjustment is required under the basis redetermination rule of Treas. Reg. § 1.1502-36(b) or the basis reduction

rule of Treas. Reg. § 1.1502-36(c) for the reasons stated in Example 1. Thus, after the application of those rules, *M*'s transfer of the 20 *S* shares continues to be a transfer of loss shares and thus is subject to the attribute reduction rule of Treas. Reg. § 1.1502-36(d).

Under the attribute reduction rule, *S*'s attributes are reduced by *S*'s attribute reduction amount. *S*'s attribute reduction amount is the lesser of (i) the net stock loss and (ii) *S*'s aggregate inside loss. The net stock loss is \$20 (the excess of the \$40 aggregate basis of the transferred shares over the \$20 aggregate value of such shares). *S*'s aggregate inside loss is \$120, the excess of *S*'s \$220 net inside attribute amount (the sum of *S*'s \$100 basis in the land and *S*'s \$120 loss carryover) over the \$100 value of all outstanding *S* shares. Accordingly, the attribute reduction amount is \$20. n9

Special Attribute Imputation Rule for Stock of Lower-Tier Subsidiaries

In determining *S*'s net inside attribute amount for purposes of Treas. Reg. § 1.1502-36(d), a special attribute imputation rule found in Treas. Reg. § 1.1502-36(d)(5)(i) applies with respect to lower-tier subsidiaries of *S*. n10 Under this special rule, all of the *S1* shares owned by *S* on the date of the transfer of *S* stock (including any *S1* shares transferred in the same transaction) are treated as a single share of stock. n11 Further, this deemed single share of *S1* stock is treated as having a basis equal to its "deemed basis," which is the greater of (i) the sum of the adjusted bases of each actual share of *S1* stock owned by *S* (including transferred and non-transferred *S1* shares, with such basis being adjusted to reflect any gain or loss recognized with respect to *S1* shares transferred in the transaction), n12 and (ii) the portion of *S1*'s net inside attribute amount allocable to the shares of *S1* stock owned by *S*. n13 If there are multiple tiers of subsidiaries in which *S* directly and indirectly owns subsidiary stock, the computation of deemed basis begins with the stock of the lowest-tier subsidiary and is then made sequentially up the chain. n14 Thus, *S1*'s deemed basis in its deemed single share of *S2* stock is included in *S1*'s net inside attribute amount for purposes of computing *S*'s deemed basis in its deemed single share of *S1* stock. *S*'s deemed basis in its deemed single share of *S1* stock is then used to determine *S*'s net inside attribute amount for purposes of the attribute reduction rules in Treas. Reg. § 1.1502-36(d). n9

Much of the complexity in the attribute reduction rules results from the fact that they both measure *S*'s loss duplication by reference to the greater of the basis of its *S1* stock and the *S1* stock's allocable portion of *S1*'s net inside attribute amount and tier down any *S* attribute reduction amount allocated to the *S1* share into *S1*'s attributes. However, according to the preamble to *T.D. 9424*, the government was unwilling to eliminate the special lower-tier rules of Treas. Reg. § 1.1502-36(d)(5) and focus solely on *S1* stock basis or *S1* inside attributes because loss duplication may occur as a result of both *S1* stock basis and *S1* inside attributes, and because the amount of loss duplication resulting from *S1* stock basis may differ from the amount of loss duplication resulting from *S1* inside attributes. n15

Allocation and Apportionment of Attribute Reduction Amount

In General. In determining the manner in which *S*'s attribute reduction amount is allocated among *S*'s attributes, Treas. Reg. § 1.1502-36(d)(4)(i) first divides *S*'s attributes into four categories:

- *Category A* consists of *S*'s capital loss carryovers. The preamble to *T.D. 9424* states that the reason capital loss carryovers are the first category to be reduced under the default allocation method is because they have a shorter lifespan than net operating loss carryovers. This is a welcome change from the proposed Unified Loss Rule, which placed *S*'s net operating loss carryovers in Category A. n16
- *Category B* consists of *S*'s net operating loss carryovers.
- *Category C* consists of *S*'s deferred deductions (e.g., loss deductions deferred under Treas. Reg. § 1.1502-13 or Section 267(f), suspended passive activity losses).
- *Category D* consists of the basis of all *S* assets other than Class I assets (cash and cash equivalents) described in Treas. Reg. § 1.338-6(b)(1). The reason for the exclusion of Class I assets is that cash can never have a basis less than its face amount.

S's attribute reduction amount is first applied to reduce or eliminate the attributes in Categories A, B and C, with any excess attribute reduction amount then being allocated to Category D. n17 However, if the total attribute reduction amount is less than the total amount of attributes in Categories A, B and C, P may specify the manner in which the attribute reduction amount is allocated among the attributes in those categories by following the procedure in Treas. Reg. § 1.1502-36(e)(5). n18 If P does not specify the manner for allocating the attribute reduction amount among the attributes in Categories A through C, the default allocation method is to first allocate the amount to Category A (capital loss carryovers, and sequentially among them from oldest to youngest until all are eliminated), then to Category B (net operating loss carryovers, and sequentially among them from oldest to youngest until all are eliminated), and then to Category C (deferred deductions, and among them presumably in proportion to the relative amounts of the deferred deductions). Thus, the default allocation method goes from short-lived attributes to longer-lived attributes and then to attributes with no expiration period. n19

Allocation Where Attribute Reduction Amount Exceeds Category A Through C Attributes. If S's attribute reduction amount exceeds the sum of the attributes in Categories A through C, the balance is allocated among the Category D attributes (i.e., asset basis). n20 To minimize the significance of the location of Category D attributes (i.e., basis of assets held directly by S or held by subsidiaries that are lower tier to S), the remaining attribute reduction amount to be allocated to S's Category D attributes is first allocated between S's basis in any stock of lower-tier subsidiaries and S's basis in other assets (the "non-stock Category D attributes"). n21 This initial allocation of S's remaining attribute reduction amount between S's basis in any stock of lower-tier subsidiaries and S's basis in the non-stock Category D attributes is made based on relative basis (using a modified version of S's deemed basis in the stock of each lower-tier subsidiary).

The amount allocated to S's non-stock Category D attributes is allocated to S's bases in its individual non-stock assets under a "reverse residual method" n22 as follows:

- First, to S's Class VII assets described in Treas. Reg. § 1.338-6(b)(2)(vii) (goodwill and going concern value). If the attribute reduction amount allocated to S's non-stock Category D attributes is less than S's aggregate basis in its Class VII assets (if any), it is applied to reduce S's basis in such assets proportionately (by basis). If the attribute reduction amount allocated to S's non-stock Category D attributes equals or exceeds S's aggregate basis in its Class VII assets (if any), it is applied to eliminate any basis S has in such assets. n23
- Any remaining amount is allocated to S's aggregate basis in its Class VI assets described in Treas. Reg. § 1.338-6(b)(2)(vi) (Section 197 intangibles other than goodwill and going concern value) (if any), and applied to reduce S's basis in such assets in the same manner. This process is then repeated sequentially with respect to S's basis in any Class V assets described in Treas. Reg. § 1.338-6(b)(2)(v) (all assets other than those in Classes I through IV, VI and VII, including real estate and property, plant, and equipment (PP&E)), Class IV assets described in Treas. Reg. § 1.338-6(b)(2)(iv) (inventory), Class III assets described in Treas. Reg. § 1.338-6(b)(2)(iii) (mainly mark-to-market assets and debt instruments), and Class II assets described in Treas. Reg. § 1.338-6(b)(2)(ii) (actively traded securities and commodities as well as foreign currency and certificates of deposit). n24

The preamble to T.D. 9424 indicates the reasons basis reduction works inversely to the residual basis allocation rules of Sections 338 and 1060 work are (i) it is easily administrable and (ii) loss duplication is more likely to be reflected in assets located in the higher asset classes (e.g., intangible assets, and PP&E) than in the lower asset classes (e.g., inventory, marketable securities, certificates of deposit, etc.).

Special Rules for Lower-Tier Subsidiaries. S's attribute reduction amount remaining after being allocated and applied to reduce S's Category A through C attributes is allocated between S's basis in lower-tier subsidiary stock and S's basis in the non-stock Category D attributes based on relative basis. Solely for purposes of this allocation, S's non-stock Category D attributes (basis in assets other than lower-tier subsidiary stock) are treated as aggregated into a single asset (the non-stock Category D asset) with a basis equal to S's aggregate basis in its assets other than lower-tier subsidiary stock, and S's stock in each lower-tier subsidiary is treated as a separate deemed single share with a basis equal to S's

deemed basis, subject to certain adjustments. For purposes of this allocation, S's deemed basis in each deemed single share of lower-tier subsidiary stock is treated as reduced by the aggregate of (i) the sum of the value of any S1 shares transferred by S (presumably in the same transaction), plus (ii) S's nontransferred S1 shares' allocable portion of any excess of S1's "non-loss assets" over its liabilities (including any liabilities not taken into account for tax purposes). n25 For this purpose, S1's "non-loss assets" are (a) the amount of its Class I assets defined in Treas. Reg. § 1.338-6(b)(1) (i.e., cash and cash equivalents), (b) the value of any shares of lower-tier subsidiary stock transferred by S1 (presumably in the same transaction), and (c) S1's nontransferred shares of lower-tier subsidiary stock's allocable portion of any excess of any further lower-tier subsidiary's non-loss assets over its liabilities. n26

The portion of S's remaining attribute reduction amount allocated to S's non-stock Category D asset is allocated among and applied to reduce S's basis in its individual assets other than lower-tier subsidiary stock under the reverse residual method described above. The portion of S's remaining attribute reduction amount allocated to each of S's deemed single shares of lower-tier subsidiary stock is apportioned among, and potentially applied to reduce, S's basis in the individual shares of lower-tier subsidiary stock owned by S in the manner described below. n27

■ *Apportionment of attribute reduction amount among S's actual S1 shares.* To the extent an attribute reduction amount is allocated to each of S's deemed single shares of lower-tier subsidiary stock, that allocated amount is apportioned among S's actual shares of S1 stock in accordance with the following specific rules. First, no amount is apportioned to any of S's shares of S1 stock that are transferred in a recognition transfer. n28 If S owns shares of S1 stock that are not transferred in a recognition transfer, the amount of attribute reduction allocated to S's deemed single share of such lower-tier subsidiary stock is apportioned among S's actual shares of such lower-tier subsidiary stock in a manner similar to the allocations required by Treas. Reg. § 1.1502-36(b)(2). Specifically, this amount is apportioned among S's actual shares of the lower-tier subsidiary's stock in a manner that first reduces loss in and, to the greatest extent possible, basis disparity among S's shares of preferred stock in the lower-tier subsidiary, and then reduces, to the greatest extent possible, basis disparity among S's shares of common stock in the lower-tier subsidiary (other than those transferred in a recognition transfer). n29

The amount apportioned to an individual share of lower-tier subsidiary stock is then applied to reduce S's basis in the share, subject to certain limitations. An attribute reduction amount apportioned to an individual share of lower-tier subsidiary stock that is either a preferred share or a common share that is transferred other than in a recognition transfer is applied to reduce S's basis in the share, but not below value. n30 An attribute reduction amount apportioned to an individual common share of lower-tier subsidiary stock that is not transferred is applied to reduce S's basis in the share without limitation. n31 To the extent an attribute reduction amount apportioned to an individual share of lower-tier subsidiary stock is not applied to reduce S's basis in the share, it has no impact on S's attributes and is not treated as a noncapital, nondeductible amount. n32 However, the portion of S's attribute reduction amount allocated to S's shares of a lower-tier subsidiary's stock may impact the lower-tier subsidiary's attributes even if such attribute reduction amount was not apportioned to or applied to reduce S's basis in the lower-tier subsidiary's stock. n33

■ *Tier-down of attribute reduction amount into S1 attributes.* The attribute reduction amount allocated to each deemed share of S1 stock (the "tier-down attribute reduction amount") is added to any attribute reduction amount determined for any transferred S1 shares (the "direct attribute reduction amount"), and the total of the two amounts then becomes an attribute reduction amount for S1 that must be allocated among its attributes as provided in Treas. Reg. § 1.1502-36(d)(4) and (5). n34 However, the amount of the attribute reduction amount that may tier down and reduce S1 attributes is limited by the "conforming limitation" unless P elects not to apply the limitation.

■ *The "conforming limitation."* Under the "conforming limitation" of Treas. Reg. § 1.1502-36(d)(5)(v)(B), unless P opts out of the limitation via an election under Treas. Reg. §§ 1.1502-36(d)(5)(v)(B) and (e)(5), S1's tier-down attribute reduction amount cannot exceed the excess of:

The portion of S1's net inside attribute amount allocable to all S1 shares held by all members as of the time of the

transaction, over

The sum of (i) *S1*'s direct attribute reduction amount resulting from a transfer of *S1* shares; plus (ii) the total value of all *S1* shares transferred by members in recognition transfers that are part of the same transaction; plus (iii) the sum of all members' bases (after any reduction under the ULR, e.g., as a result of Treas. Reg. § 1.1502-36(b), (c) or (d)) in *S1* shares transferred in the transaction other than in a recognition transfer, reduced by any direct attribute reduction amount resulting from the transfer of such *S1* shares; plus (iv) the sum of all members' bases (after any reduction under the ULR, e.g., as a result of Treas. Reg. § 1.1502-36(b), (c) or (d)) in any *S1* shares that are not transferred and are held by members as of the time of the transaction.

According to the preamble to *T.D. 9424*, the "conforming limitation" was devised to mitigate over-reductions in *S1* attributes when the loss duplication resulting from the basis of *S1* stock is greater than the loss duplication resulting from the stock's allocable portion of *S1*'s net inside attributes. For example, if a transfer of *S* stock requires an *S* attribute reduction amount to be allocated to one or more non-transferred shares of *S1* common stock (its only class of outstanding stock) owned by *S*, the "conforming limitation" ensures that the tier-down attribute reduction amount doesn't exceed the loss duplication in the transferred *S* shares that is attributable to *S1*'s net inside attribute amount. In the preamble, the government also observed that loss duplication can occur as a result of the conforming limitation when lower-tier stock reflects artificial loss.

■ **The stock basis restoration rule.** Any reduction in the basis of *S1* shares required by Treas. Reg. § 1.1502-36(d)(5)(iii) is reversed to an amount that conforms the basis of each of those shares to its allocable portion of *S1*'s net inside attribute amount (determined after Treas. Reg. § 1.1502-36(d)(5)(i) through (v) have been applied to reduce *S1*'s net inside attribute amount).ⁿ³⁵ Basis restoration computations are made sequentially from the lowest to the highest tier, and adjustments to the basis of a lower-tier subsidiary's stock do not tier up as positive adjustments to the basis of stock of a higher-tier subsidiary. Instead, basis restoration is separately determined and applied at each tier. Also, for purposes of determining a subsidiary's net inside attribute amount, (i) the subsidiary's basis in the stock of a lower-tier subsidiary is the actual basis of the stock after all adjustments to that basis required by Treas. Reg. § 1.1502-36(d)(5) have been made, and (ii) any attribute reduction amount allocated to the subsidiary's Category D attributes (other than lower-tier subsidiary stock) that is suspended under Treas. Reg. § 1.1502-36(d)(4)(ii)(C)(1) is treated as reducing the subsidiary's net inside attribute amount. According to the preamble to *T.D. 9424*, the basis restoration rule is needed to avoid an over-reduction in stock basis when the loss duplication caused by *S1*'s net inside attribute amount is greater than the loss duplication caused by the adjusted basis of the *S1* stock.

Suspension of Attribute Reduction Amount. A special rule in Treas. Reg. § 1.1502-36(d)(4)(ii)(C)(1) applies if both (i) the attribute reduction amount allocable to Category D assets exceeds the aggregate amount of attributes in that category, and (ii) *S* has liabilities (such as contingent environmental, reclamation, tort, breach of contract, or other similar liabilities) that are not taken into account for tax purposes prior to the transfer and that, when taken into account for tax purposes, will result in either a deductible expense or asset basis.ⁿ³⁶ If both these conditions exist, the excess attribute reduction amount is suspended until the liabilities are taken into account for tax purposes by *S* "or any other person," at which time or times the suspended attribute reduction amount is applied proportionately to reduce amounts "attributable to " that are deductible or capitalizable. A few observations are appropriate here:

- First, if the accrual and economic performance of the liability results in both a deductible amount (presumably a Category B or C attribute) and asset basis (a Category D attribute) when performance occurs, it may be that each is reduced proportionately. If so, such proportionate application of the suspended attribute reduction amount would differ from the sequential application required by Treas. Reg. § 1.1502-36(d)(4)(ii)(A) and (B), which would eliminate the deductible amount before reducing the asset basis.
- Second, the suspension is indefinite and, hence, may result in future attribute reductions following numerous changes in the ownership of the *S* stock. This imposes a significant administrative burden on buyers and sellers to maintain

sufficient books and records to track the suspended attribute reduction amount. Nonetheless, in the preamble to *T.D. 9424* the government observes that the concern about loss duplication via contingent liabilities, together with the fact that the final regulations (unlike the proposed) do not include marketable securities as well as cash and cash equivalents in the assets that can result in a suspended attribute reduction amount, override the administrability concerns.

■ Third, there is no limitation of the suspended attribute reduction amount to the fair market value or present value of the *S* liabilities. Thus, a contingent liability may result in a suspended attribute reduction amount even if all that has occurred by the date of the transfer is the event or events necessary to establish the fact of the liability (e.g., someone slipped and fell). Interestingly, Treas. Reg. § 1.1502-36(d)(4)(ii)(C)(2) provides that if the attribute reduction amount exceeds *S* liabilities described in Treas. Reg. § 1.1502-36(d)(4)(ii)(C)(1), the excess is disregarded and has no further effect. Given the absence on any limitation of the suspended attribute reduction to the fair market value or present value of the *S* liabilities, presumably one will not know whether any excess attribute reduction amount expires with no effect until all contingent liabilities at the time of the transfer have been settled.

■ Finally, future attribute reduction resulting from a suspended attribute reduction amount under Treas. Reg. § 1.1502-36(d)(4)(ii)(C)(1) is in addition to any reduction in *S* stock basis required under Section 358(h)(1) in connection with a Section 351 exchange in which *S* assumes a contingent liability.

Timing and Effect of Attribute Reduction. Any reduction in the attributes of *S* under Treas. Reg. § 1.1502-36(d) is effective immediately before the transfer of the *S* loss share. n37 Any reduction to the basis of *S1* stock, to the extent not reversed under Treas. Reg. § 1.1502-36(d)(5)(vi), may create an excess loss account ("ELA") in the *S1* stock; however, the ELA is not triggered as a result of the transaction causing the *S1* stock basis reduction. n38 Any reductions caused by the attribute reduction amount are not noncapital, nondeductible expenses for purposes of the investment adjustment system. n39

Elections Reducing Duplicated Loss Potential

In General. To mitigate attribute reduction in connection with a transfer of *S* loss shares, *P* is provided three options under Treas. Reg. § 1.1502-36(d)(6)(i):

- *P* may reduce all or part of a member's basis in transferred loss shares of *S* stock (including an election to reduce basis in excess of a specified amount).
- *P* may reattribute all or part of the Category A through C attributes of *S* or lower-tier subsidiaries (including an election to reattribute such attributes in excess of a specified amount) to the extent such attributes otherwise would be eliminated under Treas. Reg. § 1.1502-36(d).
- *P* may elect any combination of the foregoing.

An election to reduce *S* stock basis and/or reattribute attributes to *P* is made as provided in Treas. Reg. § 1.1502-36(e)(5). However, even though the election is irrevocable, it has no effect if either there is no attribute reduction amount or the attribute reduction amount is less than the amount specified in the election. n40 The preamble to *T.D. 9424* indicates that both allowing taxpayers to stipulate an amount above which a stock basis reduction and/or reattribution election applies and not giving the election effect if there is no stock loss or attributes to which it would apply are intended to encourage taxpayers to make "protective" stock basis reduction and reattribution elections.

In addition, the preamble to *T.D. 9424* indicates the government was concerned that a permanently disallowed *S* stock loss (e.g., under Section 311(a)) may inadvertently cause a reduction in *S*'s attributes under Treas. Reg. § 1.1502-36(d)(3) and (4). To prevent that from happening, Treas. Reg. § 1.1502-36(d)(6)(v)(C) provides that, where the *S* stock loss is permanently disallowed, *P* is deemed to have made a stock basis reduction election equal to the net loss in the *S* stock, which in turn reduces the *S* attribute reduction amount under Treas. Reg. § 1.1502-36(d)(6)(v)(B).

Limitations. There are several limitations on the election to reduce *S* stock basis and/or reattribute attributes to *P*.

- The election of one of the three options is limited in the aggregate to the tentative amount of attribute reduction that would occur absent an election under Treas. Reg. § 1.1502-36(d)(6). n41
- An election to reattribute *S* attributes in Categories A through C can be made only if, as a result of the transaction, *S* becomes a nonmember of the group within the meaning of Treas. Reg. § 1.1502-19(c)(2) (i.e., *S* leaves the group and either joins another group or files a separate return) and does not join another group of which *P* is also a member. n42 This makes sense because the purpose of the reattribution election is to permit the *P* group to retain *S* attributes, not merely shift them from *S* to *P*.
- If *S* and/or any higher-tier subsidiary is insolvent within the meaning of Section 108(d)(3), attributes in Categories A through C may be reattributed to *P* only to the extent the aggregate amount of all those attributes exceeds the sum of the separate insolvencies of *S* and higher-tier subsidiaries. For this purpose, *S* preferred stock is treated as a liability to the extent of its preferred distributions, and any *S* preferred stock or liability held by or owed to higher-tier members is disregarded. n43
- Any attributes of a lower-tier subsidiary that (absent reattribution) would be reduced by a tier-down attribute reduction amount under Treas. Reg. § 1.1502-36(d)(5)(v) may be reattributed only to the extent the noncapital, nondeductible expense resulting from the reattribution does not create an ELA in any stock. n44

Special Rules: Order and Timing . If stock of a single subsidiary is transferred, any basis reduction election and any negative investment adjustment under Treas. Reg. § 1.1502-32(c)(1)(ii)(A)(1) resulting from a reattribution election is deemed to occur before any other provision of Treas. Reg. § 1.1502-36(d) applies. If the *S* share remains a loss share, the remaining provisions of Treas. Reg. § 1.1502-36(d) apply. n45

If elections under Treas. Reg. § 1.1502-36(d)(6) are made for multiple tiers and shares of more than one subsidiary are transferred, all applicable rules of Treas. Reg. § 1.1502-36 (starting with basis redeterminations and reductions) are applied sequentially from the lowest to the highest tier, and any stock basis reductions or negative investment adjustments from reattribution elections under Treas. Reg. § 1.1502-32(c)(1)(ii)(A)(2) tier up and are reflected in higher-tier stock before elections and adjustments are made with respect to transfers at the next higher tier. n46

If *P* fails to specify in its election the attributes to be reattributed, as is permitted under Treas. Reg. § 1.1502-36(d)(6)(ii), the attributes are reattributed in the default amount, order and categories set forth in Treas. Reg. § 1.1502-36(d)(4)(ii)(A)(1). n47

Special Rules: Stock Basis Reductions. A stock basis reduction election has the following effects: (i) the amount of the reduction is allocated among all loss shares of *S* stock transferred in the transaction in proportion to the loss in each share; n48 (ii) the amount of the reduction, in addition to reducing the basis of transferred loss shares of *S*, reduces the attribute reduction amount determined under Treas. Reg. § 1.1502-36(d)(3)(i); n49 and (iii) the amount of the stock basis reduction is a noncapital, nondeductible expense for investment adjustment purposes. n50 In addition, if (a) there is a net stock loss in all transferred *S* shares after taking into account all elections under Treas. Reg. § 1.1502-36(d)(6) actually made with respect to the shares, and (b) the stock loss would otherwise be permanently disallowed (e.g., under Section 311(a)), then *P* is deemed to have made a stock basis reduction election in an amount equal to the net loss. n51 The preamble to *T.D. 9424* indicates the deemed election rule was added to prevent a permanently disallowed *S* stock loss (e.g., under Section 311(a)) from inadvertently causing a reduction in *S*'s attributes under Treas. Reg. § 1.1502-36(d)(3) and (4).

Special Rules: Section 382 Consequences of Reattribution. *P* succeeds to the reattributed attributes as if a Section 381(a) transaction had occurred, and any shift in the ownership of *S* stock within the meaning of Section 382(g) (including a deemed ownership change under Section 382(g)(4)(D) or Section 382(l)(3)) occurring as a result of the transaction is not taken into account with respect to the reattributed attributes. n52 However, the following special rules under Section 382 apply:

- If the reattributed attributes are subject to a Section 382 limitation as a result of a prior ownership change, Treas. Reg. § 1.1502-96(d)(2) ensures that the limitation continues to apply.
- Any owner shift under Treas. Reg. § 1.382-2(a)(1)(ii) with respect to the stock of *S* occurring as a result of both the reattribution election (turning *P* into an *S* successor) and the ownership of *S* stock by a minority shareholder is taken into account under Treas. Reg. § 1.1502-96(d)(3) as if that shift in the ownership of the *S* stock to the minority shareholder had occurred before the reattribution.
- If the reattributed attribute is a pre-change separate attribute of a new loss member subject to a Section 382 or Section 383 limitation, unless *P* elects under Treas. Reg. § 1.1502-96(d)(5) to apportion some or all of the limitation to *P*, the limitation on the reattributed attribute will be \$0 under Treas. Reg. § 1.1502-96(d)(4)(i). A similar rule applies if the reattributed attribute is subject to a loss subgroup Section 382 or Section 383 limitation and *P* is not a member of the loss subgroup. n53 In addition, if the reattributed attribute is a pre-change separate attribute of a new loss member or member of a loss subgroup, the deemed Section 381(a) transaction into *P* is treated as a capital contribution for purposes of Section 382(l)(1), and hence may result in a reduction in the applicable Section 382 or Section 383 limitation. n54 Generally, the reduction would be by whatever amount is required to reduce the value of *P*'s stock to the value of the stock of *S* or the loss subgroup parent. n55
- Finally, in accordance with the principles of Treas. Reg. § 1.1502-95(c) (which govern the manner in which a consolidated Section 382 limitation is allocated where one or more members leave the group with limited NOLs), *P* may elect to apportion to itself all or part of any separate Section 382 limitation (or subgroup Section 382 limitation) to which the reattributed NOL is subject immediately before the reattribution; however, this allocation is limited to the value component and/or carryover component and does not include any net unrealized built-in gain of *S* or its loss subgroup. n56

Elimination of Attributes on Worthlessness

Complimenting the new attribute elimination rule for worthless "gain" shares in Treas. Reg. § 1.1502-19(b)(1)(iv), Treas. Reg. § 1.1502-36(d)(7)(i) provides that any of *S*'s Category A through C attributes that are not otherwise reduced or reattributed under Treas. Reg. § 1.1502-36(d), and any credit carryovers attributable to *S* (including consolidated credits allocable to *S* under the principles of Treas. Reg. § 1.1502-79 if *S* had a separate return year) are eliminated if either of the following "transfers" occurs:

- An *S* share held by *M* is transferred solely as a result of the share becoming worthless under Section 165 and Treas. Reg. § 1.1502-80(c), *M* recognizes a net deduction as a result of such worthlessness, and *S* remains a member of the group on the day following the last day of the taxable year during which the *S* share becomes worthless. n57
- *M* recognizes a net deduction or loss on the stock of *S* in a transaction in which *S* ceases to be a member and does not become a nonmember within the meaning of Treas. Reg. § 1.1502-19(c)(2). n58 *S* becomes a nonmember within the meaning of Treas. Reg. § 1.1502-19(c)(2) after leaving the *M* group only if *S* has a separate return year, including a year as a member of another consolidated group.

Attributes other than consolidated attributes are eliminated immediately before the "transfer," whereas consolidated attributes are eliminated as provided in other consolidated return regulations (e.g., Treas. Reg. § 1.1502-21(b)(2) allocates a consolidated NOL carryover to *S* only to the extent it remains at the end of the year of *S*'s departure from the group). n59 The elimination of *S* attributes under Treas. Reg. § 1.1502-36(d)(7) is not a noncapital, nondeductible expense for investment adjustment purposes. n60 Treas. Reg. § 1.1502-36(d)(7)(iii) sets forth examples of the attribute elimination rule.

Return to Text

n1 Treas. Reg. § 1.1502-36(d)(1).

n2 Treas. Reg. § 1.1502-36(d)(2)(i).

n3 Treas. Reg. § 1.1502-36(d)(2)(ii).

n4 Treas. Reg. § 1.1502-36(d)(3)(iii)(B) defines *S*'s net inside attribute amount for purposes of the attribute reduction rule.

n5 Treas. Reg. § 1.1502-36(d)(3)(iii)(A).

n6 *See* Treas. Reg. §§ 1.1502-36(f)(10)(i)(A), (B), and (C).

n7 *See* Treas. Reg. § 1.1502-36(d)(8), *Ex. 1*.

n8 Treas. Reg. § 1.1502-36(f)(10)(i)(A) and (C). There is no transfer of the remaining shares because *M* continues to own such remaining shares and *M* and *S* remain members of the same group.

n9 Treas. Reg. § 1.1502-36(d)(8), *Ex. 2*.

n10 Treas. Reg. § 1.1502-36(d)(3)(iv). This special attribute imputation rule is in lieu of the lower-tier tentative reduction rule of Treas. Reg. § 1.1502-36(c)(6) that applies in determining *S*'s net inside attribute amount for purposes of the basis reduction rule of Treas. Reg. § 1.1502-36(c). The tentative reduction rule of Treas. Reg. § 1.1502-36(c)(6) is not applicable for purposes of determining *S*'s net inside attribute amount under Treas. Reg. § 1.1502-36(d)(3)(iii)(B) because the purpose of the attribute reduction rule is to eliminate loss duplication, whereas the purpose of the basis reduction rule of Treas. Reg. § 1.1502-36(c) is to disallow artificial stock loss. Thus, rather than tentatively reducing the basis of *S1* shares held by *S*, it makes better sense to treat the basis of those shares as including any excess of their allocable portions of *S1*'s net inside attribute amount

over their adjusted basis for purposes of applying the attribute reduction rules. In cases in which the basis of an *S1* share is tentatively reduced under Treas. Reg. § 1.1502-36(c)(6), thereby creating a noncapital, nondeductible expense that reduces the basis of a transferred *S* share for purposes of determining the loss allowable on the transfer of that *S* share under Treas. Reg. § 1.1502-36(c), the tentative reduction in the basis of the *S1* share is added back for purposes of computing *S*'s net inside attribute amount under Treas. Reg. § 1.1502-36(d)(3)(iii)(B). This has the effect of eliminating the tentative reduction in the *S1* shares' basis and producing an actual reduction in that basis only to the extent required by Treas. Reg. § 1.1502-36(d).

n11 Treas. Reg. § 1.1502-36(d)(5)(i)(A). This treatment as a deemed single share seems to be designed to simply assist in the subsequent process of allocating any attribute reduction amount. Further, it is important to note that *S* is treated as owning a deemed single share in *each* lower-tier subsidiary in which *S* directly owns shares. This can be gleaned from the fact that Treas. Reg. § 1.1502-36(d)(5) defines "*S1*" as generically representing any other subsidiary in which *S* owns shares. Further, in describing the allocation of any remaining attribute reduction amount between *S*'s basis in its assets and its basis in any lower-tier subsidiary stock, Treas. Reg. § 1.1502-36(d)(5)(ii) refers to "each of *S*'s deemed single shares of *S1* stock." Thus, if *S* directly owns stock in more than one lower-tier subsidiary, *S*'s shares in the various subsidiaries is not aggregated into one deemed single share, rather *S*'s is treated as owning a separate deemed single share in each such subsidiary.

n12 *S*'s basis in the actual shares of *S1* stock is adjusted for any gain or loss recognized on the transfer of any *S1* shares in the transaction, whether allowed or disallowed. Treas. Reg. § 1.1502-36(d)(5)(i)(B)(1).

n13 Treas. Reg. § 1.1502-36(d)(5)(i)(B). *S*'s deemed basis in the *S1* stock reflects the total amount of attributes with respect to *S1* that could duplicate a loss in the *S* stock (whether such attributes consist of *S*'s basis in the *S1* stock, or attributes inside *S1*).

n14 Treas. Reg. § 1.1502-36(d)(5)(i)(C).

n15 See T.D. 9424, 2008-44 I.R.B. 1012.

n16 See Prop. Treas. Reg. § 1.1502-36(d)(4)(i)(A), REG-157711-02 (Jan. 23, 2007).

n17 Treas. Reg. § 1.1502-36(d)(4)(ii).

n18 Treas. Reg. § 1.1502-36(d)(4)(ii)(A)(1).

n19 *Id.*

n20 Treas. Reg. § 1.1502-36(d)(4)(ii)(A)(2).

n21 See Treas. Reg. § 1.1502-36(d)(5)(ii).

n22 This is referred to as the reverse residual method because it is generally allocated to S's basis in assets in the reverse order from the order of asset classes identified in Treas. Reg. § 1.338-6(b).

n23 Treas. Reg. § 1.1502-36(d)(4)(ii)(B)(2).

n24 *Id.*

n25 Treas. Reg. § 1.1502-36(d)(5)(ii).

n26 *Id.*

n27 See Treas. Reg. § 1.1502-36(d)(5)(iii).

n28 Treas. Reg. § 1.1502-36(d)(5)(iii)(A). A "recognition transfer" is defined in Treas. Reg. § 1.1502-36(d)(5)(iii) as a transfer in which gain or loss is recognized.

n29 Treas. Reg. § 1.1502-36(d)(5)(iii)(B).

n30 Treas. Reg. § 1.1502-36(d)(5)(iii)(C).

n31 Treas. Reg. § 1.1502-36(d)(5)(iii)(D). An amount allocated under Treas. Reg. § 1.1502-36(d)(5)(iii) to a share of *S1* common stock can create an ELA in the stock to the extent the allocated amount exceeds the basis of the share; however, the ELA is not taken into account under Treas. Reg. § 1.1502-19 as a result of the transaction. Treas. Reg. § 1.1502-36(d)(4)(iii).

n32 Treas. Reg. § 1.1502-36(d)(5)(iv).

n33 *Id.*

n34 Treas. Reg. § 1.1502-36(d)(5)(v)(A).

n35 Treas. Reg. § 1.1502-36(d)(5)(vi)(A). As is true of the "conforming limitation" of Treas. Reg. § 1.1502-36(d)(5)(v), *P* may elect out of the basis restoration rule by complying with the procedural requirement of Treas. Reg. § 1.1502-36(e)(5). Treas. Reg. § 1.1502-36(d)(5)(vi)(B).

n36 *See, e.g.* Treas. Reg. §§ 1.461-1(a)(2), 1.461-4(g), 1.752-1(a)(4)(ii), and 1.752-1(a)(4)(i).

n37 Treas. Reg. § 1.1502-36(d)(4)(iii). While not entirely clear, pursuant to Treas. Reg. §§ 1.1502-21(b)(2)(ii)(A) and 1.1502-36(d)(4)(iii), it appears that the ordering rules for a consolidated NOL or capital loss of a departing *S* are (i) first the consolidated attribute is available to offset CTI of the group for the entire year of departure, after which (ii) the consolidated attribute is subject to reduction for any excluded cancellation of debt income of *S* or any other member of the group under Treas. Reg. § 1.1502-28(a)(2), (3) or (4), after which (iii) the consolidated attribute is reduced by any applicable attribute reduction amount resulting from a transfer of *S* stock.

n38 Treas. Reg. § 1.1502-36(d)(4)(iii).

n39 *Id.* This prevents a duplicative negative adjustment to the *S* or *S1* stock.

n40 Treas. Reg. § 1.1502-36(d)(6)(ii).

n41 Treas. Reg. § 1.1502-36(d)(6)(i).

n42 Treas. Reg. § 1.1502-36(d)(6)(iv)(A). A subsidiary becomes a nonmember under Treas. Reg. § 1.1502-19(c)(2) only if it has a separate return year, including a year as a member of another group.

n43 Treas. Reg. § 1.1502-36(d)(6)(iv)(B).

n44 Treas. Reg. § 1.1502-36(d)(6)(iv)(C).

n45 Treas. Reg. § 1.1502-36(d)(6)(iii)(A).

n46 Treas. Reg. § 1.1502-36(d)(6)(iii)(B).

n47 Treas. Reg. § 1.1502-36(d)(6)(iv)(A).

n48 Treas. Reg. § 1.1502-36(d)(6)(v)(A).

n49 Treas. Reg. § 1.1502-36(d)(6)(v)(B).

n50 Treas. Reg. § 1.1502-36(d)(6)(v)(A).

n51 Treas. Reg. § 1.1502-36(d)(6)(v)(C).

n52 *Id.*

n53 Treas. Reg. § 1.1502-96(d)(4)(ii).

n54 Treas. Reg. § 1.1502-96(d)(4)(iii). Under Section 382(l)(1)(A), a reduction in the Section 382 limitation by the amount of a capital contribution generally is required only if the capital contribution is part of a plan a principal purpose of which is to avoid or increase a Section 382 limitation. Under Section 382(l)(1)(B), a capital contribution within 2 years of an ownership change "shall, except as provided in regulations, be treated as part of a plan described in subparagraph (A)." However, in *Notice 2008-78, 2008-48 I.R.B. 851*, the government provided notice of its intent to issue regulations interpreting Section 382(l)(1) that, among other things, will provide that the mere fact that a capital contribution is within 2 years of an ownership change will not result in its being deemed to be pursuant to a proscribed plan. *Notice 2008-78* also describes four safe harbors which, if applicable, would result in the capital contribution not being treated as pursuant to a proscribed plan.

n55 In addition, Treas. Reg. § 1.1502-96(d)(4)(iv) and (v) provide that if the reattributed attribute is an attribute of a new loss member or loss subgroup, (i) proper adjustments must be made so that the value included in the limitation or limitations is not improperly duplicated or omitted, and (ii) the COBE requirement of Section 382(c)(1) is applied by reference to *P*'s trades or businesses should the reattribution occur within the two-year period beginning on the change date.

n56 Treas. Reg. § 1.1502-96(d)(5).

n57 Treas. Reg. § 1.1502-36(d)(7)(ii)(A).

n58 Treas. Reg. § 1.1502-36(d)(7)(ii)(B).

n59 Treas. Reg. § 1.1502-36(d)(7)(i). This is generally consistent with the timing rule of the general attribute reduction provisions (Treas. Reg. § 1.1502-36(d)(4)(iii)), which eliminates S's attributes immediately before the transfer of the S loss share because Treas. Reg. § 1.1502-36(f)(6) defines "loss carryover" as an NOL carryover or a capital loss carryover that is attributable to S, including any losses that would be apportioned to S under the principles of Treas. Reg. § 1.1502-21(b)(2) if S had a separate return year (i.e., after the group has had a chance to absorb the loss for the year).

n60 *Id.*

RELATED LINKS: For further information, see

■ 3-73A Taxation of Corps Filing Consolidated Returns § 73A.06

and

■ Lexis Explanation IRC Sec. 1502

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California Statutory and Regulatory Property Tax Change in Ownership Rules

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USC Gould School of Law 2010 Tax Institute: California's Statutory and Regulatory Property Tax Change in Ownership Rules

By Peter B. Kanter and Richard S. Kinyon

August 16, 2010

SUMMARY: California Constitution Article XIII A, enacted by Proposition 13, limits real property tax to one percent of a property's "full cash value," plus certain outstanding "bonded indebtedness." California property is generally assessed at factored "base year value" or current fair market value, whichever is less. This Emerging Issues Analysis examines case law and statutory and regulatory change in ownership rules adopted to implement Proposition 13.

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ARTICLE: I. Introduction

Until the adoption of Proposition 13 in 1978, California, like most states, assessed property at its current fair market value for property taxation purposes. Proposition 13 enacted Article XIII A of the California Constitution entitled "Tax Limitation" and generally limits the tax on real property to 1% of the property's "full cash value," plus certain outstanding "bonded indebtedness." These additions to the tax rate for bonded indebtedness are relatively limited and generally do not exceed 0.25%, so the overall rate, which will vary by county and even by district within each county, is usually between 1.00% and 1.25%. "Full cash value" is defined as the assessed value of the property for the 1975 tax year, or its fair market value on the date of a later change in ownership or new construction. This so-called "base year value" assessment can be increased by no more than 2% per annum or the annual increase in the Consumer Price Index, whichever is less.

Shortly after the passage of Proposition 13, Proposition 8 was passed by California voters. Proposition 8 added the additional limitation that in no event should property be assessed in any year at an amount above its current fair market value. Thus, in California today, property is generally assessed at the lesser of (1) its factored "base year value" and (2) its current fair market value.

The California Legislature enacted temporary implementation statutes that were generally effective for one year after Proposition 13 was passed, during which time the Legislature planned to consider and draft more permanent statutory provisions to carry out Article XIII A. The California State Board of Equalization (hereinafter the "SBE") promulgated regulations under the temporary statutes, including regulations on the term "change in ownership." To aid the Legislature in drafting more permanent legislation, a Task Force on Property Tax Administration (hereinafter the

"Task Force"), including representatives of the government and taxpayers, was appointed to make recommendations to the Legislature concerning the implementation of Article XIII A. The Task Force issued a report which formed the basis of the current statutory scheme. n1

The general definition of "change in ownership" envisioned by the Task Force is set forth in California Revenue and Taxation Code Section 60. n2 It provides: **"change in ownership" means a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest.** The Legislature also enacted several statutory provisions that follow R&TC § 60, which provide examples of particular types of transactions that either fall under the definition of "change in ownership" or are excluded from it. n3

Notably, the California Supreme Court in *Pacific Southwest Realty Co. v. County of Los Angeles* n4 has ruled that the general definition of what constitutes a change in ownership contained in R&TC § 60 is the overarching rule that must be met for any transaction to be deemed a change in ownership under Proposition 13. The court held that the statutory provisions that follow R&TC § 60 are merely examples of types of transactions that will, in most cases, meet that definition or are excluded from it. **However, when there is a conflict between one of the exemplary provisions and Section 60, the court ruled, the overarching definition contained in Section 60 must govern over the specific examples in the provisions that follow.**

The exemplary statutory provisions, however, govern in most cases to determine whether a transaction has triggered a change in ownership. The SBE has also promulgated regulations implementing Article XIII A of the constitution and the related statutory provisions. n5

This Emerging Issues Analysis will examine the specific statutory and regulatory change in ownership rules that were adopted by the legislature and SBE to implement Proposition 13. It will also discuss relevant case law related to these provisions.

II. Specific Statutory and Regulatory Change in Ownership Rules:

A. R&TC §60's Overarching Definition of "Change in Ownership":

As mentioned in the introduction above, R&TC § 60's overarching definition of a "change in ownership" under Proposition 13 as **"a transfer of a present interest in real property, including the beneficial use thereof, the value of which is substantially equal to the value of the fee interest"** was interpreted by the California Supreme Court in the *Pacific Southwest Realty* case as imposing a three-prong test which must be satisfied for all determinations that a change in ownership has occurred. The three prongs are:

- 1) A transfer of a **present interest**,
- 2) which includes the **beneficial use of the real property**,
- 3) and which transfers the **substantial equivalent of the taxable fee interest**.

If there is any conflict between application of the overarching rule of Section 60, and the application of the examples of changes in ownership in Section 61, or examples of transactions excluded from change in ownership in Section 62, the overarching rule of Section 60 must prevail. n6

B. Leases

How Proposition 13's change in ownership rule would apply to the creation, termination, and assignment of leasehold interests in real property was specifically addressed by the Task Force Report. The Task Force noted that when an estate in property was divided up temporally, as in the case of a leasehold interest, there would be great administrative difficulty resulting in chaotic assessments if a separate base year value needed to be set for each time a

lease was created, terminated, or assigned, as well as when the lessor's interests were transferred. Thus, the Task Force recommended that for all change in ownership purposes, a "primary owner" of the real property be identified. The Task Force recommended that only when the primary owner's interest was transferred should there be a change in ownership. n7 In order to determine whether the primary owner would be the lessee or the lessor for change in ownership purposes, the Task Force recommended, and the California legislature adopted, a bright-line "35-year rule."

Thus, ***the creation or termination of a leasehold interest with an original term of 35 years or more (including optional renewal periods that are exercisable at the discretion of the lessee) is considered a change in ownership.*** n8 As a corollary, the lessee's transfer of a lease with a remaining term of 35 years or more (including renewal options) also is a change in ownership, but the lessee's transfer of a lease with a remaining term of less than 35 years (including renewal options) is not a change in ownership. n9 On the other hand, the transfer of the underlying fee subject to a lease with a remaining term of 35 years or more (including renewal options) (*i.e.*, the landlord's reversion interest) is not a change in ownership. n10 (This rule implies that the transfer of the underlying fee subject to a lease with a remaining term of less than 35 years (including renewal options) is a change in ownership.)

The rationale underlying the 35-year rule is that transferring a leasehold interest of 35 years or more effectively transfers the substantial equivalent of the fee simple interest in the property because the reversion interest is *de minimis*, as the property will not revert until far in the future. The rule was upheld on these grounds in *E. Gottschalk & Co. v. County of Merced*. n11 The court noted that the legislature adopted 35 years as the bright line cut-off because that length of term was typically the minimum length of a leasehold that institutional lenders required before they would provide a mortgage loan secured by the leasehold interest.

C. Tenancy in Common Interest Transfers

Unlike those transfers that split up an estate temporally, the legislature did not have concerns about identifying a primary owner for transfers of fractional interests in real property that divided the ownership interest among joint owners as tenants in common. Thus, R&TC § 61(f) provides that except as otherwise provided in R&TC § 62 (relating to transfers not considered a change in ownership), a change in ownership occurs upon "[t]he creation, transfer, or termination of any tenancy-in-common interest, except as provided in subdivision (a) of Section 62 [which excludes (1) transfers between co-owners resulting in a change in the method of holding title without changing the proportional interests of the co-owners, such as a partition, and (2) transfers between individuals and legal entities or between legal entities, including "a trust to a cotenancy," resulting solely in a change in the method of holding title and in which proportional ownership interests of the parties in each and every piece of real property transferred, remains the same after the transfer] and in Section 63 [relating to interspousal transfers]." n12

R&TC § 65.1(a) provides in general that when an interest in a portion of real property is purchased or changes ownership, only the interest or portion transferred is reappraised. However, there is a small "safe harbor" exclusion for a purchase or transfer of an undivided tenancy in common interest with a market value of less than five percent of the market value of the total property *and* less than \$10,000. For purposes of determining whether the exclusion will apply, all transfers during any one assessment year are cumulated in determining the percentage interests and market value transferred. n13

D. Joint-Tenancy Interest Transfers

Joint tenancies in real property have their own unique change in ownership rules. R&TC § 61(e) provides that except as otherwise provided in R&TC § 62 (relating to transfers not considered a change in ownership), a change in ownership occurs upon "[t]he creation, transfer, or termination of any joint tenancy interest, except as provided in subdivision (f) of R&TC § 62; and in R&TC § 63 [relating to interspousal transfers] and R&TC § 65 [relating to joint tenancy interests generally]." n14

R&TC § 62(f) provides a broad exclusion from a change in ownership for "the creation or transfer of a joint

tenancy interest if the transferor, after the creation or transfer, is one of the joint tenants as provided in subdivision (b) of R&TC § 65."

R&TC § 65 provides as follows:

Only the interest or portion of a joint tenancy interest in property that is treated as a change in ownership is reappraised.

There is no change in ownership upon the creation or transfer of a joint tenancy interest if the transferor or transferors remain among the joint tenants after such creation or transfer. Upon the creation of such a joint tenancy, the transferor or transferors are the "original transferor or transferors" for purposes of determining the property to be reappraised on subsequent transfers; and the spouse(s) of the original transferor(s) also are considered original transferor(s).

Upon the termination of an interest in a joint tenancy, described in the previous paragraph, the entire portion of the property held by the original transferor or transferors prior to the creation of the joint tenancy is reappraised unless all or part of it vests in any remaining original transferor, in which case there is no reappraisal. However, upon the termination of the interest of the last surviving original transferor, that interest, along with all other interests in the property held by all original transferors that were previously excluded from reappraisal pursuant to Section 65, will be reappraised.

For purposes of Section 65, it is refutably presumed that for joint tenancies created on or before March 1, 1975, each joint tenant holding an interest in property as of that date is an original transferor.

The joint tenancy change in ownership rules are somewhat complex and best illustrated by examples in which the creation, transfer and termination of joint tenancy interests can be described. 18 CCR 462.040 (Change in Ownership - Joint Tenancies) contains numerous examples illustrating these rules. Therefore we will not go into more detailed analyses and description of those rules in this article.

E. Trusts and Legal Interests (Estates for Years or for Life Remainders, and Reversions)

1. Relevant Statutory and Regulatory Provisions

R&TC § 61(h) provides that except as otherwise provided in R&TC § 62 (which provides specific statutory examples of types of transfers not considered a change in ownership), a change in ownership occurs when a revocable trust becomes irrevocable and any interests in real property vest in persons other than the trustor (or, pursuant to R&TC § 63, his or her spouse). *A fortiori*, if an individual owns property outright (free of trust) and dies, the entire property is transferred to the beneficiary or beneficiaries of his or her estate, resulting in a change of ownership unless an exclusion is applicable.

R&TC § 61(g) provides that except as otherwise provided in R&TC § 62 a change in ownership occurs upon the vesting of the right to possession or enjoyment of a remainder or reversionary interest following the termination of a life estate or other similar precedent property interest, except as provided in R&TC § 62(d), and in R&TC § 63, relating to the interspousal transfer exclusion.

R&TC § 62(d) provides that a change in ownership does not include any transfer by the trustor, or by the trustor's spouse or registered domestic partner, or by both, into a trust for so long as (1) the transferor is the present beneficiary of the trust, or (2) the trust is revocable; any transfer by a trustee of such a trust described in either clause (1) or (2) above, back to the trustor; or, any creation or termination of a trust in which the trustor retains the reversion and in which the interest of others does not exceed 12 years duration.

The last part of this subsection implies that the creation or termination of a trust in which the Trustor retains the reversion and the interest of others exceeds 12 years duration is a change in ownership. However, that would appear to

be inconsistent with the 35-year rule applicable to leases in R&TC §§ 61(c) and 62(g) as well as 18 CCR 462.060. Moreover, as the court of appeal noted in *Gottschalk*, the 35-year rule applicable to leases satisfies the "substantial equivalent of the fee interest" prong of Section 60's overarching definition of "change in ownership," and it appropriately identifies the primary owner of the property, which is the purpose of the substantial equivalent of the fee prong of Section 60's overarching change in ownership test. n15 R&TC § 62(d)'s 12-year reversion rule for trusts thus is susceptible to a judicial challenge that it does not satisfy the substantial equivalency prong of Section 60, and is not in harmony with the constitutional definition of "change in ownership" that the California Supreme Court, in *Pacific Southwest Realty*, has said is embodied in Section 60.

R&TC § 62(e) provides that a change in ownership does not include any transfer by an instrument whose terms reserve to the transferor an estate for years or an estate for life. However, the termination of such an estate for years or for life constitutes a change in ownership, except as provided in subdivision (d) of R&TC § 62, discussed above, and in R&TC § 63, relating to the interspousal transfer exclusion.

18 CCR 462.060 provides that the creation of a life estate or an estate for a term of 35 years or more in real property in favor of someone other than the transferor or his or her spouse is a change in ownership at that time. Although the creation of such an estate in the transferor or his or her spouse is not a change in ownership at that time, the subsequent transfer of such an estate by the transferor or his or her spouse to a third party or the later termination of a reserved life estate or a reserved estate for years for any term, and the vesting of the right to possession or enjoyment in a third party remainder person, is a change of ownership at that time. The creation or transfer of an estate for a term of less than 35 years is not a change in ownership regardless of whom it favors.

As noted above, this regulation seems to conflict with R&TC § 62(d)'s 12-year reversion rule for trusts. However, that 12-year reversion rule may be subject to challenge as inconsistent with Section 60's substantial equivalency requirement.

2. Relevant Cases -- Steinhart, Leckie, Reilly, and Phelps

The provision in 18 CCR 462.060 that the creation of a life estate in real property in favor of someone other than the transferor or his or her spouse is a change in ownership was recently challenged by the life tenant in *Steinhart v. County of Los Angeles*. n16 This case involved the transfer by a decedent (Esther Helfrick) of her Los Angeles County residence that was held in her revocable trust at the time of her death. Following Helfrick's death, her sister (Lorraine Steinhart) received a life estate in the residence. The remainder beneficiaries of the trust were those of Helfrick's other siblings (or their surviving issue) who survived Steinhart.

The county assessor applied 18 CCR 462.060 and determined that the creation of the life estate constituted a change of ownership so as to trigger a reassessment. The taxpayer sought a refund of real estate taxes paid to the county, but the Superior Court of Los Angeles County, California, sustained the county's demurrer to the original complaint. The taxpayer appealed, and the court of appeal reversed the trial court. n17

The court of appeal found that a life estate was an estate of questionable value because it is subject to "complete defeasance at an unknown time." The court of appeal relied on dicta found in the California Supreme Court's decision in *Pacific Southwest Realty*, where the Supreme Court had suggested that life estates are not substantially equivalent to fee simple estates because they are subject to defeasance at anytime and thus, are of indeterminate value. n18 Therefore, the court of appeal in *Steinhart* reasoned that the value of a life estate was not substantially equal to the value of the fee interest for purposes of change in ownership pursuant to R&TC § 60's overarching three-prong test. Rather, the court ruled, when the life estate ended and the remainder or reversion indefeasibly vested in the grantees, the value of the estate became known and was identical to the value of the fee. Thus, according to the court of appeal, it was at that point that a change in ownership would occur pursuant to R&TC § 61(g).

The California Supreme Court granted the county's petition for review of the court of appeal's decision. n19 In a

unanimous decision issued in February of 2010, the Supreme Court reversed the court of appeal's judgment and remanded the matter for further proceedings consistent with the analysis in its opinion. Rather than focusing on whether the creation of a life estate in favor of Steinhart constituted a change in ownership so as to trigger a reassessment, the Supreme Court focused on the entirety of what Helfrick transferred and decided that a change in ownership occurred upon Helfrick's death, at which time her trust became irrevocable, as provided in R&TC § 61(h). The Supreme Court held:

[T]he *entire* equitable estate in the residence, which Helfrick had personally held during her lifetime, *transferred from Helfrick* to Steinhart and her siblings (or their issue) as beneficiaries of the irrevocable trust. . . . It is true that, under the terms of the trust, the beneficial estate in the residence was divided among Steinhart, who, as life tenant, held the right to immediate possession, and Steinhart's siblings (or their issue), who held only a remainder interest in any net proceeds that might someday be realized from sale of the residence after Steinhart's death. But that circumstance does not alter the fact that, upon Helfrick's death, the *entire* equitable estate in the residence was *transferred from Helfrick* to, collectively, Steinhart and her siblings (or their issue) as beneficiaries of the irrevocable trust. In other words, upon Helfrick's death, real ownership of the residence-which, as explained above, follows the equitable estate-transferred from Helfrick to Steinhart and her siblings (or their issue) as beneficiaries of the irrevocable trust. n20

As a result of the Supreme Court's determination in *Steinhart* that R&TC § 61(h) was controlling an mandated that a change in ownership occurred when, effectively, *all* of the beneficial interests in the property transferred upon Helfrick's death, the analysis of the court of appeal regarding whether the value of a life estate does not meet the substantial equivalent of a fee interests as required under Section 60, is still an open question. However, the court of appeal's decision in this regard appears to conflict with several prior court of appeal decisions.

In *Leckie v. County of Orange*, n21 the facts were similar to those in *Steinhart*, except that the remainder beneficiaries of the trust in *Leckie* were two of the deceased settlor's four children. This is an important distinction, because of the possible application of the parent/child exclusion from a change in ownership under R&TC 63.1. The trial court in *Leckie*, like the court of appeal in *Steinhart*, had held that the value of the life estate was not substantially equal to the value of the fee interest and that the transfer of the property was exempt from reassessment under R&TC § 63.1. In reversing the trial court, the court of appeal in *Leckie* held that the life estate in the non-family member was sufficient to block the application of the parent/child exclusion, resulting in a change in ownership upon the settlor's death. n22 Addressing the same discussion by the California Supreme Court in *Pacific Southwest Realty* that the court of appeal in *Steinhart* relied upon to find that a life estate was *not* the substantial equivalent to the fee interest, the court in *Leckie* stated:

Leckie points out the Supreme Court in *Pacific Southwest Realty* characterized a life estate as "an estate of questionable value" which does "not approach that of a fee." (1 Cal. 4th at p. 165.) But these comments were made, as dicta, in a discussion of a retained life estate, which is clearly exempt from the change of ownership provisions. Furthermore, the holding in *Pacific Southwest Realty* determined that a transfer of a fee with a retained leasehold estate was a change of ownership not subject to the exemption in section 62, subdivision (e) because the beneficial use had been transferred in the form of the right to receive rent. The court did not discuss what the result would be where, as here, the holder of the life estate was someone other than the transferor. n23

The decision of the court of appeal in *Steinhart*-that the value of a life estate is not substantially equal to the value of the fee interest for purposes of satisfying the third prong of the three-prong test for a change in ownership under R&TC § 60-also conflicts with the decision of the court of appeal in *Reilly v. City & County of San Francisco*. n24 In *Reilly*, the court held that the vesting of a successive life estate following the termination of a prior life estate resulted in a change in ownership under R&TC § 61(g), on the ground that it qualified as a remainder interest for purposes of that section, and a life beneficiary acquires the trust property's "primary economic value," which is substantially equivalent to the value of the fee interest. Notably, the court of appeal in *Reilly* also relied on the California Supreme Court's decision in *Pacific Southwest Realty*, to find that Reilly's life estate *does* satisfy the substantial equivalent of the fee requirement of Section 60:

The trustee further contends that, even if his interest could be characterized as a life estate, its value is not equivalent to the fee interest. The trustee relies on *Pacific Southwest*, which the trustee claims disparages the value of a life estate when compared to a fee interest. *Pacific Southwest* does not aid the trustee. In that case, the Supreme Court did not address life estates in general but instead limited its analysis to a life estate retained by the grantor. . . . The court noted in dicta that a purchaser of a retained life estate limited to the grantor's life would have "an estate of questionable value" because it would be subject to defeasance at an unknown time. . . . Upon the grantor's death, the purchaser's interest would disappear and the purchaser would retain nothing of value. Here, by contrast, Reilly's interest in the trust property was measured by his own lifetime and not someone else's. The fact the trustee could sell the property during the term of the trust does not render Reilly's interest of questionable value, because he still would have a right to the income from the sale proceeds for the rest of his life. n25

The court of appeal in *Phelps v. Orange County Assessment Appeals Board No. 1* n26 also held that the vesting of a successive life estate following the termination of a prior life estate constituted a change in ownership under R&TC § 60. However, the more significant holding in *Phelps* is that the income beneficiaries in the trust are deemed to have a present interest in the improvements to the previously unimproved real property owned by the trust and leased to a commercial tenant under a long-term lease that required the lessee to construct improvements on the unimproved land, even though those improvements are owned by the lessee (and its sublessees) for the duration of the lease and are to be transferred to the trust only upon termination of the lease. Relying on *Auerbach v. Assessment Appeals Board No. 1*, n27 the court of appeal in *Phelps* found that the life tenant also was deemed to have the beneficial use of the improvements as well as the land, the value of which is substantially equal to the value of a fee interest, resulting in a change in ownership of the entire property under R&TC § 60.

The California Supreme Court granted review of the court of appeal's decision in *Phelps* on September 9, 2009, resulting in its depublication. The court of appeal did not mention whether the grandparent-grandchild exclusion from the change in ownership was available to the trust, as it was in *Auerbach*. The court of appeal also did not mention the length of the remaining term of the lease at the time of the life tenant's death in 2002, which was a crucial factor in *Auerbach* because the remaining term of the lease at the time of the life tenant's death in *Auerbach* was only about 17 years. Had the remaining term of the lease in *Phelps* been 35 years or more at that time, there would have been no change in ownership because under R&TC § 62(g) the property would have been treated as owned by the lessee.

The facts in *Auerbach* were very similar to those in *Phelps*. The Supreme Court in *Auerbach* stated that "[t]he issue in this case is to what extent a 'change in ownership' . . . occurred when the trusts' interest in the property . . . changed from the grandparents to the grandchildren. The parties agree that the land changed ownership, but they disagree whether the change in ownership included the building as well." n28 The court noted that "[t]he general purpose of section 60, evident from its three subdivisions, is to ensure that it is the fee interest, or its equivalent value, that is generally subject to property taxation, and that tax reassessment follows the fee interest or its equivalent through various changes in ownership. In this case, for purposes of a section 60 change in ownership, [the Lessee] does not own the fee interest in the building, or its equivalent, but owns an estate of lesser value. The trusts owned the fee interest in the entire premises before they entered into the lease, and they still own the fee interest." n29 Finally, the court cited *Pacific Southwest Realty* and R&TC §§ 61(c) and 62(g), respectively, for the proposition that the change in ownership included the building as well as the land; and the change in ownership for the entire property was attributable to the fact that the remaining term of the lease was for less than 35 years at the time that the trusts' interest in the property changed from the grandparents to the grandchildren. Presumably, there would have been no change in ownership of the land or the building if the remaining term of the lease had been 35 years or more at that time, as provided in R&TC § 62(g). On April 28, 2010, the Supreme Court transferred the *Phelps* case back to the court of appeal for reconsideration in light of the Supreme Court's decision in *Steinhart*.

3. A Proposal for Resolving the Life Estate Change in Ownership Question and Dealing with Cumulative Transfers

In order to harmonize the rule relating to life estates with the 35-year rule relating to estates for years and leases and the Legislature's determination that an interest in real property must extend for a period of at least 35 years for it to

be considered the substantial equivalent to the fee interest, the Legislature or possibly the SBE might provide that, in general, the creation of a life estate in real property in favor of someone whose life expectancy is 35 years or more is a change in ownership at that time, and the creation of a life estate in real property in favor of such a person whose life expectancy is less than 35 years is not a change in ownership. As a corollary, the transfer by the holder of a life estate with respect to which his or her remaining life expectancy is 35 years or more should be considered a change in ownership, but the transfer of such an interest with a remaining life expectancy or term of less than 35 years should not be considered a change in ownership. Also, the same reciprocal rules should apply to the transfer of the reversionary interest in that real property following the creation of such a life estate or estate for years as those that apply to the transfer of the underlying fee interest in real property subject to a lease.

To provide uniform guidelines to assessors for purposes of determining whether a life tenant's remaining life expectancy is greater or lesser than 35 years, such a rule could refer to the actuarial tables adopted by the Internal Revenue Service for federal estate and gift tax purposes. ⁿ³⁰ The new rule could apply a rebuttable presumption that the life expectancy determined by use of the actuarial tables simply by reference to the age of the life tenant is the length of the interest transferred unless the taxpayer overcomes the presumed life expectancy with evidence of a shorter period (*e.g.*, as in the case of a transferee who is suffering from a terminal disease).

Finally, the Legislature or possibly the SBE might apply a "cumulative interest" rule to aggregate transfers of present and future interests in real property, outright or in trust. Thus, even though the transfer of a present interest by itself or a future interest by itself might not meet the three-prong test of R&TC § 60 independently, if sufficient remaining interests in the property are transferred at a later date such that the cumulative interests transferred meet all three prongs, a change in ownership of the entire parcel could be treated as having occurred on the later date. However, such a rule might still be challenged as unconstitutional and in violation of Section 60's overarching three-prong test.

Return to Text

ⁿ¹ See Report of the Task Force on Property Tax Administration to the Assembly Revenue and Taxation Committee, January 22, 1979 ("Task Force Report").

ⁿ² All references to "R&TC" hereafter refer to the California Revenue and Taxation Code.

ⁿ³ See R&TC §§ 61 through 69.

ⁿ⁴ 1 Cal. 4th 155 (1991).

ⁿ⁵ All references to "regulations" throughout this article refer to the regulations relating to Change in Ownership and New Construction in the California Code of Regulations, Title 18, Chapter 4, Article 4.

n6 *Pacific Southwest Realty, 1 Cal. 4th at 162.*

n7 Task Force Report at p. 39.

n8 R&TC § 61(c).

n9 *Id.*

n10 R&TC § 62(g).

n11 *196 Cal. App. 3d 1378 (1987).*

n12 The creation or transfer of a tenancy-in-common interest to a parent, child, or grandchild of the transferor, as provided in R&TC § 63.1, also would not be a change in ownership.

n13 R&TC § 65.1(a); 18 CCR 462.020 (Change in Ownership - Tenancies in Common).

n14 Presumably the creation or transfer of a joint tenancy interest to a parent, child, or grandchild of the transferor as provided in R&TC § 63.1 also would not be a change in ownership.

n15 *Gottschalk, 196 Cal. App. 3d at 1385-86.*

n16 *47 Cal. 4th 1298 (2010).*

n17 *Steinhart v. County of Los Angeles*, 155 Cal. App. 4th 1082 (2007) (depublished).

n18 *Pacific Southwest Realty*, 1 Cal. 4th at 165.

n19 Thus, the court of appeal's decision has been decertified.

n20 *Steinhart*, 47 Cal. 4th at 1320 (emphasis in original).

n21 65 Cal. App. 4th 334 (1998).

n22 However, the parent-child exclusion might still apply under the *Leckie* decision to avoid another change in ownership upon the termination of the life estate, when the remainder interest in the property will be deemed to be transferred from the settlor of the trust to his children. See SBE, Ltr. to Assessors No. 2008/018, Q&A 31, pp. 31-32 (Feb. 29, 2008).

n23 *Leckie*, 65 Cal. App. 4th at 340.

n24 142 Cal. App. 4th 480 (2006).

n25 *Id.* at 498.

n26 175 Cal. App. 4th 448 (2009) (depublished).

n27 39 Cal. 4th 153 (2006).

n28 *Id.* at 160.

n29 *Id.* at 162.

n30 See Treas. Regs. §§ 20.2031-7 and 25.2512-9.

RELATED LINKS: For further discussion about constitutional limits on property taxation, see

■ 2-18 Bender's State Taxation: Principles and Practice 18.03

For discussion about real property transfers with property tax implications, see

■ 2-20 Bender's State Taxation: Principles and Practice 20.04

For discussion of right-to-travel principles relevant to Proposition 13, see

■ 2-18 Bender's State Taxation: Principles and Practice 18.09

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Pension Funding Relief--Temporary or Here To Stay?

2010 Emerging Issues 5251

Pension Funding Relief--Temporary or Here To Stay?

By Professor David Pratt

August 13, 2010

SUMMARY: The Pension Protection Act of 2006 strengthened the minimum funding rules for defined benefit pension plans. The financial crisis and recession led to lobbying by employers for relief from the rules. On June 25, 2010, President Obama signed the Pension Relief Act of 2010, which provides temporary funding relief for both single-employer and multiemployer plans. In general, the larger the funding shortfall, the greater the amount of relief.

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ARTICLE: The Pension Protection Act of 2006 [PPA, Pub. L. No. 109-280] was enacted in part to strengthen the minimum funding rules for defined benefit (DB) pension plans. The subsequent financial crisis and recession led to vigorous lobbying by employers for relief from the new rules. On June 25, 2010, after lengthy partisan wrangling, President Obama signed into law the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (the "Act", Pub. L. No. 111-192), which provides temporary funding relief for both single-employer and multiemployer DB plans.

In general, the larger the funding shortfall, the greater the amount of relief.

Scope of the Relief

In general, the Act provides relief only from the basic minimum funding requirements and does not provide relief from the penalties and additional restrictions applicable to plans that are less than 60% or 80% funded. However, the Act does extend to 2010 the temporary relief provided by the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA). This allows the sponsor to use valuations as of the beginning of the 2008 plan year in determining whether the plan is less than 60% funded and thus must freeze accruals. Similar relief is provided for restrictions on Social Security level income payments. These special rules apply for plan years beginning on or after October 1, 2008 and before October 1, 2010.

Section 303 of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), contains funding rules that parallel those of section 430(c) 26 USCS 430(c) of the Code. The Act makes corresponding changes to section 303 of ERISA. [Act Section 201(a)] *IRS Notice 2001-55 [2010-33 I.R.B. 1]* notes that, under section 101 of Reorganization Plan No. 4 of 1978 [43 Fed. Reg. 47713], the Secretary of Treasury has interpretive jurisdiction over

funding for purposes of ERISA as well as the Code, so the Notice applies for both purposes.

Funding Relief for Single Employer Plans

Section 430 26 *USCS* Section 430 of the Internal Revenue Code ("Code") specifies the minimum funding requirements that apply to single-employer DB plans, pursuant to IRC Section 412 26 *USCS* 412. Under the PPA, the annual minimum contribution for a DB plan is generally equal to the sum of (1) its Target Normal Cost, or the present value of the benefits accrued during the year, and (2) the amount required to amortize its Shortfall Amortization Bases. The Shortfall Amortization Base established each year is equal to (1) the excess (if any) of the plan's Funding Target, the present value of all accrued benefits over its assets, minus (2) the present value of the remaining installments due on all Shortfall Amortization Bases established in prior years. PPA generally requires that each Shortfall Amortization Base be amortized in level installments over the 7 year period beginning with the year in which it is established.

Section 201(b) of the Act adds a new Code Section 430(c)(2)(D) 26 *USCS* 430(c)(2)(D), which allows the plan sponsor to reduce the minimum required contribution by electing one of two alternative shortfall amortization schedules:

The "2 plus 7 year" amortization schedule [Section 430(c)(2)(D)(ii) 26 *USCS* 430(c)(2)(D)(ii)]: the plan sponsor may pay only interest on the shortfall for 2 years, and then amortize the shortfall over the following 7 years. Thus the amortization period is extended from 7 years to 9 years.

The "15 year" amortization schedule [Section 430(c)(2)(D)(iii) 26 *USCS* 430(c)(2)(D)(iii)]: the shortfall is amortized over 15 years instead of 7 years.

Under the Act, a plan sponsor may elect to use one of these alternatives for any plan year, or any two plan years, between 2008 and 2011. However, the due date of the minimum required contribution for a plan year for which the election is made must be after June 24, 2010, so few plan sponsors could make the election for the 2008 plan year. "For example, a plan sponsor may not elect an alternative amortization schedule for a plan year beginning on October 1, 2008 and ending September 30, 2009, because the due date for contributions for that plan year was June 15, 2010." [IRS Notice 2010-55, 2010-33 I.R.B. 1] In addition, in the case of a plan described in section 106 of the PPA (plans of certain government contractors), the only plan year for which an election may be made is the plan year beginning in 2011.

If the plan sponsor elects to use an alternative amortization schedule for two plan years, the same schedule must be used for both years [Section 430(c)(2)(D)(iv)(II) 26 *USCS* 430(c)(2)(D)(iv)(II)], but the two plan years need not be consecutive.

The funding relief is available to frozen plans under which no further benefits are accruing.

Practice Tip:

For a plan sponsor which needs the maximum current amount of relief, 2 plus 7 year amortization provides the greater savings in the early years, as only interest need be paid for the first two years. However, the shortfall must then be fully amortized over years 3 through 9. For sponsors with less pressing needs, 15 year amortization provides the better alternative as it gives the plan sponsor an additional 6 years, i.e. 15 years rather than 9 years.

Funding Relief for Multiemployer Plans

Section 431 26 *USCS* 431 of the Code specifies the minimum funding requirements for multiemployer DB plans, pursuant to section 412 26 *USCS* 412. Section 211 of the Act added a new Code Section 431(b)(8) 26 *USCS* 431(b)(8) and a new section 304(b)(8) of ERISA.

Section 431(b)(2)(B)(iii) 26 *USCS* 431(b)(2)(B)(iii) provides for a 15 year amortization of net experience loss with

respect to a plan. New Section 431(b)(8)(A) 26 USCS 431(b)(8)(A) provides a special amortization rule for certain net investment losses in the case of a multiemployer plan that meets a solvency test. The special rule applies to the portion of the plan's experience loss or gain attributable to net investment losses (if any) incurred in either or both of the first two plan years ending after August 31, 2008 (an "applicable plan year"). This portion is amortized over the period (1) beginning with the plan year in which it is first recognized in the actuarial value of assets and (2) ending with the last plan year in the 30-plan-year period beginning with the plan year in which the net investment loss was incurred. *IRS Notice 2010-56 [2010-33 IRB 1]* describes how the amortization period works. If the plan sponsor elects to use this special rule, is made, the plan sponsor may not also apply to IRS for an extension of the amortization period under the pre-existing rules. If IRS has granted the plan an extension before the election is made, the total amortization period is limited to 30 years. Net investment losses are to be determined by reference to the difference between actual and expected returns on assets, under rules to be provided by the IRS.

Section 431(b)(8)(B) 26 USCS 431(b)(8)(B) provides a special asset valuation rule in the case of a multiemployer plan that meets the solvency test. The plan may change its asset valuation method in a manner that (1) spreads the difference between expected returns and actual returns, for either or both of the applicable plan years, over a period of not more than 10 years, (2) provides that, for either or both of the applicable plan years, the value of plan assets at any time cannot be less than 80 percent or greater than 130 percent (rather than the usual 120 percent) of the fair market value of the assets at that time, or (3) provides for both (1) and (2).

The solvency test is met only if the plan's actuary certifies that the plan is projected to have sufficient assets to timely pay expected benefits and anticipated expenditures over the amortization period, taking into account the changes in the funding standard account under section 431(b)(8). [Section 431(b)(8)(C)]

If either or both of the special funding rules apply for a plan year, a special restriction on benefit increases applies, in addition to any other applicable restrictions on benefit increases. [Section 431(b)(8)(D) 26 USCS 431(b)(8)(D)] Under this special restriction, a plan amendment increasing benefits may not go into effect, during either of the two plan years immediately following a plan year for which the special funding rules apply, unless (1) the plan's actuary certifies that the increase is paid for by additional contributions not allocated to the plan immediately before the application to the plan of the special rule(s) and the plan's funded percentage and projected credit balances for the two plan years are reasonably expected to be at least as high as they would have been if the benefit increase had not been adopted, or (2) the amendment is required as a condition of qualification under the Code, or to comply with other applicable law.

Section 431(b)(8) 26 USCS 431(b)(8) generally takes effect as of the first day of the first plan year ending after August 31, 2008. [Act section 211(b)] However, if the application of the special funding rules affects the plan's funding standard account for that first plan year, the special rules are disregarded in applying Code Section 432 26 USCS 432 and Section 305 of ERISA (multiemployer plans in endangered or critical status). The restriction on benefit increases is effective on June 25, 2010.

The Cash Flow Rules

If a plan sponsor wishes to take advantage of funding relief under the Act, it must comply with special "cash flow" rules, which may limit the amount that the sponsor may pay in compensation, dividends and stock redemptions. [Code Section 430(c)(7) 26 USCS 430(c)(7)] To comply with these restrictions, a company can either reduce the amount of these payments or increase the amount contributed to the plan.

During the three year period (under the 2+7 alternative) or the five year period (for the 15 year alternative), beginning with the later of (1) the election year or (2) the first plan year beginning after 2009, the minimum contribution for any year is increased by the sum of:

Excess compensation: Compensation paid to *any* employee, during the calendar year in which the plan year begins, for services performed by the employee for the plan sponsor (whether or not such services were performed

during the calendar year), that (1) is includible in income under the Code or (2) is set aside in a rabbi trust or similar vehicle, to the extent that it exceeds \$1 million (indexed beginning in 2011).

Compensation attributable to services rendered before March 1, 2010 is disregarded. There are also exceptions for (1) nonqualified deferred compensation, restricted stock, stock options, or stock appreciation rights (but not other amounts, e.g. bonuses) paid or granted under a binding written contract that was in effect on March 1, 2010, and was not materially modified before the remuneration is paid; (2) commissions paid solely on account of income generated by an individual's performance; and (3) restricted stock granted after February 28, 2010 that is subject to a substantial risk of forfeiture for at least five years from the date of grant. The amount of the increase in the required contribution to the DB plan is equal to the sum of the excess compensation with respect to *all* employees.

Extraordinary dividends and redemptions: the excess of (1) the sum of dividends declared during the plan year and the aggregate fair market value of stock redeemed during the plan year; over (2) the greater of: (a) The company's adjusted net income for the preceding plan year, without any reduction for interest, taxes, depreciation, or amortization-essentially, earnings before interest, taxes, depreciation, or amortization (EBITDA); or (b) If the company paid dividends in the "same manner" for at least five consecutive years preceding the current year, the amount of dividends so determined in that manner. For example, assume that the plan sponsor has paid an annual dividend of \$1.00 per share for at least the last five years. The plan sponsor, in the current year, pays a dividend calculated in the same way. In determining the threshold for extraordinary dividends and redemptions, the actual amount of the \$1.00 dividend for the current year will be substituted for adjusted net income, but only if that amount is greater than adjusted net income. This rule allows an employer to keep paying its historical dividend even if the employer has a bad year and has little or no net income.

The Act does not specifically provide how the excess is calculated if the company has a loss for the year in question. Also, income is measured on a *plan* year basis: for a company with a plan year that differs from its fiscal year, this could be problematic.

The following dividends and redemptions are disregarded: (1) dividends declared, and redemptions occurring, before March 1, 2010; (2) dividends paid within a controlled group; (3) redemptions made pursuant to an employee benefit plan or made on account of the death, disability, or termination of employment of a shareholder or employee; and (4) dividends and redemptions with respect to preferred stock if (a) dividends accrue with respect to the stock in all events, (b) interest accrues on any unpaid dividends, and (c) either the stock was issued before March 1, 2010 or the stock is held by an employee benefit plan. There is no specific exception for dividends paid in company stock rather than in cash.

The required contribution, as increased by these rules, will not exceed (i) the total of the Shortfall Amortization Bases or (ii) the amount of the contribution that would have been required if the alternative amortization schedule had not been elected. Any amounts not included for the year, because they exceed this second cap, are carried over to the next year. The carryover amount is treated as an additional required contribution for the following plan year. However, no amount can be carried over to a plan year that begins after the last plan year in the restriction period, or, in the case of the 15 year election, the second plan year after that last plan year.

These additional contributions are disregarded in calculating the amount of any required quarterly contribution. The additional contributions reduce future shortfall amortization installments, in reverse order, starting with the final scheduled installment, so that the present value of the future installments does not exceed the present value of the remaining Shortfall Amortization Base. The total required amortization payment- shortfall amortization payment plus additional contribution- for any year will not be greater than the present value of the remaining Shortfall Amortization Bases.

If an employer elects relief with respect to more than one DB plan, the additional contributions must be allocated, under Treasury rules, on a pro rata basis among all of the plans, including collectively bargained plans.

For purposes of the cash flow rules, all members of the plan sponsor's controlled group (including foreign entities) are aggregated. Thus, excess compensation paid by one member of a group may require additional contributions to a plan of another member of the group.

Treasury is to prescribe rules for the application of the cash flow rules where there is a merger or acquisition.

Additional Rules

Section 202(a) of the Act amends Title I of PPA to allow the sponsor of a plan described in sections 104 through 106 of PPA (multiple employer plans of certain cooperatives, certain PBGC settlement plans, and plans of certain government contractors) to elect, for certain plan years, one of two alternative amortization schedules with respect to a portion of the plan's unfunded new liability. The schedules, set forth in sections 107(b) and 107(c) of PPA, as amended by the Act, are similar to the 2 plus 7 year schedule and the 15 year schedule.

"Eligible charity plans", multiple employer plans (determined without regard to the employer aggregation rules under Code Section 414(c)) 26 USCS 414c maintained exclusively by Code Section 501(c)(3) 26 USCS 501c(3) organizations (charities and similar organizations), are treated like eligible cooperative plans described in section 104 of PPA, so that the PPA funding rules will not apply until 2017. This is effective for plan years beginning in or after 2008, unless the employer elects to delay its application by one year.

Under the PPA, an employer is not permitted to use its credit balance with respect to a plan if the plan was less than 80% funded in the prior year. The Act provides relief from this rule for a plan maintained exclusively by one or more Code Section 501(c)(3) 26 USCS 501c(3) organizations, for plan years beginning after August 31, 2009 and before September 1, 2011.

Election and Notice Procedures

An election for a single employer DB plan under Code Section 430(c)(2)(D) 26 USCS 430(c)(2)(D) must be made at such time, and in such form and manner, as is prescribed by the Secretary of the Treasury. Any election may be revoked only with the consent of the Secretary, after taking into account any comments from the Pension Benefit Guaranty Corporation (PBGC). [Section 430(c)(2)(D)(iv)(III) 26 USCS 430(c)(2)(D)(iv)(II)] The plan sponsor is required to give notice of the election to participants and beneficiaries of the plan, and to inform the PBGC of the election, in such form and manner as the PBGC may prescribe. [Section 430(c)(2)(D)(vi) 26 USCS 430(c)(2)(D)(vi)]

The plan sponsor of a multiemployer DB plan to which either or both of the special funding rules apply must give notice to plan participants and beneficiaries. The plan sponsor must also inform the PBGC that the special funding rules apply, in such form and manner as the PBGC may prescribe. [Code Section 431(b)(8)(E) 26 USCS 431(b)(8)(E)]

IRS Reporting Guidance

On July 30, 2010, IRS provided reporting guidance in the form of two Notices, *Notice 2010-55 [2010-33 IRB 1]* for single employer plans and *Notice 2010-56 [2010-33 IRB 1]* for multiemployer plans. The Notices clarify that an election of funding relief for the 2009 plan year may be made after the 2009 annual report (Form 5500) has been filed. For a calendar year plan, and subject to extensions, the 2009 due date for Form 5500 was August 2, 2010. Future guidance will address reporting requirements if the plan's Form 5500 for a plan year has been filed before an election is made for that year.

Future Guidance

Notice 2010-55 states that the IRS plans to issue additional guidance on the special funding rules for single employer plans, which may cover (1) calculation of the alternative amortization schedules and the effect on funding balances; (2) rules on installment acceleration amounts under the cash flow rules; (3) procedures for making the election

to use an alternative amortization schedule; and (4) notice requirements.

Notice 2010-56 states that the IRS plans to issue additional guidance on the special funding rules for multiemployer plans, which may cover (1) determining the part of the experience loss or gain attributable to net investment losses incurred in either or both of the first two plan years ending after August 31, 2008; (2) notification requirements; and (3) the effect of application of the special rules on the certification of a multiemployer plan's status under Code section 432(b) 26 USCS 432(b), including certifications already made.

CONCLUSION

The Act provides important short term funding relief for DB plan sponsors. According to an announcement from Congressman Earl Pomeroy (D-N.D.), the Act will give relief to employers totaling \$129 billion over the next seven years and will reduce the federal deficit by up to \$2 billion over the next decade. However, the relief is only temporary: it may encourage some employers to soldier on with their DB plans, but it will not halt the trend away from DB plans or prevent future funding problems.

RELATED LINKS: For further information, see

- 1-10 Federal Income Taxation of Retirement Plans § 10.01

For further information, see

- LexisNexis Tax Advisor -- Federal Topical § 1C:7.01

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When Irrevocable Trust Beneficiaries Fall Out of Favor

2010 Emerging Issues 5246

USC Gould School of Law 2010 Tax Institute: When Irrevocable Trust Beneficiaries Fall Out of Favor

By Andrew Katzenstein and Stephanie Zaffos

August 13, 2010

SUMMARY: Sometimes estate plans need to be modified because relationships change. A testator's desires may change and affect the designation of beneficiaries in an irrevocable trust. Where trusts have "bad" beneficiaries or undesirable terms, one option to fix the problem is to modify the trust. In general, modification of irrevocable trusts is governed by state law. We discuss a few methods used in modifying a trust to impact beneficiaries.

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ARTICLE: Sometimes estate plans need to be modified because relationships change. A testator's desires may change and affect the designation of beneficiaries in an irrevocable trust. Where trusts have "bad" beneficiaries or undesirable terms, one option to fix the problem is to modify the trust. In general, modification of irrevocable trusts are governed by state law, and these rules differ from state-to-state. This Emerging Issues Analysis discusses a few different methods used in modifying a trust to impact beneficiaries and offers examples utilizing the law in several different states. Practitioners should consult the appropriate state laws in connection with each of the options discussed below.

Contribution of Assets to a Limited Partnership or LLC

One of the most common problems facing fiduciaries with "bad" beneficiaries is the requirement of outright distribution of the assets at a specific age. This can be in the trust context (i.e., outright distribution to a child at age 30) or in connection with a Uniform Transfers to Minors Act trust. In California, the latter is called a California Uniform Transfer to Minors Act (CUTMA) account and the account must end by age 18 or 25, depending on how initiated. Parents often seek a way to postpone that distribution date. One of the best options a client can consider is causing the trust (or CUTMA) assets to be added to a limited partnership or LLC in which the client (or trustee) directly or indirectly retains control over the management and distribution of the partnership or LLC assets. When the child attains the specific age, the child receives all of the trust (or CUTMA) assets as required by law - in this case, a non-managing member interest in an LLC or a limited partner interest in a partnership.

Some clients worry about inclusion of the LLC or limited partner interest received by the child in the parents' taxable estate based on the assertion of the "transfer with a retained interest" argument under IRC § 2036, 26 USCS § 2036. Though this should not result in a successful attack, the very cautious client can consider naming a trust for the benefit of his children or others (just not himself) as the managing member of the LLC or general partner of the

partnership. The client can retain the power to remove and replace the trustee of the trust (so long as a related or subordinate party under IRC § 672, 26 USCS § 672 cannot become the trustee).ⁿ² In this indirect fashion, the client decides when distributions are made from the entity to its owners, effectively deciding when the child receives assets and when he does not.

Typically, enough would be distributed to the child from the entity to pay income taxes on the child's distributive share. When the child attains the age at which the client is comfortable having the child receive the assets (or when the child recovers from drug addiction, attains financial maturity, or otherwise demonstrates that the reason the parent wanted to postpone distribution has been resolved), the LLC or partnership can be terminated and the assets distributed to the members or partners. This provides the most flexibility in waiting to see when the child is able to handle the funds before receiving them.

Note: CUTMA custodians always ask whether they can simply contribute the CUTMA assets to a trust for the child that lasts until the age the parents desire. The answer is clearly "no." This would be a breach of the custodian's fiduciary duties (a CUTMA custodian must distribute at age 18 or 21, he cannot simply "give away" the assets in which the child is vested), and if added to a trust that parents established for the child previously, can also cause tax problems. For example, the child will now be treated as creating a (portion of) trust for himself with a retained interest, so that portion of the trust would be subject to estate tax when the child dies under IRC § 2036. That portion of the trust could not generation-skip (the child is the transferorⁿ³), and that portion of the trust is probably a grantor trust as to the child.ⁿ⁴

The child could attack the trustee or custodian for investing the trust or CUTMA assets in the LLC or partnership, in an attempt to gain control of the entity's assets (based on some sort of breach of duty argument). Therefore, it is best to have a "business reason" for making the investment in the entity. If the client invests alongside the trust or CUTMA in the LLC or partnership, percentage fees charged by investment advisors are often minimized (the bigger the account the smaller the investment advisory fee from the perspective of the percentage charged) - this is one business reason for establishing the entity. If real estate is owned by the trust or CUTMA, forming the entity to provide creditor protection for the child is another "business" reason.ⁿ⁵

The longer before the child attains the distribution age that the assets are invested in the LLC or partnership, the less likely an attack will be brought. The child will see that this is how the family investing has been organized for some time, rather than noting the entity was created right before the specified age to keep him from getting his hands on the money.

Decanting to Another Trust

Decanting is often a useful tool to fix tax problems that arise in the original trust, but it can also be used as a trust modification tool. Depending on the jurisdiction, the second trust that the assets are transferred to can have additional beneficiaries, or eliminate certain beneficiaries from the original trust. Even where the beneficiaries are required to be identical (either by statute, local law, or the trust power permitting decanting), the second trust may contain different trustee provisions (such as a different order of trustee succession) or dispositive provisions for the beneficiaries (such as granting limited powers of appointment to the beneficiaries at their deaths over the assets of the trust), thereby providing flexibility to a Settlor who is dissatisfied with the terms of the current trust.

Seven states have specific "decanting" statutes, which permit a trustee in certain circumstances to appoint all of the assets of a discretionary trust to another trust.ⁿ⁶ Although the decanting statutes vary by state, in New York and Delaware the prerequisites include the following:

- Trustee has discretion to invade principal of the trust;
- Exercise of the power cannot reduce the fixed income right of any beneficiary; and

- Exercise of the power must be in favor of one or more of the proper objects of the power. n7

In the absence of a state statute explicitly permitting decanting, authority may be found in a state's common law. n8 In addition, a decanting power may be explicitly granted in the trust instrument.

Even if the provisions of trust do not explicitly allow decanting, trusts often include language that allows the trustee to make payments from the trust *"to or for the benefit of"* the trust beneficiaries. The *"for the benefit of"* language might be interpreted to mean that the trustee has the discretion to pay to another trust *"for the benefit of"* the beneficiaries (with better terms). Structured properly, tax benefits can be maintained or improved. n9 In this manner, the trust assets can be distributed to a new trust, with stricter distribution guidelines, trustee ages, outright distribution ages, etc. n10 To be able to assert that the *"for the benefit of"* language includes the right to pay to other trusts for the beneficiary, consider asking the draftsman to provide a declaration under penalty of perjury to that effect. Also, consider application to the local probate court for interpretation of the instrument in this fashion. Armed with the draftsman's declaration, the court is almost guaranteed to interpret the trust to allow payments to new trusts for the benefit of the trust beneficiaries. n11

Insurance Trust Planning

To avoid inclusion of life insurance proceeds as part of a client's taxable estate, a client will often choose to make the owner and beneficiary of the policy an irrevocable life insurance trust. However, if the client later decides he wants to disinherit one of the life insurance trust beneficiaries, the irrevocable nature of this trust can leave the client in a difficult situation. One option is to consider selling the policy to a new insurance trust with the *"right"* beneficiaries.

The first issue to address is IRC § 2035, 26 USCS § 2035 which causes insurance transferred for less than full and adequate consideration within 3 years of an insured's death to be subject to estate tax - even if held by a (new) insurance trust. A sale for full fair market value, rather than a gift, avoids this issue.

Term insurance must be sold for its *"replacement cost"* - i.e., a value equal to the pro rata portion of the premium paid prior to the sale that will *"last"* until the next premium is due. n12 For example, if premiums of \$1,000 are due on January 1st of each year, a sale on July 1st would be for \$500.

Permanent policies (e.g., whole life, universal life, etc.) must be sold for their interpolated terminal reserve value (similar to cash value) plus the pro rata portion of the premium paid prior to the sale that will *"last"* until the next premium is due. n13 Note that if the insured is very ill prior to the sale, these rules will be ignored; instead, the value will be deemed to be much closer to the *"face"* amount since the insured is close to death.

The next issue to address is the *"transfer for value"* rule under IRC § 101(b), 26 USCS § 101(b). In general, there is no income tax on life insurance proceeds. However, if an insurance policy is sold, the buyer generally is charged with *"basis"* in the policy equal to what was paid for it and, as a result, the proceeds received in excess of that basis are subject to income tax. There are exceptions to this rule (called the *"transfer for value"* rule). One important exception is that if the policy is sold *to the insured* (or a partner of the insured), the proceeds can be received without income tax. n14

The final issue to address is whether the seller of the policy must recognize gain on sale. In general, if the policy is sold for more than the premiums the seller paid, the difference is subject to income tax. n15

If the existing life insurance trust is a *"grantor"* trust, selling to a new life insurance trust that is also a grantor trust can avoid all these issues. n16

- Since the sale is deemed to have been made to the insured, the transfer for value rules are avoided.
- A sale to a grantor trust avoids recognition of gain. Therefore, the existing insurance trust can sell to the new insurance trust without incurring income tax.
- Finally, a sale for full value avoids the application of the *"3-year rule."*

These results have been confirmed in *Revenue Ruling 2007-13, 2007-11 I.R.B. 684*. In it, the IRS states that a sale of a life insurance policy (by the insured, in this case) to a wholly grantor trust, of which the insured is treated as owner for income tax purposes, will either not be a transfer for value or, if a transfer for value, qualifies for an exception to the transfer for value rules as a transfer to the insured.

Although the sales proceeds will remain part of the old insurance trust for the "wrong" beneficiaries, those proceeds are usually significantly less than the face amount of the policy sold. Though a small amount therefore passes to the "bad" person, the bulk of the proceeds pass where the client desires.

The sale can be for cash or a note, or a combination thereof. n17 If cash must be given to the new trust to make a purchase from the old trust, carefully consider the gift tax consequences. If the gift tax consequences of funding the purchase price with cash is too steep, the sale can be for a note. Recognize, however, that the payoff won't come until the insured dies, so interest is running in favor of the "wrong" beneficiaries. This is not a big problem if the insured is older, but if young it can significantly impact who receives what when the insured dies.

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n1 One of the requirements to fall within IRC § 2036 is that the interest, right or power must be "retained" at the time of initial transfer by the client (to the trust or CUTMA custodian), which would not be met in this example. If a trustee or custodian transfers assets to a LLC or partnership many years after the initial transfer it would appear difficult for the IRS to assert the retention of an interest. However, since the retention requirement has been interpreted to include not only express retention, but implicit and indirect retentions as well, caution is advisable in this arena. See *Gynn v. U.S.*, 437 F.2d 1148 (4th Cir. 1971); *Rapelje v. Comm'r*, 73 T.C. 82 (1979). Indirect retention could include the transferor's domination of the trustee or a "side agreement" with the trustee/custodian. See *Klauber v. Comm'r*, 34 T.C. 968 (1960), *nonacq. on other issues*, 1964-2 C.B. 8; TAM 9043074. See also *Whitt v. Comm'r*, 751 F.2d 1548 (11th Cir. 1985); *Skinner v. U.S.*, 316 F.2d 517 (3rd Cir. 1963). Estate tax inclusion under IRC § 2038 (power to alter, amend, revoke or terminate enjoyment) does not require a transfer with a *retained* impermissible interest, but merely a lifetime transfer and that the power be "possessed" at the transferor's death. However, so long as exercise of an administrative power (such as investment authority) is pursuant to a fiduciary duty and subject to fiduciary liability, the power should be outside of IRC § 2038. See *King v. Comm'r*, 37 T.C. 973 (1962), *nonacq.* 1963-1 C.B. 5.

n2 *Revenue Ruling 95-58, 1995-2 C.B. 191. See also PLR 200213013.*

n3 "Transferor" means the donor as to any property subject to the gift tax (without regard to exemptions, exclusions, deductions and credits). IRC § 2652(a)(1), 26 USCS § 2652(a)(1); Treas. Reg. § 26.2652-1(a)(2). In addition, portions of a trust attributable to transfers from different transferors are treated as separate trusts. IRC § 2654(a)(3), 26 USCS § 2654(a)(3); Treas. Reg. § 26.2654-1(a)(2)(i). If separate shares exist because different

transferors have transferred property to a single trust, the trustee may divide the trust into actual separate trusts for GST tax purposes. Treas. Reg. § 26.2654-1(a)(3).

n4 See, e.g., IRC § 677(a), 26 USCS § 677(a).

n5 The custodian will probably want the parents' indemnity for making the investment of CUTMA assets in the entity.

n6 States with decanting statutes include Alaska, Delaware, Florida, New Hampshire, New York, South Dakota and Tennessee. In addition, there is currently a proposed statute pending in Colorado.

n7 12 Del. C. § 3528; NY EPTL § 10-6.6(b). In New York, the new trust cannot include provisions that violate public policy.

n8 Comment d. to Section 12.2 of the *Restatement (Second) of Property (1986)* provides that a trustee holding a discretionary power holds a power of appointment over trust property. The holder of a power of appointment may exercise a the power to make a distribution of property either outright or in further trust, unless the powers are expressly limited in the trust instrument. *Restatement (Second) of Property*, Sections 12.2 and 19.3 (1986).

n9 See, e.g., *PLR 200530012* (where taxpayer used this approach to pay assets that were outside the transfer tax system to a new trust that will keep them outside the transfer tax system, rather than to have those assets distributed outright to children when their parents died, which would have brought the assets back into the system). See also Treas. Reg. § 26.2601-1(b)(4)(A).

n10 This could also be used to pour-over assets to a pre-existing trust that has better terms than the trust the client is trying to avoid. If the goal is to transfer the assets to a trust with stricter beneficiary terms, this may pose a challenge as the disappointed beneficiary may (successfully) object to the petition for interpretation. Most of the states with decanting statutes do not require notice to be given to the beneficiaries (with the exception of New York and Florida, and New Hampshire as to charitable beneficiaries), so this is not an issue in those jurisdictions.

n11 If the client is using this technique to solve a "tax" problem (such as eliminating a provision that unwittingly would cause inclusion of the original trust's assets in the Settlor's taxable estate at his or her death), there is a risk that the IRS will not recognize the transaction for tax purposes and would still assert tax liability under the terms of the original trust. However, under *Estate of Bosch*, 387 U.S. 456 (1967), the IRS has to give "proper regard" to a state decision of a contested matter, and the court order would assist the client in building a base to "fix" a trust with bad tax provisions by decanting to a trust that has no such provisions.

n12 Treas. Reg. § 25.2512-6(a).

n13 Id. See also *PLR 200228019*.

n14 IRC § 101(a)(2)(B); 26 USCS 101(a)(2)(B).

n15 See Revenue Ruling 2009-13, 2007-11 I.R.B. 684.

n16 If the existing trust is not a grantor trust, a similar result can be obtained by the formation of a partnership between the insured and the new life insurance trust. The sale is then to a "partner of the insured", thereby avoiding the transfer for value rule. However, gain may be recognized and taxes payable by the existing life insurance trust in this scenario.

n17 See, e.g., *PLR 200606027*.

RELATED LINKS: For further information, see

- LexisNexis Tax Advisor -- Federal Topical § 3H:5.12

For further information, see

- 3-37 Modern Estate Planning § 37.17

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Marc A. Countryman on the Unified Loss Rule and the Basis Redetermination Rule

2010 Emerging Issues 5257

USC Gould School of Law 2010: Marc A. Countryman on the Unified Loss Rule: Basis Redetermination Rule of Treas. Reg. § 1.1502-36(b)

By Marc A. Countryman

August 13, 2010

SUMMARY: In the first installment of a series of articles on the Unified Loss Rule, Marc A. Countryman provides an overview of the Unified Loss Rule and discusses the first prong under Treas. Reg. § 1.1502-36(b). The purpose of the basis redetermination rule of Treas. Reg. § 1.1502-36(b) is to prevent the realization of noneconomic loss and facilitate the elimination of duplicated loss when members hold S shares with disparate bases.

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ARTICLE: In the first installment of a series of articles on the Unified Loss Rule, Marc A. Countryman provides an overview of the Unified Loss Rule and discusses the first prong under Treas. Reg. § 1.1502-36(b). The purpose of the basis redetermination rule of Treas. Reg. § 1.1502-36(b) is to prevent the realization of noneconomic loss and facilitate the elimination of duplicated loss when members hold S shares with disparate bases. If a share of S stock is "transferred" by a member of the P group, and at the time of the transfer the S share is a "loss share," Treas. Reg. § 1.1502-36(b) may apply to redetermine the basis of the share by allocating all or part of the loss to other S shares. Under this rule, only basis attributable to investment adjustments can be reallocated among the shares. See also:

- USC Gould School of Law 2010: Marc A. Countryman on the Unified Loss Rule: Basis Reduction Rule of Treas. Reg. § 1.1502-36(c), *2010 Emerging Issues 5260* and
- USC Gould School of Law 2010: Marc A. Countryman on the Unified Loss Rule: Attribute Reduction Rule of Treas. Reg. § 1.1502-36(d), *2010 Emerging Issues 5262*.

On January 23, 2007, the government issued a notice of proposed rule making that would combine the loss disallowance rules (or "LDR") and duplicated loss regulations, as well as a new attribute reduction rule, into a single set of rules under Treas. Reg. § 1.1502-36. n1 On September 17, 2008, the government finalized the regulations proposed on January 23, 2007. n2 The new final regulations in Treas. Reg. § 1.1502-36 n3 adjust members' bases in the stock of a subsidiary (S) and S's attributes when a member (M) "transfers" n4 a loss share of S stock. n5 The regulations were titled the "Unified Rule for Loss on Subsidiary Stock," and are generally referred to as the "Unified Loss Rule."

The new regulations replace the various consolidated return loss disallowance regulations of Treas. Reg. §§

1.337(d)-2 and 1.1502-20. In addition, the new regulations limit the consolidated return anti-loss duplication regulations of Treas. Reg. § 1.1502-35 to pre-September 17, 2008 dispositions of S stock and post-September 16, 2008 dispositions of assets other than S stock where the basis of the asset is determined, in whole or in part, directly or indirectly, by reference to the basis of S stock.

The Unified Loss Rule applies to transfers of shares of subsidiary stock occurring on or after September 17, 2008 unless the transfer was made pursuant to a binding agreement that was in effect prior to September 17, 2008 and all times thereafter. n6 For prior transfers of subsidiary stock shares, the loss disallowance rules of Treas. Reg. §§ 1.337(d)-2, 1.337(d)-2T, and 1.1502-20, as well as the basis redetermination rules of Treas. Reg. § 1.1502-35, may be applicable. n7

For purposes of the Unified Loss Rule, (a) "P" is the common parent of the consolidated group; (b) "S," "M," and "M1" are members of P's consolidated group; (c) "X" is not a member of the P group; (d) all transactions illustrated in the examples are between unrelated persons and are independent of each other; (e) tax liabilities and their effects, and the application of other Code provisions (including Section 267), are disregarded; (f) all persons are calendar-year taxpayers that use the accrual method of accounting; and (g) all tax reporting and filing requirements are complied with. n8

Substantive Rules

The Unified Loss Rule contains three substantive rules: (i) the basis redetermination rule of Treas. Reg. § 1.1502-36(b); (ii) the basis reduction rule of Treas. Reg. § 1.1502-36(c); and (iii) the attribute reduction rule of Treas. Reg. § 1.1502-36(d). If, after taking into account the effects of all other applicable rules of law (such as basis reductions under Sections 108 and 1017 and Treas. Reg. § 1.1502-28), a share of S stock is "transferred" by a member of the P group, and at the time of the transfer the S share is a "loss share," n9 the Unified Loss Rule of Treas. Reg. § 1.1502-36 applies to determine the following:

(i) Whether the basis of the share must be redetermined by allocating all or part of the loss to other S shares (the basis redetermination rule of Treas. Reg. § 1.1502-36(b)). Under this rule, only basis attributable to investment adjustments can be reallocated among the shares.

(ii) If the share remains a loss share after the basis of the share is adjusted under the basis redetermination rule, whether all or part of the loss must be eliminated by a further basis reduction that does not result in a reallocation of basis (the basis reduction rule of Treas. Reg. § 1.1502-36(c)). Under this rule, basis in a share can be reduced (but not below the share's fair market value) by the lesser of the share's "disconformity" amount (i.e., the amount by which the basis of the share exceeds the proportionate interest in S's inside net attributes) and the share's net positive investment adjustment (determined without regard to the negative adjustment for distributions).

(iii) If the share remains a loss share after the basis of the share is adjusted under the basis reduction rule, whether any of S's attributes must be reduced in order to prevent loss duplication (the attribute reduction rule of Treas. Reg. § 1.1502-36(d)).

In addition to these three substantive rules of Treas. Reg. § 1.1502-36(b), (c) and (d), n10 the Unified Loss Rule contains general operating rules, n11 definitions relevant to the substantive and operating rules, n12 and an anti-avoidance rule. n13

What Constitutes a "Transfer"

The Unified Loss Rule applies only if a member of the P group "transfers" a loss share of another member of the P group. Treas. Reg. § 1.1502-36(f)(10)(i) defines "transfer" of an S share as the earliest to occur of the following:

(i) The date M ceases to own the S share as a result of a transaction n14 in which, but for the application of the

Unified Loss Rule (and notwithstanding the deferral of any amount recognized on the transfer, "other than by reason of Treas. Reg. § 1.1502-13"), *M* would recognize income, gain, loss or deduction with respect to the share;

(ii) The date *M* and *S* cease to be members of the same consolidated group;

(iii) The date a nonmember acquires the *S* share from *M*; and

(iv) The last day of the tax year during which the share becomes worthless under Section 165, taking into account Treas. Reg. § 1.1502-80(c). n15

Treas. Reg. § 1.1502-36(f)(10)(ii) then excludes the following from the definition of "transfer":

(i) *M* ceases to own the *S* share as a result of a Section 381 transaction in which (a) either a member of the group acquires assets from *S* or *S* acquires assets from *M*, (b) *M* recognizes no income, gain, loss or deduction with respect to the *S* share, and (c) if the transaction is a Section 332 liquidation, *M* is the only member that owns shares of *S* stock; and

(ii) *M* ceases to own the *S* share as a result of a distribution of the share to a nonmember in a transaction to which IRC Section 355 26 USCS 355 applies and in which the share is treated as qualified property for purposes of Section 355(c) 26 USCS 355(c) or Section 361(c) 26 USCS 361(c).

In addition, if a Section 332 26 USCS 332 liquidation of *S* would have been excluded from the definition of "transfer" but for the fact that *M* is not the only member of the group that owns *S* stock, then Treas. Reg. § 1.1502-36(e)(4) provides that the basis reduction rule of Treas. Reg. § 1.1502-36(c) and the attribute reduction rule of Treas. Reg. § 1.1502-36(d) are not applicable. The basis redetermination rule of Treas. Reg. § 1.1502-36(b), however, remains applicable.

Transfer of Stock of Multiple Subsidiaries

When stock of more than one subsidiary (*S*) is transferred in a single transaction, Treas. Reg. § 1.1502-36 generally applies first to the lowest tier subsidiary (*S*₂), then to the second lowest tier subsidiary, etc. If no shares of the lowest tier *S*₂ shares are loss shares, the gain (if any) on the disposition of those shares tiers up as positive investment adjustments to the higher tier shares. If any of the transferred *S*₂ shares is a loss share, the basis redetermination and the basis reduction rules of Treas. Reg. § 1.1502-36(b) and (c) apply to that share. After taking into account the application of those rules to the lowest tier *S*₂ stock transferred in the transaction, the investment adjustments caused by the application of those rules and any other investment adjustments resulting under the investment adjustment regulations tier up into the basis of the stock of higher tier subsidiaries. If, after taking into account all such investment adjustments, any of the next highest tier shares is a loss share, then the Unified Loss Rule of Treas. Reg. § 1.1502-36 applies to any such loss shares of higher tier subsidiaries transferred in the transaction. n16

Once the basis redetermination and the basis reduction rules of Treas. Reg. § 1.1502-36(b) and (c) are applied to the transferred loss shares in the highest tier, the attribute reduction rules of Treas. Reg. § 1.1502-36(d) are applied to the transferred loss shares in the highest tier. The attribute reduction rules are then applied with respect to transferred shares in each next lower tier, successively, to the extent such shares are loss shares after the application of the attribute reduction rules of Treas. Reg. § 1.1502-36(d).

Application of Other Rules

Treas. Reg. § 1.1502-36 applies immediately before the transfer of the loss share and regardless of whether any other rule applies (such as deferral of the loss under Section 267(f)). n17 However, Treas. Reg. § 1.1502-36(e)(3)(i) defers the application of the Unified Loss Rule with respect to a transfer of a loss share in an intercompany transaction until such time as the loss is taken into account by the selling member under Treas. Reg. § 1.1502-13. In addition, Treas. Reg. § 1.1502-36(e)(3)(ii) provides *P* with an election to apply Treas. Reg. § 1.1502-36 to an intercompany loss

taken into account on or after September 17, 2008 in connection with an intercompany transaction completed prior to September 17, 2008.

Basis Redetermination Rule of Treas. Reg. § 1.1502-36(b)

The basis redetermination rule of Treas. Reg. § 1.1502-36(b) applies only if, after making all other adjustments to the basis of an *S* share that is "transferred," the share transfer results in a loss to the transferring member of the *P* group. There are two exceptions that limit the scope of the basis redetermination rule:

(i) the rule does not apply if there is no disparity among the bases of the shares held by all members of the group; n18 and

(ii) the rule does not apply if all the *S* shares held by all members of the *P* group prior to the transfer are disposed of or become worthless in a single taxable transaction. n19 However, in the latter case, Treas. Reg. § 1.1502-36(b)(1)(ii)(B) provides that *P* nonetheless may elect to apply the basis redetermination rule. n20

If the basis redetermination rule applies, all it can do is reallocate basis caused by investment adjustments among the existing *S* shares-it cannot eliminate basis or investment adjustments. n21

General Rule: Adjustments to the Basis of Transferred Loss Shares. If a loss share of *S* stock is transferred, there have been "investment adjustments" n22 with respect to the *S* stock, and (subject to the exception discussed below) one or more *S* shares are not transferred, the following adjustments to the basis of the transferred loss share are required by Treas. Reg. § 1.1502-36(b)(2)(i):

(i) first, if the transferred loss share is a share of *common stock* of *S*, n23 any positive investment adjustments previously allocated under Treas. Reg. § 1.1502-32(c) to the transferred *S* common share are removed from the share (until its basis equals its value) and reallocated under other provisions of the regulation; n24 and

(ii) second, if the transferred share (whether common or preferred stock) remains a loss share after any applicable basis reduction under the positive investment adjustment reallocation rule, any negative investment adjustments previously allocated under Treas. Reg. § 1.1502-32(c) to *S* common shares that are not transferred are reallocated first to any transferred loss share of *S* that constitutes preferred stock, until its basis equals its value, and then to any transferred loss share of *S* that constitutes common stock, until its basis equals its value. n25 If there are not sufficient negative adjustments to bring the bases of all transferred loss shares constituting preferred stock down to their fair market value, the negative adjustments must be reallocated in a fashion that, to the greatest extent possible, reduces the disparity between the basis and value of each such share. Any negative adjustments remaining after the allocation to preferred shares are reallocated to all outstanding shares that constitute common stock under the same basis disparity reduction method.

Reallocations of positive adjustments from a transferred loss share that constitutes common stock are applied in any reasonable manner chosen by the taxpayer that has the effect of minimizing, to the greatest extent possible, first any differences between the adjusted basis and value of shares of *S* preferred stock that are not transferred and second any differences between the adjusted basis and value of shares of *S* common stock, including any shares that are transferred in the transaction. n26 However, a reallocation of positive investment adjustments to a share of *S* preferred stock may not cause the basis of that share to be increased above its value. n27

In addition, there are two significant limitations on the extent to which investment adjustments may be reallocated to non-transferred shares. First, an investment adjustment may only be reallocated to shares of *S* stock owned by members of the group at the time of the original allocation of the investment adjustment. Second, reallocations under Treas. Reg. § 1.1502-36(b) are subject to a prior use limitation.

Shares Owned at Time of Original Allocation. Notwithstanding the general reallocation rules, an investment

adjustment may only be reallocated to shares of S stock owned by members of the group at the time of the original allocation of the investment adjustment under Treas. Reg. § 1.1502-32(c).ⁿ²⁸ Presumably this rule is intended to prevent members from acquiring additional S shares to attract investment adjustments after the effect of a reallocation can be determined.

Example: Share owned by nonmember at time of original allocation. For all of Year 1, X (a nonmember) owns 1 out of 100 shares of the common stock of S (its only class of stock) and P owns the remaining 99 shares. During Year 1, S sells an asset recognizing \$200 of gain that results in a positive adjustment to the basis of each S share owned by P in the amount of \$198 under Treas. Reg. § 1.1502-32(b)(2)(i) and (c). While \$2.00 of this positive investment adjustment is also allocated to the 1 share of S stock owned by X under Treas. Reg. § 1.1502-32(c), the allocation does not increase the basis of that share. On the first day of Year 2, P purchases X's one share of S stock, and on the second day of Year 2, P sells 10 shares of S stock at a loss, retaining 90 shares (including the one share purchased from X on day one of Year 2). As a result of the transfer of S loss shares, the basis redetermination rule applies to require a reallocation of all or part of the \$2.00 positive investment adjustment originally allocated to each of the transferred loss shares from those transferred loss shares to the S shares retained by P. However, pursuant to Treas. Reg. § 1.1502-36(b)(2)(iii)(B)(1), because the 1 share of S stock purchased by P from X was not owned by P when the positive investment adjustment was made under Treas. Reg. § 1.1502-32(b)(1)(i) (the close of Year 1), no portion of the reduction in the basis of the transferred loss shares can be reallocated to this S share.

Prior Use Limitation. Notwithstanding the general investment adjustment reallocation rules, no investment adjustment may be reallocated to the extent it was (or would have been) used prior to the time it would otherwise be reallocated by reason of a prior transaction (such as a transfer of the S share) in which the share's basis has been taken into account.ⁿ²⁹ The stated purpose for the prior use limitation is "to prevent the reallocation of investment adjustments from either increasing or decreasing members' aggregate bases in subsidiary stock."ⁿ³⁰

Example: Prior use limitation. P owns all 20 shares of M stock and 10 shares of S stock. M owns the remaining 10 shares of S stock. In Year 1, S recognizes \$200 of income that results in a \$10 positive investment adjustment being allocated to each share of S stock. The group does not recognize any other items. The \$100 positive adjustment to M's basis in its S stock tiers up, and results in a \$5 positive adjustment to each share of M stock. In Year 2, P sells one share of M stock and recognizes a gain. In Year 3, M sells one loss share of S stock, and the basis redetermination rule of Treas. Reg. § 1.1502-36(b) applies and requires a reallocation of the Year 1 positive investment adjustment applied to the basis of the transferred S share.

M's basis in the transferred loss share of S stock reflects a \$10 positive investment adjustment attributable to S's Year 1 income. Under the general basis redetermination rule of Treas. Reg. § 1.1502-36(b), that \$10 would be subject to reallocation to reduce basis disparity. However, that \$10 adjustment had originally tiered up to adjust P's basis in its M shares and, as a result, \$.50 of that adjustment was reflected in P's basis in each share of M stock. When P sold the one share of M stock in Year 2, the basis of that share (which included the tiered-up \$.50 adjustment) was used in determining the gain on the sale. Thus, \$.50 of the \$10 investment adjustment originally allocated to the transferred S share that tiered-up to the sold M share was previously used and, as such, cannot be reallocated in a manner that would (if it were the original allocation) affect the basis of the sold M share. Accordingly, no more than \$9.50 of the adjustment to M's transferred S share could be reallocated to P's shares of S stock. If so, under the special allocation of Treas. Reg. § 1.1502-32(c)(1)(ii)(B), the tier-up of this \$9.50 would only be allocated among P's remaining 19 shares of M stock. Alternatively, all \$10 of the investment adjustment could be reallocated to M's other S shares (because the tier-up to P's M shares would have been the same regardless which of M's shares of S stock were adjusted).ⁿ³¹

However, if the prior use of the basis of the S share was as a result of an intercompany transaction subject to Treas. Reg. § 1.1502-13, the prior use limitation does not apply to the extent that Treas. Reg. § 1.1502-13 has prevented the gain or loss on the transaction from being taken into account.ⁿ³² Furthermore, the prior use limitation does not apply to the extent its application would not change the basis of the share (e.g., because the reallocation is between shares that are both lower-tier to the share with previously used basis).ⁿ³³

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n1 REG-157711-02, 2007-8 I.R.B. 537 (Jan. 23, 2007).

n2 *T.D. 9424, 2008-44 I.R.B. 1012. See also Notice 2008-9, 2008-3 I.R.B. 1156* (stating that while the final regulations under § 1.1502-36 will generally apply to transactions occurring on or after the date they are published (September 17, 2008), they will not apply to a transfer of subsidiary stock to an unrelated person pursuant to an agreement that is binding before the date the regulations are published and at all times thereafter, incorporating Section 267(b) in determining whether persons are related); *Announcement 2007-74, 2007-2 C.B. 483* (making technical corrections to the proposed regulations); RIN 1545-BB61, *2007-1 C.B. 537* (making technical corrections to the proposed regulations).

n3 *T.D. 9424, 2008-44 I.R.B. 1012.* The Service had issued Prop. Treas. Reg. § 1.1502-36 on January 23, 2007. *See* REG-157711-02, *2007-1 C.B. 537. See also Announcement 2007-74, 2007-2 C.B. 483* (making technical corrections to the proposed regulations).

n4 Treas. Reg. § 1.1502-36(f)(10) defines the term "transfer" for purposes of the Unified Loss Rule.

n5 Treas. Reg. § 1.1502-36(a)(1).

n6 Treas. Reg. § 1.1502-36(h).

n7 *See* Treas. Reg. §§ 1.337(d)-2(a)(1) ("[F]or transactions involving loss shares of subsidiary stock occurring on or after September 17, 2008, see § 1.1502-36. Further, this section [1.337(d)-2] does not apply to a transaction that is subject to § 1.1502-36."); 1.337(d)-2(g) ("This section applies with respect to dispositions and deconsolidations on or after March 3, 2005. In addition, this section applies to dispositions and deconsolidations for which an election is made under § 1.1502-20(i)(2) to determine allowable loss under this section... . For dispositions and deconsolidations after March 6, 2002 and before March 2, 2005, see § 1.337(d)-2T as contained in the 26 CFR part 1 in effect on March 2, 2005."); 1.1502-20(h) as contained in the 26 CFR part 1 in effect on March 2, 2005 (providing generally that Treas. Reg. § 1.1502-20 applies with respect to dispositions and deconsolidations during the period from February 1, 1991 through and including March 6, 2002, subject to binding agreement transition rules and certain provisions allowing taxpayers to apply, in certain cases, other loss disallowance rules); 1.1502-35(a)(2) (providing in part that § 1.1502-35 can apply when a member recognizes

loss on the disposition of a share of stock of a subsidiary on or after March 7, 2002 but that § 1.1502-35 does not apply to a loss recognized on the disposition of a share of stock of a subsidiary if the disposition is a transfer to which § 1.1502-36 applies).

n8 Treas. Reg. § 1.1502-36(a)(5).

n9 Treas. Reg. § 1.1502-36(f)(7) defines "loss share" as a share of S stock the adjusted basis of which exceeds its value and "gain share" as a share of S stock the value of which exceeds its adjusted basis. Treas. Reg. § 1.1502-36(f)(11) defines "value" as the amount realized on a disposition of the share, or if there is no amount realized, the share's fair market value.

n10 Treas. Reg. § 1.1502-36(a)(3)(i).

n11 Treas. Reg. § 1.1502-36(e).

n12 Treas. Reg. § 1.1502-36(f).

n13 Treas. Reg. § 1.1502-36(g).

n14 Treas. Reg. § 1.1502-36(f)(9) defines "transaction" to include all steps taken pursuant to the same plan or arrangement. Thus, it appears the definition is broad enough to treat a series of multiple transactions as a single transaction, applying the "end-result" formulation of the step-transaction doctrine (i.e., transactions following the first transaction are combined with the first transaction and treated as a single transaction if the subsequent steps were contemplated at the time of the first).

n15 Treas. Reg. § 1.1502-80(c) generally provides that, for consolidated groups, subsidiary stock is not treated as worthless under Section 165 until immediately before the earlier of the time (i) the stock is worthless within the meaning of Treas. Reg. § 1.1502-19(c)(1)(iii) or (ii) the subsidiary for any reason ceases to be a member of the group.

n16 Treas. Reg. § 1.1502-36(a)(3)(ii)(A), (B), and (C).

n17 Treas. Reg. § 1.1502-36(a)(4).

n18 Treas. Reg. § 1.1502-36(b)(1)(ii)(A).

n19 Treas. Reg. § 1.1502-36(b)(1)(ii)(B).

n20 The form and manner of making such an election are set out in Treas. Reg. § 1.1502-36(e)(5)(ii). There may be cases in which it is advantageous to apply the basis redetermination rule by making such an election.

n21 Treas. Reg. § 1.1502-36(b)(1)(i). Because the basis redetermination rule can only reallocate *investment adjustments* previously reflected in the basis of the S shares, it has no application to a high Section 358(a)(1) basis of a block of S shares received by M in exchange for loss property contributed in a Section 351 26 USCS 351 exchange even though Section 362(e)(2) has no application to the exchange pursuant to Treas. Reg. § 1.1502-80(h)(1). Similarly, the basis reduction rule of Treas. Reg. § 1.1502-36(c) will not apply to a sale of that loss block of S stock due to the absence of positive investment adjustments, and the attribute reduction rule of Treas. Reg. § 1.1502-36(d) will not apply if the aggregate amount of S's inside attributes does not exceed the value of the S stock. However, if (i) M's contribution of the loss property to S is done with a view to prevent the consolidated return regulations from properly addressing loss duplication with respect to the contributed loss property and, (ii) absent Treas. Reg. § 1.1502-80(h)(1), Section 362(e)(2) 26 USCS 362(e)(2) would have applied to the contribution, then an appropriate adjustment must be made (in the form of either a reduction in the basis of the S loss shares a'la Section 362(e)(2)(C) 26 USCS 362(e)(2)(C) or a reduction in the basis of the contributed loss property a'la Section 362(e)(2)(A)) 26 USCS 362(e)(2)(A). Treas. Reg. § 1.1502-80(h)(2)(i).

n22 As defined in Treas. Reg. § 1.1502-36(b)(1)(iii).

n23 Treas. Reg. § 1.1502-36(b)(2) can never apply to remove positive investment adjustments from the basis of a transferred share of preferred stock, even if the preferred share is a loss share. The apparent reason for this is the notion that, under Treas. Reg. § 1.1502-32(c)(1), (3) and (4), preferred stock picks up positive investment adjustments only to the extent Section 301 distributions accrue on the preferred stock, hence those positive investment adjustments have economic reality. However, as noted in the following text, negative investment adjustments initially allocated to common stock are permitted to be reallocated to a share of

preferred stock that is a transferred loss share.

n24 Treas. Reg. § 1.1502-36(b)(2)(i)(A).

n25 Treas. Reg. § 1.1502-36(b)(2)(i)(B). Treas. Reg. § 1.1502-36(f)(8) defines "preferred stock" and "common stock" by incorporating the definitions of those terms found in Treas. Reg. § 1.1502-32(d)(2) and (3). Treas. Reg. § 1.1502-32(d)(3) defines "common stock" as any class of stock that is not "preferred stock" within the meaning of Treas. Reg. § 1.1502-32(d)(2). Treas. Reg. § 1.1502-32(d)(2) generally defines "preferred stock" as "stock that is limited and preferred as to dividends and has a liquidation preference." However, if members of the group own less than 80% of each class of common stock, the second sentence of Treas. Reg. § 1.1502-32(d)(2) reclassifies "preferred stock" as "common stock." The reason for the reclassification is to permit negative adjustments for absorbed losses and noncapital, nondeductible expenses to be allocated under Treas. Reg. § 1.1502-32(c)(1) to preferred shares held by members of the group where affiliation under Section 1504(a)(2) results from their ownership of voting preferred stock and less than 80% of the participating common stock. Because preferred shares reclassified under Treas. Reg. § 1.1502-32(d)(2) as common shares may be allocated negative investment adjustments for absorbed losses and noncapital, nondeductible expenses that are reallocable under Treas. Reg. § 1.1502-36(b)(2), the Unified Loss Rule has an interest in being consistent with the investment adjustment rules in the classification of preferred shares and common shares.

n26 Treas. Reg. § 1.1502-36(b)(2)(ii) and (iii)(A).

n27 Treas. Reg. § 1.1502-36(b)(2)(ii)(A).

n28 Treas. Reg. § 1.1502-36(b)(2)(iii)(B)(1).

n29 Treas. Reg. § 1.1502-36(b)(2)(iii)(B)(2)(i). A similar limitation was placed in Treas. Reg. § 1.1502-32(c)(1)(ii)(B) preventing any reallocated investment adjustment with respect to an *S* share held by *M* from tiering up and being reflected in the basis of an *M* share if that *M* share was responsible for the prior use limitation.

n30 Treas. Reg. § 1.1502-36(b)(2)(iii)(B)(2)(i).

n31 Treas. Reg. § 1.1502-36(b)(2)(iii)(B)(2)(ii), *Exs. (i)-(ii)*. The special allocation provision of Treas. Reg. § 1.1502-32(c)(1)(ii)(B) provides as follows: "If the reallocation of an investment adjustment under § 1.1502-36(b)(2) is subject to the prior use limitation in § 1.1502-36(b)(2)(iii)(B)(2), no amount of the tier-up of such reallocated investment adjustment shall be allocated to any share whose prior use resulted in the application of the limitation. Thereafter, the tier-up of this amount is included in the remaining adjustment (see paragraph (c)(1)(iii) of this section)."

n32 Treas. Reg. § 1.1502-36(b)(2)(iii)(B)(2)(i). In such a case, appropriate adjustments must be made to the intercompany item from the prior intercompany transaction that has not yet been taken into account. *Id.*

n33 *Id.*

RELATED LINKS: For further information, see

■ Lexis Explanation IRC Sec. 1502

and

■ 3-73A Taxation of Corps Filing Consolidated Returns § 73A.04

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Taxation of Short Sales and Foreclosures

2010 Emerging Issues 5250

Mark S. Ericsson on Taxation of Short Sales and Foreclosures

By Mark Ericsson

August 10, 2010

SUMMARY: Short sale and foreclosure tax inquiries focus on how much gain and cancellation of indebtedness (COD) to recognize. Gain is the amount realized over the amount invested. Net worth increase is income realized, unless statutory or case law allows exclusion from income. The maximum 15% federal tax on gain and 35% on COD income will be 20% and 39.6% in 2011, respectively. Look for gain and COD income exclusion downsides.

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ARTICLE: The schedules included **in the PDF version of this article** purport to illustrate the tax consequences of a divestiture of property through a short sale (in which the lender agrees to take less than the loan balance), foreclosure, or deed in lieu of foreclosure in four different settings. In each case, the property is "underwater." The four scenarios:

1. The owners have held the principal residence for a long time and their cost (basis) is currently far less than their loan balance.
2. The house was bought at the top of the market and their cost is more than the home is worth and more than the current loan balance.
3. An investment property is involved in the same circumstances as in 1. above.
4. An investment property is involved in the same circumstances as in 2. above.

The focus of any inquiry as to the tax consequences is how much gain and how much cancellation of indebtedness is recognized in the transaction. Gain is the amount one realizes over the amount that one has invested, or how much the value increased. Income is realized to the extent that one's net worth increases, unless the income can be excluded by statute or case law. In the case of cancellation of indebtedness income, if the bank agrees to compromise a \$20,000 debt to \$10,000, one's net worth has gone up by \$10,000 and that is income. As one studies the four schedules (see PDF version), he or she will note that two factors come into play. First, gain is taxed federally at a maximum rate of 15% (20% next year) while cancellation of indebtedness income is taxed at a maximum rate of 35% (39.6% next year). Therefore, any comparison must start with how much tax is generated at the two different rates.

Secondly, both gain and ordinary income can be excluded. There is one exclusion for gain on principal residences, and there are five exclusions for cancellation of indebtedness income. Therefore, one must determine if one of the

exclusions applies and if there is any detriment caused by applying the exclusion.

The exclusion for gain is the \$250,000/\$500,000 IRC Sec. 121 exclusion for homeowners who have owned and occupied the home for two out of the last five year prior to sale. There are five ways to exclude income from cancellation of indebtedness income, which are found in IRC Sec.108. They are the insolvency exclusion (taxpayer may exclude an amount of COD Income equal to the excess of the COD Income over the net worth of the taxpayer immediately after the sale); the bankruptcy exclusion (where personal liability has been eliminated by a bankruptcy before or within the bankruptcy); the election to exclude acquisition indebtedness under IRC Sec. 108(a)(1)(E); and two that rarely apply to personal residences or rentals (farms and property used in a trade or business).

If either of the first two exclusions under IRC Sec. 108(a)(1) are relied upon, the taxpayer's tax attributes must be reduced by the amount excluded, effective the first day on the year following the exclusion. Tax attributes are the results of events that allow the taxpayer future tax reduction such as the net operating loss carryforward. For example, if the taxpayer has a \$100,000 net operating loss and excludes \$50,000 of cancellation of indebtedness income in a bankruptcy, he can only carry forward \$50,000 of the net operating loss. The reduction of the taxpayer's attributes includes these attributes, in the following order:

1. net operating loss carryovers, business credit carryforwards;
2. minimum tax credit carryforwards;
3. capital loss carryforwards;
4. the taxpayer's basis in his assets;
5. passive loss carryforwards; and
6. foreign tax credit carryforwards.

Since the attributes are reduced on the first day of the year following the exclusion, the taxpayer will generally want to realize any gains that he might have in the year of exclusion.

There is an open question on the IRC Sec. 108(a)(1)(E) election. IRC Sec. 108(h)(1) says that the taxpayer must lower his basis in his principal residence by the amount excluded. The attached schedules (PDF version) assume that this means that the basis of the home foreclosed or sold must be reduced, but there is no guidance as to whether this reduction of basis should be retroactively applied to a home that the taxpayer no longer owns. California has passed a similar statute, but with an \$800,000 limitation on the amount of acquisition debt applicable rather than the \$2,000,000 allowable under federal law.

In the first schedule (PDF) (Principal Residence - Low Basis) the loan balance is \$1,000,000, the fair market value of the property is \$600,000 and the owners paid \$300,000 for the property. There are two columns, one illustrating the tax consequences of a short sale and the other illustrating the tax consequences of a foreclosure. The tax consequences of tendering a deed in lieu of foreclosure are the same as those of a short sale with the fair market value substituting for the sale price.

Following the first column, we will first look at the ramifications of a short sale. In a short sale where the bank forgives the balance of the loan, the sale is traditionally treated as a sale and cancellation of the balance of the loan. There will be \$400,000 in cancellation of indebtedness income (the difference between the loan balance and the sales price). This may be excludable under one of the five exclusions referenced above. There will also be \$300,000 in gain, which will be excludable if the owners are a couple who have lived in the house two out of the last five years.

Following the second column (Foreclosure), it will not make a difference whether the loan is recourse or

non-recourse, but whether the foreclosure was judicial or non-judicial. The Internal Revenue analysis of the tax consequences generally begins with a determination of whether the loan is a recourse or non-recourse loan. If the loan is non-recourse, the property is treated as sold for the outstanding loan balance. If the loan is recourse, the property is treated as sold for its fair market value (the price at which it sells at the foreclosure sale) and the balance of the recourse loan is treated as canceled debt (the same treatment as a short sale or deed in lieu of foreclosure transaction). However, one might ask in the case of a non-judicial foreclosure where the bank essentially converts a recourse loan to a non-recourse loan whether the loan should be treated as recourse or nonrecourse. The bank will invariably report that the debtor was "personally liable" on the Form 1099-A. IRC Sec. 7434 provides a remedy for misreporting by a bank, which is a fairly common occurrence.

The Court in *Chilingirian v. Commissioner*, 918 F.2d 1251 (6th Cir. 1990) found that in the case of a non-judicial foreclosure, it made no difference whether the loan is recourse or non-recourse. The Court pointed out that under IRC Sec. 1001, gain is determined by the excess of cash and property received over the basis in the property. Essentially, the debtor is exchanging the deed to the property for the canceled note. Therefore, the value of the canceled note is property received by the taxpayer, and the result is the same as the treatment of a non-recourse loan. See also *Wicker v. Commissioner*, T.C. Memo 1993-431 (T.C. 1993). The inquiry is focused on whether the cancellation of personal liability was part of the sale. One might wonder if this is true in a short sale, although the short sale can be distinguished in that the buyer in a short sale is not the lender cancelling the debt. Keep in mind that in the Ninth Circuit, the issue remains open and the Internal Revenue could pursue the recourse/non-recourse line of reasoning.

Under the *Chilingirian* reasoning in the non-judicial foreclosure which I would argue any day, the property is deemed to be sold at the loan balance and no cancellation of indebtedness income is generated. The taxpayers gain is \$700,000 of which \$500,000 can be excluded by a couple. The schedule (PDF) follows the *Chilingirian* reasoning. If the *Chilingirian* reasoning is followed, the return should include an explanation since the 1099-A will suggest a different treatment. This is one of those delicious conundrums in that you could report the transaction consistent with the IRS thinking and are not likely to be questioned.

In the case of a non-judicial foreclosure, the gain will be \$300,000 which is excludable gain, and the deficiency will become cancellation of indebtedness income if it is forgiven. Often, particularly in the case of a second loan which remains an unsecured liability following the foreclosure, personal liability will be discharged in a bankruptcy following the foreclosure or short sale, and the cancellation of indebtedness income will be excluded.

Going back to the non-recourse loan in the short sale column, the reasoning of *Chilingirian* would certainly suggest that if the debt is forgiven as part of the short sale, the result should be the same as in the foreclosure case (no cancellation of indebtedness income and \$700,000 in gain). Here again, one may have one's choice of outcome with relative impunity.

In analyzing the case of a low basis residence, a short sale might make sense if the COD income can be excluded. If a second loan was used to procure the residence, it is treated as acquisition indebtedness. Since the second becomes an unsecured promissory note when a first forecloses, a short sale may allow the homeowner to negotiate a resolution of the second. A deed in lieu of foreclosure produces the same results as a short sale, and might be advantageous because there may be more room for negotiation on the fair market value, and the credit implications are slightly less severe. However, in most cases, the non judicial foreclosure route provides the preferable tax result.

The results shift when analyzing commercial or rental property. This is in part because while a loss on a personal rental is not deductible, a loss in the case of an income producing property is deductible under IRC Sec. 1231 against ordinary income. Therefore, a short sale or deed in lieu transaction can lock in an ordinary loss if the COD income is excludable and produce a desirable result.

RELATED LINKS: For more information about exclusion of gain from the sale of a principal residence and related issues, see

■ 1-9 Federal Taxes Affecting Real Estate § 9.02

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The Even More Curious Case of Xilinx, Inc. v. Commissioner

2010 Emerging Issues 4850

Rufus Rhoades on the Even More Curious Case of Xilinx, Inc. v. Commissioner

By Rufus Rhoades

August 9, 2010

SUMMARY: Rufus Rhoades, Esq., co-author of the treatise Rhoades & Langer, U.S. International Taxation and Tax Treaties, reviews the new decision in *Xilinx, Inc. v. Commissioner* and what that revised decision may mean for transfer pricing.

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ARTICLE: Editor's Note: *In AOD-2010-3, the Internal Revenue Service (Service) announced that it believes the Ninth Circuit's opinion in Xilinx, Inc. v. Comm'r [598 F.3d 1191 (9th Cir. 2010), aff'g, 125 T.C. 37 (2005)] is erroneous and acquiesces in the result of the decision, not the reasoning, with respect to employee stock options (ESOs) granted in taxable years governed by Treas. Reg. §§ 1.482-1(b)(1) and 1.482-7(d) in effect prior to their amendment in 2003.*

The court's narrow holding was, of course, blunted by the amendments to the regulations in 2003 by T.D. 9088, 2003-2 C.B. 841. The court's conclusion remains, however, that Treasury cannot issue conflicting regulations under the arm's length banner and try to enforce whichever one suits Treasury's needs at any given time. Treasury's acquiescence, though, does not recognize the obvious - that Treas. Reg. § 1.482-7 does not apply the arm's length standard to the stock option problem. From Treasury's point of view, the emperor is still wearing clothes even though the rest of us know he is not.

* * * * *

On May 27, 2009, the Ninth Circuit issued its original opinion in *Xilinx, Inc. v. Comm'r* (567 F.3d 382 (9th Cir. 2009)), reversing the Tax Court. On January 13, 2010, the court withdrew the opinion. The other shoe dropped on March 22, 2010, when the court issued its revised opinion (2010 U.S. App. LEXIS 5795), this time affirming the Tax Court's conclusion that the Service had acted arbitrarily.

Arm's Length Concept. Let's go back a step. For the decades-even generations-that Section 482 has been in the Code, the premise upon which the transfer pricing rules have been built is the arm's length standard. That standard requires all related taxpayers that engage in commercial activity with one another to do so using an arm's length approach. Thus, the U.S. multinational corporation that has a foreign manufacturing subsidiary from which the parent buys inventory for resale is required to pay that subsidiary an arm's length price for the inventory.

The concept is pervasive. Related parties are required to pay an arm's length interest on loans, one from the other; related parties are required to pay an arm's length rent for property leased by one from the other; related parties are required to pay an arm's length royalty on licenses from one to the other.

The concept is also international. Most, if not all, of our treaty partners apply some form of similar transfer pricing theories which form the basis of enforcement of their tax laws.

The Background of Xilinx. Xilinx is in the computer software business. That means that research and development are a major part of its budget expenditures. As was common in that industry, Xilinx created an Irish subsidiary to conduct a good deal of that R&D. The parent and its subsidiary entered into a cost sharing agreement, applying Treas. Reg. Section 1.482-7(a)(2), under which the parties are to share the benefits of the R&D in proportion to their respective costs.

Xilinx also gave to those employees working in R&D stock options (which the court referred to as "employee stock options" or "ESOs"). The cost sharing agreement was silent on how the cost of ESOs should be handled by the parties. As a result, Xilinx did not treat the ESOs as a "cost" for purposes of the cost sharing agreement. The Internal Revenue Service challenged that position, claiming that the Irish subsidiary should have shared in the costs of ESOs granted to both the parent's and the subsidiary's employees who worked on R&D matters.

A good deal was at stake, for the Service had issued a statutory notice for well over \$100 million to Xilinx. Additionally, a number of other taxpayers have taken the same position on ESOs as Xilinx did.

The Law. Both IRC Section 482 and Treas. Reg. Section 1.482-1(b)(1) apply the arm's length standard, the latter stating: ". . . the standard to be applied *in every case* is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer." (italics added)

Contrast that regulation with the regulation dealing with cost sharing agreements (Treas. Reg. Section 1.482-7(d)(1)) which provides that participants in a cost sharing arrangement are to allocate *all* costs of developing the intangible.

The Problem. The parties agreed (and the Tax Court found as a fact) that unrelated persons entering into a cost sharing arrangement would not include the cost of employee stock options as a "cost." Since the arm's length principle would require related parties to only share costs that unrelated parties would share, that principle dictates that ESOs should not be included as a shared cost.

The Decision. In its original opinion, the Ninth Circuit held that the arm's length principle controls unless the government does not want it to control (or, perhaps, unless the arm's length approach simply doesn't work):

" . . . the regulatory history suggests the Secretary viewed cost sharing agreements related to intangible product development as a unique type of controlled transaction meriting a distinct method of analysis." *Xilinx v. Comm'r*, 567 F3d at 489.

Note that the court looked at regulatory history, not legislative history. The reason is that the legislative history does not contain any support for either Treasury's or the court's abandonment of the arm's length standard.

Having reached that conclusion, in its 2009 opinion, the court went on to find that the cost sharing regulations trumped the general arm's length regulations, so ESOs should be included as a cost in the cost sharing calculations (thereby increasing Xilinx's taxable income). The court reversed that holding in its 2010 opinion. The new decision, however, has three different opinions—one, a dissent—so we are really pressed to learn anything from the holding. The lead opinion (by Judge Noonan) found that the regulations on the treatment of ESOs were ambiguous and concluded that the general rule of "arm's length" should take precedence over the more specific regulation dealing with ESOs. Judge Fisher, in his concurring opinion, found the two regulations irreconcilable and found the government's attempt to

shove the square peg of "all costs" into the round hole of "arm's length" troubling.

Comment on the 2010 Decision. The two regulations are certainly irreconcilable. Given that, one does wonder why the government did not meet that conflict between the two regulations head on and state that the "all cost" regulation is a divergence from the general arm's length standard, but that Treasury is authorized to take that action. That position may not have carried the day, but it would have been far more difficult for the panel to hold that Treasury is not authorized to make small in-roads on the arm's length principle than to try to convince the court that an obvious conflict really did not exist. Perhaps counsel for the government had never heard the Emperor's Clothes story.

Is Transfer Pricing Dead? The answer is no, but it is headed for significant limitation, if not oblivion. The reason is that transfer pricing does not work. In addition to not working, transfer pricing policy imposes significant costs on both the business community and the governments that attempt to enforce that policy throughout the first world and does not carry any commensurate benefit.

When we suggest that transfer pricing does not work, we are assuming that transfer pricing, as a policy, has a purpose and that the purpose is to ensure that each country involved in any transaction generates an appropriate amount of tax on the profit made in the transaction. Even a cursory review of the statistics indicates that is not happening, that we are not even close to such a goal.

The costs of the transfer pricing policy are staggering. Year after year, businessmen throughout the first world identify transfer pricing as the most difficult and burdensome tax issue they face. From the government's standpoint, it spends significant amounts attempting to enforce the policy all the way from writing (and re-writing) complex, unintelligible regulations to expensive lawsuits to enforce those regulations.

Is There a Better Way? Well, certainly there is another way—a way that, in our view, is a better way. That way falls under the heading of "unitary business". Although that form of intercompany pricing has a number of iterations, the unitary business approach is generally built on the concept that the separate existence of corporate related parties should be disregarded. The idea is not all that different than if Congress mandated that all subsidiary corporations would be treated as filing a consolidated return with their parents.

If the unitary business theory had applied to Xilinx, Xilinx and its Irish subsidiary would have been treated as a single taxpayer for U.S. tax purposes. All intercompany payments would be washed out and the combined income would be treated as the group's income. The primary issue would then be to identify how much income should be allocated to Ireland and how much to the United States. One approach would be to adopt the Massachusetts formula—sales, payroll, and assets—although that formula has its detractors.

No one disputes that the unitary approach has its problems. However, the reason that it appears better to us than the current policy is that the unitary approach, unlike the arm's length approach, is based on commercial reality. The arm's length approach is based on a legal fiction, which is the genesis of its difficulties. Corporations are legal fictions; they "exist" only because we say they do. That legal fiction has come to rule the game, similar to a robot taking on a mind of its own.

The unitary approach disregards the corporate existence and attempts to allocate income and deductions based on commercial reality. That, alone, makes it a better approach to the problem.

RELATED LINKS: For more information, see

- LexisNexis Tax Advisor -- Federal Topical § 4A:18.01

For discussion of the arm's length standard, see

- 2-18 Rhoades & Langer, U.S. Int'l Tax'n & Tax Treaties § 18.03

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When Assets Given to a GRAT Decline in Value

2010 Emerging Issues 5244

USC Gould School of Law 2010 Tax Institute: When Assets Given to a GRAT Decline in Value

By Andrew Katzenstein and Stephanie Zaffos

August 6, 2010

SUMMARY: Sometimes estate plans fail to address the possibility that assets will drop in value. This Emerging Issues Analysis discusses what happens when this occurs in the context of a grantor retained income trust (GRAT) and proposes a potential remedy for this problem.

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ARTICLE: Sometimes estate plans fail to address the possibility that assets will drop in value. This Emerging Issues Analysis discusses what happens when this occurs in the context of a grantor retained income trust (GRAT) and proposes a potential remedy for this problem.

How a GRAT is Supposed to Work

A gift to a GRAT is structured as a gift of an asset to an irrevocable trust from which the settlor keeps the right to an annuity for a specified number of years. Each year, on the anniversary date of the GRAT, the annuity is paid to the settlor. At the end of that specified number of years (the GRAT term), the assets remaining in the GRAT pass to the settlor's children (or trusts for their benefit). If the settlor fails to outlive the GRAT period, the technique is ineffective - IRC § 2036, 26 USCS Section 2036 includes the GRAT assets as part of the settlor's taxable estate and estate tax is imposed on the value of those assets (though, depending on the interest rate at the time of the settlor's death and the value of the GRAT assets at that time, a portion of the GRAT may escape estate tax and actually provide some nominal tax benefit for the children). The value of the gift to the GRAT is reduced, for gift tax purposes, by the actuarial value of the annuity retained by the settlor. In most cases, the value of the annuity is calculated to equal the value of the assets gifted to the GRAT - so that the gift is valued for gift tax purposes as zero (a "zero out GRAT"). If the annuity is stated as a percentage of the value of the asset gifted *as finally determined for Federal gift tax purposes*, the settlor never has to worry about paying gift tax if the IRS determines that the value of the gifted asset is worth more than the settlor reported on his gift tax return; in that event, the annuity automatically adjusts and the gift stays at zero. n1

The annuity includes an "interest factor" - the IRC § 7520, 26 USCS Section 7520 rate. This rate, established each month, must be paid in addition to the "principal amount" of the value of the gifted asset in order for the gift to be valued at zero. In effect, the 7520 rate is the "hurdle rate" that the gifted assets must appreciate by more than in order for the GRAT to pass any assets without gift tax to the children. To the extent that the gifted asset appreciates in value more

than the 7520 rate, that appreciation passes tax-free to the children. The zero out GRAT is illustrated by the following examples:

Example 1: Parents anticipate that their closely held business will be purchased within the next 6-9 months for a substantial sum. They value the business now at \$10 million, and gift all of their stock in the business to a 2-year GRAT. Based on March 2010 rates, the annuity that must be paid to "zero out" the gift is 52.41364% of the value of the asset gifted to the GRAT each year. The present value of that annuity is \$10 million, so the value of the gift for gift tax purposes is zero. The "hurdle rate" is 3.2% -- so any appreciation in the value of the business in excess of that amount is transferred to the children without incurring transfer tax.

The offer to buy the business comes in, and it is sold for \$20 million 9 months after the GRAT is created. The parents are paid \$5,241,364 (i.e., 52.41364% x \$10,000,000) at the end of the first year, \$5,241,364 at the end of the second year, and the remaining \$9,517,272 passes to the children without transfer tax. Assuming a 45% rate, the estate tax saved is \$4,282,772. n2

Example 2: Same facts as Example 1, but IRS audits the gift tax return reporting the gift to the GRAT and determines that the value of the company at the time of the gift was \$15 million. The annuity amount is increased to \$7,862,046 (because the annuity was stated as a percentage of the gift to the GRAT as finally determined for Federal gift tax purposes) but the gift, for gift tax purposes, is still zero.

The company is sold for \$20 million. The amount that passes tax-free to the children after 2 years of \$7,862,046 annuity payments is \$4,275,908, and the tax savings (assuming a 45% rate) is \$1,924,159.

Problems that Arise When a GRAT Fails

If the value of the assets gifted to a GRAT fail to appreciate more than the "hurdle rate," the tax benefits sought by the GRAT will fail to be achieved. The following example illustrates this point:

Example 3: Assume the same facts as Example 1, except that in this circumstance the economy suffers a deep reversal shortly after the GRAT is funded. Credit is unavailable in the market and the expected buyer, unable to gain financing, does not purchase the business. Worse yet, the business drops substantially in value and is teetering on bankruptcy.

The first problem with the GRAT is that it appears clear that over the next 2 years there is likely to be *no* appreciation in value. Not only will the "hurdle rate" not be achieved, but the business will be lucky to survive. The drop in value may be seen by the parents as an opportunity - if the business does survive, and could be reacquired for a gift to a new GRAT, there is an opportunity for transferring more appreciation to the children than what was initially thought. However, the payment of the annuity to the parents (in this event, to be made in the form of the business stock) is not due until the end of the GRAT's first (and second) year. This gives rise to a second problem; if the economy recovers over that period, that opportunity for pushing appreciation is lost until that time.

One problem that does not arise in the context of a zero out GRAT is that the parents have not wasted any of their unified credit in funding the GRAT. If the parents had used another estate planning technique where they made a gift that exceeded their annual gift tax exclusions, they would have used unified credit *to no benefit*. n3

What Are the Tax Consequences When a GRAT Fails?

When the GRAT fails, the GRAT is unable to pay the annuity in full. In that circumstance, it pays the annuity to the extent it can (typically by returning the gifted asset, now worth significantly less) to the settlors. GRATs are grantor trusts, so that there is no income tax impact of any payment from the GRAT to the Settlers. n4 Though the GRAT's failure to pay the annuity could be seen as forgiveness of a debt (it is not, but some practitioners worry that IRS might make that argument), there would be no tax consequence because a debt forgiven to one's own grantor trust is ignored

for income tax purposes. n5

Is there a tax consequence if the settlor-parents don't sue the GRAT for the annuity payments they did not receive? Many practitioners worry that somehow this will be treated as a gift. However, this would seem to be more of a potential concern with a sale to an intentionally defective irrevocable trust (IDIT) than with a barren GRAT. n6 In essence, there should be no tax consequence at all for a failed GRAT.

How Can the Parents Seek to Re-Gain the Benefits of the Failed GRAT?

Where the parents believe that the value of the business will recover, its drop in value provides a new GRAT opportunity to push appreciation to the children. However, unless the parents can reacquire the GRAT assets before that appreciation occurs, another opportunity can be lost. This problem arises because the GRAT requires payments (typically) on its anniversary date. If the drop in value occurs shortly after the gift to the GRAT, and that drop in value is recovered before the anniversary date payments are to be made, the parents must find a way to reacquire the GRAT assets before that appreciation occurs.

The parents should purchase the GRAT assets as quickly as possible, in order to reacquire those assets for "re-GRATting." The sale by the GRAT to the parents has no income tax consequences (a sale from a grantor trust to its grantors is ignored). n7 Consider the following example:

Example 4: Assume the same facts as Example 1, except that the business falls to \$1 million in value shortly after the gift to the GRAT is made. Parents purchase the shares back for \$1 million, and re-GRAT those shares to a new, 2-year zero out GRAT.

The annuity that must be paid from the new GRAT is \$524,136. At the end of the first year of the GRAT when that first payment is due, the GRAT assets are worth \$5 million. In that circumstance, 10.48272% of the stock is transferred back to make the GRAT payment. At the end of the second year, the company is again worth \$10 million. The annuity payment of \$524,136 is made by transferring 5.24136% of the stock back to the parents. The remaining 84.27592% of the company, worth \$8,427,592, passes to the children without transfer tax. Assuming a 45% rate, \$3,792,416 is saved.

The payment to purchase the GRAT shares may be made using cash or a note. n8 If the parents' note is used, care should be taken to charge an interest rate and require payments to be made that correspond to the GRAT's rate and term (otherwise gift tax consequences could arise).

The initial GRAT makes the annuity payments with the cash or note received from the parents who purchased the stock back from it. Again, those payments will "fail" to transfer anything to the children without tax, but (for the reasons described above) there should be no tax consequence for the failure of the initial GRAT.

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n1 Treas. Reg. §§ 25.2702-3(b)(2), 1.664-2(a)(1)(iii).

n2 The GRAT is a grantor trust, so the parents paid the capital gains tax generated by the sale. As a result, the children receive the entire \$9,517,272, and the "net" tax saved is \$4,282,772!

n3 For further information on this issue, see Andrew M. Katzenstein and Stephanie Zaffros, *USC Gould School of Law 2010 Tax Institute: When Assets Sold to an IDIT Decline in Value*, LexisNexis Emerging Issues Analysis, 2010 Emerging Issues 5245, Matthew Bender 2010).

n4 See, e.g., *PLRs 9519029 and 9449012*.

n5 *Revenue Ruling 85-13, 1985-1 C.B. 184*; H.R. 4170, 98th Cong., at 530 (1984)(enacted). In the Revenue Ruling, the IRS averred that a grantor trust is not recognized as a separate taxpayer capable of entering into a sales transaction with the grantor. Consequently, the transfer of assets to a grantor trust was not a sale for federal income tax purposes. The IRS reasoned that under Treas. Reg. §1.671-3(a)(1) it would be anomalous to suggest that Congress intended for the trust to be ignored for purposes of attribution of income, deduction and credit, and yet retain its status as a separate entity capable of entering into a sales transaction with the grantor. The Settlor is treated as the owner of all of the trust's assets.

n6 With a GRAT, once all of the assets are distributed to the grantor, there are simply insufficient assets to make the continuing annuity payments. Contrast this with a sale to an intentionally defective irrevocable trust (IDIT) for a promissory note where the assets depreciate in value and the trust defaults on the loan, where the concern becomes "forgiveness" of a debt. There is no debt owed to the grantor of a GRAT like there is with a sale to an IDIT.

n7 Since additional contributions to GRATs are prohibited (Treas. Reg. §25.2702-3(b)(5)), the parents should be sure to pay fair market value for the assets purchased, so that there is no additional "gift" to the GRAT. Although there is no authority on point, it seems reasonable to assume that the trustee would be required to "give back" the second contribution to the grantor, or that there would be no discount associated with the second contribution for the remaining term of the GRAT. It may also be appropriate for the GRAT instrument to prohibit any addition to the original GRAT but authorize the trustee to accept new transfers to be held in new and separate GRATs with the same provisions and the same initial term as the original GRAT. In *PLR 200149016*, addressing an additional contribution to a CLAT (like GRATs, additional contributions are prohibited to CLATs), the IRS ruled that additional contributions to a CLAT could qualify for charitable deductions because the governing instrument required that each additional contribution and its earnings be held in a separate account with various restrictions.

n8 A grantor can also reacquire the GRAT assets by substituting other assets of equal value, such as stock in another corporation. In *PLR 200846001* (November 14, 2008), the IRS said that neither the existence nor the exercise of the power of substitution disqualifies the grantor's retained interest as a qualified interest under IRC §2702(b) 26 USCS Section 2702(b) (conclusion based on fact that grantor could only exercise power in a fiduciary capacity). In order to avoid making a gift to the GRAT, and hence, a disallowed additional contribution, the grantor should use his best efforts to ensure that the value of the substituted property is equivalent in value to the exchanged assets. See footnote 6, above.

RELATED LINKS: For further information, see

- LexisNexis Tax Advisor -- Federal Topical § 3F:3.10

For further information, see

- 2-21 Modern Estate Planning § 21.10

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When Assets Sold to an IDIT Decline in Value

2010 Emerging Issues 5245

USC Gould School of Law 2010 Tax Institute: When Assets Sold to an IDIT Decline in Value

By Andrew Katzenstein and Stephanie Zaffos

August 6, 2010

SUMMARY: Sometimes estate plans fail to address the possibility that assets will drop in value. This Emerging Issues Analysis discusses the effect of an asset value decrease in the context of a sale to an intentionally defective irrevocable trust (IDIT) and proposes a potential remedy for this problem.

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ARTICLE: Sometimes estate plans fail to address the possibility that assets will drop in value. This Emerging Issues Analysis discusses what happens when this happens in the context of a sale to an intentionally defective irrevocable trust (IDIT) and proposes a potential remedy for this problem.

How a Sale to an IDIT is Supposed to Work.

A sale to an IDIT is intended to accomplish the same results as a gift to a grantor retained income trust (GRAT) - a transfer of appreciation occurring after the sale to the (trust for the) children. In this context, the parents establish a "grantor" trust for the benefit of their children. Parents make a gift to the trust, typically equal to 10% of the amount of the asset to be sold. n1 The IDIT then uses its cash gift to purchase the asset expected to appreciate, for 10% down and a promissory note. In many cases, the note is an interest-only note, with no prepayment penalty. The applicable federal rate is the interest rate charged - in essence, the AFR serves as the "hurdle rate." There is no gain or loss recognized on the sale - and no income tax payable as a result of interest received by the parents. When the parents believe that the asset has "peaked" in value, the parents can ask the trustee of the IDIT to repay the note. What remains after the note is repaid passes to the children without transfer tax.

IDIT sales are "better" than GRAT gifts in four ways:

First, the AFR (.64% in March 2010 for a 3-year note) is less than the Section 7520 rate (3.2% in March 2010). Therefore, the "hurdle rate" that has to be exceeded for the transaction to succeed.

Second, payments can be made at any time in the IDIT context, as opposed to the GRAT context where payments must be made on specified dates. Further, only interest is required to be paid in the IDIT sale (before the due date of the note), while "principal" payments must be made each year when a GRAT is used (payments aren't really principal

payments, as the GRAT doesn't involve a sale - this term is used for analogy only). These differences make the IDIT sales a more "flexible" technique than the GRAT technique.

Third, and most importantly, IDIT sales allow generation-skipping tax ("GST") exemption to be allocated to the IDIT in connection with the gift of the down payment on initial funding. Later growth in the value of the IDIT assets can therefore pass without GST to grandchildren when the children die (so long as the IDIT lasts for the child's lifetime). Since GST exemption can't be allocated to the GRAT until the end of the GRAT term, it is effectively impractical to use the GRAT technique to pass assets further than one generation down. n2

Finally, the parents must outlive the GRAT term for the GRAT to work. There is no such survivorship requirement for an IDIT.

The main advantage a GRAT gift has over an IDIT sale is that the GRAT annuity (if stated as a percentage of value as finally determined for Federal gift tax purposes) automatically adjusts if the IRS revalues the gift to the GRAT - allowing a zero out GRAT gift to never be valued at more than zero. In the IDIT sale context, practitioners typically use a formula price adjustment clause - often coupled with a gift of the bulk of any "increase" in value determined on audit to pass to a trust that defers or avoids the gift tax n3 - to provide for the same result. *However, only very recently have the courts sanctioned this approach - so there is a risk that the taxpayer might have to pay gift tax in the context of a sale to an IDIT.* n4 Where the taxpayer can't afford to pay that tax, he or she must use a GRAT! Consider the following example to show how an IDIT sale is supposed to work:

Example 1: Assume parents gift \$1 million to an IDIT. Then, they sell their closely-held family business to the IDIT for \$1 million down and a \$9 million interest-only note, with principal due in 3 years. Using March 2010 rates, the interest rate equal to the AFR is .64% (assuming interest is payable annually). The business generates a dividend of .64%, which is just enough to make the interest payment due under the note from the IDIT. Two years later, a buyer purchases the business from the IDIT for \$20 million. The IDIT pays off the \$9 million principal balance due on the note and retains \$11 million of the sales proceeds. n5 The end result is that \$11 million has been transferred without gift or estate tax, saving \$4,950,000 in transfer tax.

The IDIT is retained in trust for the lifetime of the Settlor's children. Assuming that \$1 million of GST exemption was allocated to the initial gift to the IDIT, it has an inclusion ratio of zero. That means that whatever is held in the IDIT when the children die passes to their children without transfer tax.

Problems that Arise When a Sale to an IDIT Fails.

If the value of the assets sold to an IDIT fail to appreciate more than the "hurdle rate," the tax benefits sought by the IDIT will fail to be achieved. The following example illustrates this point:

Example 2: Assume the same facts as in Example 1, except that in this circumstance the economy suffers a deep reversal shortly after the sale to the IDIT takes place. Credit is unavailable in the market and the expected buyer of the business, unable to gain financing, does not purchase the business. Worse yet, the business drops substantially in value and is teetering on bankruptcy.

The first problem with the IDIT is that it appears clear that over the next two years there is likely to be *no* appreciation in value. Not only will the "hurdle rate" not be achieved, but the business will be lucky to survive. The drop in value may be seen by the parents as an opportunity - if the business does survive, and could be reacquired for a sale to a new IDIT, there is an opportunity for transferring more appreciation to the children than what was initially thought. To accomplish that end, the trustee of the IDIT could miss a payment due under the note. If the parents' note is secured by the business sold to the IDIT, the parents might foreclose on their security, reacquire the shares, and sell them to a new IDIT - now at the depressed price.

However, if this approach is followed, the parents will need to consider another gift to the new IDIT to allow it to

make its 10% down payment. Though likely, in this scenario, to be a much smaller gift than the \$1 million used to fund the initial IDIT, the fact that a new gift must be made points out the significant problem that has occurred because of the failure of the initial IDIT: *parents have used up \$1 million of their unified credits and \$1 million of their GST exemptions and gotten nothing for it!*

As a result of that problem, parents might choose to simply "let it ride" - leave the IDIT sale intact and hope that the business will increase in value over time. If the value rises back to the sales price used for the sale to the IDIT, there is at least a "break even" and no *waste* of unified credits or GST exemptions (because the \$1 million of equity after the IDIT makes its down payment remains in the IDIT for the children when the note is repaid). Alternatives to avoid this problem are discussed in greater detail below.

What Are the Tax Consequences When an IDIT Sale Fails?

When the IDIT sale fails, the parents are simply paid less than they are entitled to receive under the note. They take all of the assets the IDIT has - here, the depreciated value of the stock sold to it - and the balance of the amount owed them is just not paid:

Example 3: Assume the same facts as Example 2, except that the business drops to \$2 million in value. The parents take all of the stock back from the IDIT, which is essentially a \$2 million payment for the \$9 million they are owed. They don't get paid the \$7 million balance.

IDITs are grantor trusts, so that there is no income tax impact of any payment from the IDIT to the settlors. Though the IDIT's failure to pay the balance of the note principal is a forgiveness of a debt, there would be no tax consequence because a debt forgiven to one's own grantor trust is ignored for income tax purposes. n6

Is there a tax consequence if the settlor-parents don't sue the IDIT for the principal payments they did not receive? Many practitioners worry that somehow this will be treated as a gift. However, failure to sue a barren trust that will not receive assets in the future should not be deemed a gift. There is no authority directly on point, but the following cases provide a helpful analysis of the issues. In *Hunt v. Comm'r*, parents made various cash transfers to their children to meet margin calls in commodities transactions. n7 The transfers were evidenced by demand notes, with interest payable at the floating prime rate. The children became insolvent during the course of the year. The parents made a "demand" on the loans at the end of the year and the children transferred substantially all of their assets (except for creditor exempt assets) to their parents, who thereafter cancelled the remaining portion of the debt. Relevant to this discussion, the Court held that under the facts and circumstances of this case, the cancellation of the debts were not gifts and that the loans were "worthless" when the parents made the demand. Consequently, the parents were entitled to a bad debt deduction for the unpaid loan amounts. The Court stated, "when the attendant circumstances indicate that a debt is worthless and uncollectible and that in all probability, legal action to enforce the payment would not result in satisfaction, the taxpayer has met his burden of proving worthlessness."

Similarly, in *Diab v. Comm'r*, a taxpayer was allowed a bad debt deduction for the year in which a \$300 debt to a friend became worthless because of the inability of the friend to repay the loan. n8 The Service argued the forgiveness of the debt was a gift rather than a worthless bad debt because taxpayer made no legitimate effort to collect the debt. The Court disagreed and reasoned that the law does not require a creditor to engage in futile acts. "If the creditor can show that the debtor's financial condition was such that attempts to collect would have been useless, then the creditor is excused from collection activities."

Thus, the primary tax consequence for a failed IDIT is the wasting of the parents' unified credits and GST exemptions, discussed above.

How Could the Parents Have Structured the IDIT Sale to Reduce the Risk of Wasting Unified Credits and GST Exemptions?

The parents' unified credits and GST exemptions are used in an IDIT sale in connection with the gift to "seed" the trust with the 10% down payment most practitioners believe is necessary to allow the IDIT to succeed. If assets sold to the IDIT appreciate, those credits and exemptions are effectively used to provide benefit to future generations. However, where assets sold decline in value, those credits and exemptions are wasted. The obvious way to risk less of these credits and exemptions is to use less of them when funding the IDIT. This can be accomplished - and still avoid having the IDIT transactions fail - where the beneficiaries of the IDITs guarantee the notes owed to the parents.

Before the economic downturn, practitioners who used this technique typically had the beneficiaries guarantee the entire amount due under the notes. Because assets appreciated in value, the guarantees never had to be called upon to satisfy the notes. However, where the value of the assets sold to the IDITs decline in value, the guarantees will likely be called upon to make the note payments. In essence, the children will have to repay the notes they guaranteed on behalf of the IDIT when the IDIT cannot make the payments itself:

Example 4: Assume the same facts as Example 3 except that the gift to fund the IDIT is \$100,000 and only \$100,000 is paid "down" - with the note in the amount of \$9,900,000. To make the sale "work," practitioners suggest that 10% down be paid. ⁿ⁹ Where that amount is not paid as the down payment, conventional wisdom says that the IDIT beneficiaries should guarantee the loan. ⁿ¹⁰

In this instance, the IDIT is for the benefit of the children. The children guarantee the \$9,900,000 note. The value of the IDIT asset drops to \$2 million. The IDIT trustee decides to pay the note off immediately. The trustee transfers the \$2 million IDIT asset back to the parents, reducing the principal due to \$7,900,000. The parents must call on the guarantee to repay the balance. The children are wiped out when they have to make good on the guarantee.

The good news in this example is that the parents only used \$100,000 of their unified credits and GST exemptions in the failed sale. The bad news is that what was accomplished was "reverse" estate planning - the children were wiped out and the parents' estates grew. To avoid some of the "bad news" aspect of this example, consider the following:

First, consider having the children only guarantee 10% of the loan. ⁿ¹¹ If 10% "down" makes the sale work why wouldn't a guarantee of 10% of the loan work the same way? In each situation, the IDIT and its assets are to be relied upon for repaying 90% of the note - economically, there is no difference between a 10% down payment and reliance on the IDIT assets to repay the other 90% or a minimal down payment with a 10% guarantee so that the IDIT assets are relied upon for payment of the other 90%.

Second, consider having the guarantee expire on its own terms if the value of the IDIT assets increases by at least 10%. This "self-expiration" provision protects the children guarantors from ever having to pay in the event that the IDIT assets "spike" for a brief moment and then later fall below the value that the IDIT paid for them. ⁿ¹²

Another option would be to repay the note when the IDIT assets increase by 10% in value, and then to immediately sell those assets back to the IDIT for 10% down and a note for the balance. What is "left behind" when the initial note is repaid is used to provide for the down payment in the second sale, without further use of parents' unified credits or GST exemptions. When the first note is repaid the guarantee is extinguished and it is not needed at all for the second sale.

What should be done if the guarantee exists and is for 100% of the amount outstanding?

- Try to at least service the interest on the loan using cash flow from the IDIT assets or gifts within the amount of the annual gift tax exclusion. This way, the problem doesn't get any worse!
- Hope that the value of the IDIT asset becomes worth more than the principal balance on the loan - and then pay off the loan immediately!
- Keep the loan outstanding until the parents die. Extend the loan if possible. On death, discount the unsecured, long-term, low interest note. Perhaps a 20% discount on the note can "save" the transaction.
- Consider having the parent's close friend form a business by contributing \$7,900,000 of stocks and bonds to it. Then, have the parent agree to pay that company to guarantee the IDIT's loan - and extinguish the children's guarantee in favor

of this new guarantee that the parent believes is more sound. A few years later, the parent can purchase the business from his friend for the value of its assets - and subject to the liability of the guarantee. Now, the parent can use the assets of the company *he owns* to make good on the guarantee. In essence, the parent's assets have been used to pay off the note so that nothing had to come from the children who originally provided the guarantee. Be wary of the step transaction doctrine - and the parent must have a *really good* friend to make this work - but perhaps this unusual approach could work in the right circumstance!

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n1 See Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note - An End Run Around Chapter 14?*, 32 U. of Miami, Phillip E. Heckerling Inst. of Est. Plan (1998) at 1505.2.

n2 An allocation of GST exemption to certain transfers is not effective until the close of the Estate Tax Inclusion Period, or "ETIP." IRC § 2642(f), 26 USCS Section 2642(f). The ETIP is the period during which, if the transferor died, the transferred property would be included in the transferor's estate. The ETIP terminates upon the first to occur of the transferor's death or the time at which no portion of the transferred property would be includible in the transferor's gross estate (except by reason of IRC § 2035, 26 USCS § 2035). Treas. Reg. § 26.2632-1(c)(3). Hence, no effective allocation of GST exemption can be made until the end of the GRAT term. See, e.g., *PLR 200227022*.

n3 For example, the "increase" can be made to pass to charity, avoiding the tax. Another option is to cause the "increase" to pass to a QTIP trust, deferring the tax until the Settlor's spouse dies. A third option is to cause the "increase" to pass to a "zero-out" GRAT, avoiding a taxable gift entirely. A fourth option is to cause the "increase" to pass to a trust over which the Settlor holds a power of appointment, rendering the gift "incomplete" and not subject to gift tax.

n4 In *Christiansen v. Comm'r*, 104 AFTR 2d 2009-7352 (8th Cir. 2009), the Court upheld a formula disclaimer (that operated much like a "defined value" transfer clause, where "excess amounts" poured-over to charitable foundation) over public policy objections by the IRS, thereby "blessing" defined value clauses. The IRS argued that fractional disclaimers fail to preserve a financial incentive for the IRS to audit an estate's tax return (because any post-challenge adjustment to the value of an estate would consist entirely of an increased charitable donation), and should be categorically disqualified as against public policy. The Court rejected the IRS' argument on three grounds. First, the IRS' role is to enforce tax laws, not simply maximize tax receipts. Second, Congress seeks to encourage charitable donations by allowing deductions for such donations. And third,

there are sufficient other mechanisms imposing duties on taxpayers, such as fiduciary obligations of executors and trustees, to accurately report estate values, so that the IRS is not the only arbiter of a "watchdog function." The first and third reasons given by the Court apply to all defined value clauses, while the second would apply only to formula allocation clauses that pour-over the "excess" over a defined value amount to charity. Further, in another recent case, *Petter v. Comm'r*, *TC Memo 2009-280*, the Tax Court upheld a defined value gift clause for LLC interests given to the grantor's children and charities. The IRS argued that the defined value gift clause was unenforceable as against public policy. The Court noted in its categorization of prior cases that "savings clauses are void, but formula clauses are fine." The Court disagreed that defined value clauses are against public policy and referenced other situations where the IRS expressly blesses formula clauses, such as disclaimers, charitable remainder trusts and marital deductions. *See also McCord v. Comm'r*, *461 F.3d 614 (5th Cir. 2006)*, rev'g *120 T.C. 358 (2003)*.

n5 Since the IDIT is a "grantor" trust, it retains the gross proceeds - the parent grantors pay the capital gains tax due on the sale.

n6 *See, e.g., PLRs 9519029 and 9449012*. If the trust is not a grantor trust, the cancellation may give rise to income from discharge of indebtedness under IRC § 61(a)(12), 26 USCS § 61(a)(12). However, IRC § 108(a)(1)(B), 26 USCS § 108(a)(1)(B) provides that gross income does not include amounts otherwise includible in income because of discharge of indebtedness if the discharge occurs when the taxpayer is insolvent. Under IRC § 108(a)(3) 26 USCS § 108(a)(3) the amount excluded from gross income by reason of the insolvency cannot exceed the amount by which the taxpayer is insolvent.

n7 *T.C. Memo 1989-335*.

n8 *T.C. Memo 1979-475*.

n9 In *Petter*, *TC Memo 2009-280*, Judge Holmes remarked that taxpayer's counsel indicated that "there was a rule of thumb" that a trust capitalized with a gift of 10% of its assets would be viewed by the IRS as a legitimate, arm's length purchaser in a later sale.

n10 *See generally* Hatcher and Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 *Journal of taxation* 152 (March 2000). In *PLR 9515039* the IRS acknowledged that a beneficiary guarantee can serve the same function as funding the trust and prevent estate tax inclusion under IRC § 2036(a)(1), 26 USCS § 2036(a)(1).

n11 In order to prevent the beneficiary guarantee from being treated as a gift, each beneficiary who issues a guarantee may be paid a reasonable guarantee fee. *See* Hesch and Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 Heckerling Inst. Est. Plan, CH. 16 (2000). A guarantee fee in the range of 1%-2% of the amount of the guarantee should be considered reasonable. *See Hatcher and Manigault* at 153. If the trust pays the children a fee it is moving that money out of the parents' estates, though it will be income taxable to the children. In addition, the parents have to gift more to the trust to provide it with the cash to pay the fee.

n12 This would seem to be a logical, though fairly aggressive approach, however, and there is no case or ruling indicating whether it is effective or not.

RELATED LINKS: For further information, see

- LexisNexis Tax Advisor -- Federal Topical § 3F:3.10

For further information, see

- 2-21 Modern Estate Planning § 21.10

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Outright Gifting of Property Interests

2010 Emerging Issues 5242

USC Gould School of Law 2010 Tax Institute: Strategies for Transferring Family Homes -- Outright Gifting of Property Interests

By Nancy G. Henderson

August 5, 2010

SUMMARY: From the donor's perspective, the simplest alternative for transferring a family home to children and grandchildren is to make outright gifts of real property interests. This article discusses gifting with the annual exclusion, issues with gift tax, a relevant perspective of tenancy-in-common agreements, and continued use of the property.

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ARTICLE: The following is an overview of a tax planning techniqueⁿ¹, termed "Outright Gifting of Property Interests," that should be considered in the context of planning for family homes. From the donor's perspective, the simplest alternative for transferring a family home to children and grandchildren is to make outright gifts of real property interests. This article discusses gifting with the annual exclusion, issues with gift tax, a relevant perspective of tenancy-in-common agreements, and continued use of the property.

(1) Outright Gifting with the Annual Exclusion. With the possible exceptions of certain vacation timeshares and campground memberships, it is unlikely that there are many family properties that could be entirely transferred to children in a single round of gifts using the gift tax annual exclusion. However, gifts of fractional interests in real property are, in most cases, gifts of present interests in property that qualify for the gift tax annual exclusion.ⁿ² Further, such fractional interest transfers should be discounted for gift tax valuation purposes by some reasonable factor that takes into account the lack of marketability and lack of control inherent to co-ownership of real property as tenants-in-common.ⁿ³

The annual exclusion is indexed for the effects of inflation, presently allowing a donor to give up to \$13,000 in cash or property to any individual donee during any calendar year free of gift tax.ⁿ⁴ The annual exclusion can be effectively doubled if the donor's spouse participates in the gifting program, either because the donor's spouse is a co-owner of the property or because the donor's spouse agrees to gift splitting.ⁿ⁵ It is therefore possible to make incremental annual gifts of interests in a family home to children, grandchildren or others which, over time, can result in the complete transfer of the property without gift tax.

There are many disadvantages to this strategy, however. First, annual gifting of interests in real property generally requires a reappraisal of the property before each round of gifts to maximize the benefits of the exclusion without

exceeding it. Such appraisals can be expensive, particularly if they involve the determination of the appropriate fractional interest discount, which typically must be done by a business interest appraiser or an expert in the valuation of Tenancy in Common interests. Another disadvantage of gifting direct real property interests in small annual increments is that, over time, title to the property can become complicated, and it may be difficult after several years of fractional interest transfers to calculate the interests acquired by each donee as compared to the donor's remaining interest in the property. A third potential disadvantage is that annual exclusion gifts typically are not reported on a gift tax return and, therefore, the statute of limitations will not run and the IRS will have the ability to question the values used for the annual transfers, in most cases, at any time until an estate tax return is filed the donor's estate. Perhaps most importantly, once a direct interest in the property has been titled in the name of a child or grandchild, the property becomes potentially subject to the claims of the child or grandchild's creditors. As a result, liens can be placed on the property that will make selling or borrowing against the property difficult for everyone, and the debtor's interest in the property can be foreclosed by his or her creditors. Further, absent a Tenancy-in-Common Agreement (discussed below) restricting transfers of interests in the property, any child or grandchild could freely sell his or her interest in the property. As a result, the family could find itself co-owners of the property with strangers or even hostile persons. Finally, all co-owners will need to agree with regard to the sale or lease of the property, potentially diminishing its value to all of the owners.

(2) Outright Gifting with the Applicable Exclusion or by Paying Gift Tax. To address some of the disadvantages of gifting real property in small, incremental amounts, gifts or more significant interests in the property (or possibly the entire property) can be made using the \$1,000,000 gift tax applicable exclusion for the donor and the donor's spouse (with respect to jointly owned property or separate property if a gift-splitting election is made). Such gifts will require the filing of a federal gift tax return and, in states that have a state gift tax, a state gift tax return as well. If the cumulative value of the property transfers exceeds the donor's remaining gift tax applicable exclusion, a gift tax will be paid. Note that, in large taxable estates that are subject to significant estate tax, there can be substantial transfer tax savings achieved by paying gift tax on the lifetime transfer of a family home as compared to paying estate tax on the value of the donor's remaining interest in the home. This is because the gift tax is "tax exclusive" meaning the gift tax is a liability of the donor that is not treated as an additional taxable transfer, so long as the donor survives for a period of three years following the transfer. n6

(3) The Importance of a Tenancy-in-Common (TIC) Agreement. Co-ownership of real property, particularly real property that is held for the personal use of the owners, is fraught with peril. The subject of addressing issues of co-ownership and the resolution of disagreements or disputes between co-owners is beyond the scope of this article. However, in the context of gifts of direct interests in real property, it is worth at least some discussion as to the importance of a Tenancy-in-Common (or "TIC") Agreement and the issues that should be addressed in such an agreement.

(a) Waiver of Rights of Partition. Under the law of most, if not all states, tenants-in-common have a right of "partition." A right of partition provides a co-owner, among other rights, the right to cause the property to be sold. Because it is almost always the intent of the donor that the property be retained, it is generally advisable for a TIC Agreement to contain a provision waiving the owners' state law rights of partition. A waiver of state law rights of partition should also decrease the value of the TIC interests for gift, estate and GST tax purposes, as the official position of the IRS has been that the discount applicable to TIC interests should be limited to the costs of a partition of the property. n7

(b) Restrictions on Transferability. A TIC Agreement should address the further transfer of interests in the property. It is not advisable to prohibit transfers of property interests, as such a provision could be attacked as an unreasonable restraint on alienation, a forfeiture, or a violation of the rule against perpetuities. It is, however, reasonable to provide the family a right of first refusal should an owner seek to transfer a property interest outside of the family (or should an involuntary transfer occur, such as upon the divorce or bankruptcy of an owner). Such a provision can allow the family to either match the price and terms of a given offer or have the property interest appraised and purchase the interest for favorable terms, such as on an interest-only note with a balloon payment at maturity. Further, the agreement

can require that discounts be applied to the valuation of a fractional property interest, to reflect its lack of marketability, and lack of control, as well as the costs of the transaction (such as attorneys fees and recording costs), and even the estimated future costs of selling the property, as those costs will be borne by the remaining purchasers.

(c) Expenses and Capital Contributions. The TIC Agreement should address the relative responsibilities of the co-owners for the expenses of owning and maintaining the property. The agreement should address not only the relative contribution percentages, but also how much will be spent each year in connection with ownership and maintenance of the property. Because expenses will change over time, the agreement must be flexible. One option is to establish an agreed annual budget, to allow adjustments to the budget for the effects of inflation, and then to require a certain number of owners (such a majority in interest) to approve any change to that budget. Another option is to appoint one of the owners to manage the property (or to serve as the primary interface with a professional property manager) and to provide that owner the authority to incur expenses up to a certain threshold. Even if such procedures are established, however, the agreement should also provide some enforcement mechanism should an owner fail to honor his or her expense contribution obligation. For example, the agreement might provide that, should any owner fail to make a required contribution, the contributing owners will be deemed to have made a loan to the non-contributing owner. The deemed loan might be repaid, with interest, out of the eventual proceeds of the sale of the property. If, however, it is not likely that the property will be sold in any reasonable time frame, the agreement can provide that the deemed loan will be converted into an equity interest in the property when the loan reaches a certain amount or has been outstanding for a certain time period, or may permit the contributing owners to buy out the non-contributor for a favorable price and under favorable payment terms.

(d) Use of the Property by the Owners. With regard to family homes, the TIC Agreement should address the rights of, and restrictions imposed upon, the owners with regard to the use of the property. If the property is not large enough to accommodate multiple occupants at the same time, the agreement should address how a calendar will be established for the use of the property and, in particular, how to insure that the owners equitably share the most desirable dates, such as holidays and school vacations. The agreement might also address such issues as who is allowed to be a guest at the property, whether pets are permitted and whether personal items can be stored at the property. Finally, the agreement might account for damages to the property (or to furnishings or other tangible items) attributable to the use of the property by the owners or their guests. To address this last issue, it might be advisable to require a damage deposit before anyone may use the property and to perform an inspection of the property (preferably by a third party) before and after each use.

(4) Continued Use of the Property by the Donor. Often, donors will wish to retain some (if not the exclusive) use of a gifted family home after ownership has been legally transferred to children or others. In such circumstances, care needs to be exercised to avoid the reinclusion of the gifted property in the donor's estate under Section 2036(a)(1) of the Code (26 USCS 2036(a)(1)). The strategy to be utilized to avoid reinclusion will depend upon a number of factors, some of which are discussed below.

(a) Retained Use for Only Limited Periods. If a donor transfers the property to children or grandchildren, and then retains the right to use the property for a specified period of time each month, and if that is in fact the amount of time that the donor spent in the property prior to death, the IRS has ruled that the entire value of the property is not included in the donor's estate under Section 2036(a)(1). Rather, only the portion of the value of the property that is related to the donor's retained use of the property is so included. ⁿ⁸ For example, where a donor gifted a vacation home to the donor's children, retaining the right to use the property for the entire month of January each year, the IRS computed the reasonable rental value of the property for the month of January as compared to the reasonable rental value of the property for the rest of the year to arrive at the inclusion of 13.3% of the value of the home in the donor's estate. ⁿ⁹ On this basis, if a donor retains a partial interest in a gifted vacation home, and only retains the right to the use of the property that is reasonably attributable to such retained interest, the gifted interests should not be included in the donor's estate under Section 2036(a)(1).

(b) Non-Exclusive Retained Use by Donor. When a donor transfers property by gift but continues to use the

property on a rent-free basis at such times as the donor wishes, the IRS can be expected to seek to include the property in the donor's taxable estate under Section 2036(a)(1) of the Code on the basis of an actual or implied agreement between the donor and the donees that the donor would retain the use and enjoyment of the property. The Tax Court, however, has taken the position that such an implied agreement has to be shown to exist on the basis of all of the facts and circumstances, particularly if the decedent has a retained ownership interest in the property. For example, if the facts suggest that, while the decedent continued to use a gifted property, such use was not exclusive and the possession of the property was not at any time denied to the donees, an implied agreement will not exist and inclusion under Section 2036(a)(1) is not justified. n10 If, on the other hand, the decedent transfers property and retains the rent-free use of the property to the exclusion of the new owners, an implied agreement may exist, in which case Section 2036(a)(1) will apply to include the property in the donor's estate at death. n11

(c) Payment of Rent for Use of the Property. Where the donor either will not retain an interest in the property, or where the donor wishes to use the property disproportionately to his or her retained interest, estate tax inclusion may nevertheless be avoided so long as the donor pays fair market rent to use the property. Specifically, in several private letter rulings in the context of terminated QPRTs, n12 the Service has ruled that the donor's retained use of property formerly held in a QPRT will not result in estate tax inclusion of the property in the donor's estate so long as the donor pays fair market rent for the continued use of the property. Importantly, however, the donor's agreement to continue to pay the expenses of ownership and maintenance of the property will not be deemed a substitute for paying fair market rent. n13 Rather, to defeat estate tax inclusion under Section 2036(a)(1), donors should be strongly advised to pay rent to the new owners and to require the new owners, rather than the donor, to pay their respective shares of the expenses of owning and maintaining the property. Further, a formal lease agreement should be entered into between the donor and the donees, and the donees should report the rental income received from the donor, net of any deductible expenses, as income from real property on their personal income tax returns.

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n1 A significant assumption for purposes of this article is that there are federal estate and generation-skipping transfer (GST) taxes. As of the date, Congress had failed to take any action to preserve the estate and GST tax, which were repealed for a one-year period as of January 1, 2010. If Congress takes no action at all during calendar year 2010, the estate and GST taxes will be restored on January 1, 2011 to what they would have been under the tax law as it existed in May of 2001. This article, however, assumes for purposes of an organized discussion that the 2009 estate, GST and gift tax exclusions, exemptions and rates are made permanent sometime in 2010.

n2 I.R.C. § 2503(b) (26 USCS § 2503(b)).

n3 The discounts applied to fractional interests in real property can be significant. Although it is typical that appraisers value standard tenancy-in-common interests by applying discounts commonly ranging from 15% to 35% depending upon the facts and circumstances, courts have applied valuation discounts of as high as 60% to fractional real property interests. See *Est. of von Loben Sels v. Comr.*, 52 TCM 731 (1996) and *Est. of Baird v. Comr.*, TC Memo 2001-58.

n4 Several states impose a state gift tax. These states each have annual gift tax exclusions. It is important for the estate planning advisor working with a client holding property in any of these states not to assume that the amount and application of the state gift tax annual exclusion will be identical to the federal gift tax annual exclusion.

n5 I.R.C. § 2513 (26 USCS § 2513).

n6 I.R.C. § 2035(b) (26 USCS § 2035(b)).

n7 TAM 9336002 (September 10, 1993) *But, see, TAM 199943003* (June 7, 1999) in which the IRS appears to have conceded that reducing the value of a fractional property interest to reflect the cost of partition is not the only method for valuing a fractional property interest.

n8 *Rev. Rul. 79-109, 1979-1 CB 297.*

n9 *Id.*

n10 *See, egs., Wineman Est. v. Comr., TC Memo 2000-193; Est. of Powell v. Comr., TC Memo 1992[#8209]367.*

n11 *Estate of Trotter, T.C. Memo 2001-250.*

n12 See the discussion of QPRTs in the emerging issue analysis article "*QPRTS and PRTS: Planning Strategies for Transferring Family Homes, 2010 Emerging Issues 5238.*

n13 *Timothy J. Tehan v. Comr., 89 T.C.M. 1374 (2005).*

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Primary Tax Considerations in Planning for Succession to Family Homes

2010 Emerging Issues 5243

USC Gould School of Law 2010 Tax Institute: Primary Tax Considerations in Planning for Succession to Family Homes

By Nancy G. Henderson

August 5, 2010

SUMMARY: Estate planning for the succession to family properties requires careful consideration of a number of complicated, and sometimes conflicting, tax laws. The primary tax considerations in estate planning for family homes are discussed in this article.

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ARTICLE: Estate planning for the succession to family properties requires careful consideration of a number of complicated, and sometimes conflicting, tax laws. The primary tax considerations in estate planning for family homes are discussed below. A significant assumption for purposes of this article is that there are federal estate and generation-skipping transfer (GST) taxes. n1

A. Federal Estate Tax. For most clients, the primary impediment to a successful transfer of a valuable family home to children and grandchildren is the federal estate tax. The federal estate tax is imposed upon the cumulative fair market value of all of a decedent's assets held at death. n2 Important in the context of planning for family homes is that, included in the decedent's taxable estate are not only assets legally owned by the decedent at the time of death, but also assets which the decedent may have given away from a state property law perspective, but over which the decedent held impermissible "strings attached" for federal estate tax purposes. Such "impermissible strings" include the right to retained use or enjoyment of transferred property without adequate consideration to the donee, the right to receive the income generated from transferred property, or the right to control the donees' beneficial interests in transferred property in a manner that is not limited to a reasonably definite standard. n3 The decedent's taxable estate will also include assets transferred by others over which the decedent held a general power of appointment exercisable during life or upon death. n4

No estate tax is imposed upon transfers at death to qualified charities or to U.S. citizen spouses due to the availability of the unlimited estate tax charitable deduction and unlimited estate tax marital deduction, respectively. n5 Estate tax can also be deferred upon transfers at death to the decedent's non-U.S. citizen spouse so long as the transfer is made to a "qualified domestic trust" or "QDOT." n6

Where real property is included in a decedent's estate, there are other exclusions and valuation rules that may

reduce the estate taxes that will be imposed upon that property. One exclusion of potential importance in the context of family real property arises from the Special Use Valuation rules, which permit an estate to reduce the estate tax value of certain real property used in agricultural (or in a trade or business) by up to \$1,000,000 if the value of the property at its current use is less than its value at its highest and best use. n7 In addition, an estate tax exclusion of up to \$500,000 is available for certain property that is subject to a qualified conservation easement at the time of the decedent's death. n8 An estate tax deduction is also available for the value of certain post-mortem grants of qualified conservation easements. n9

In addition to the foregoing exclusions and deductions, a decedent's estate is entitled to an estate tax applicable exclusion. Until December 31 of 2009, the estate tax applicable exclusion served to shelter the first \$3,500,000 of net taxable value of a decedent's estate from federal estate tax. n10 This exclusion is reduced dollar for dollar by lifetime gifts made by the decedent using the \$1,000,000 gift tax applicable exclusion. The tax imposed upon the otherwise taxable value of the decedent's estate in excess of the applicable exclusion was 45% in 2009. As a result of EGTRRA 2001, unless some action is taken by Congress, the estate tax has been entirely repealed for a one-year period as of January 1, 2010, after which there will be a \$1,000,000 estate tax applicable exclusion and graduated estate tax rates that will be as high as 55% (or even 60% for a portion of taxable estates exceeding \$10,000,000).

B. State Inheritance Tax. Until EGTRRA 2001, decedents' estates were entitled to a federal estate tax credit for state inheritance taxes or other state "death" taxes up to certain maximum thresholds. Most states enacted inheritance tax laws that simply absorbed the maximum amount of the state death tax credit (a "pickup tax"). However, EGTRRA 2001 eliminated the state death tax credit and replaced the credit with a deduction for state death taxes. As a result, many states have since enacted inheritance tax laws that impose a state inheritance tax in addition to the federal estate tax. In the context of planning for family homes, if real property is located in a state that imposes a separate inheritance tax, the property will likely be subject to such tax even if the decedent resided at the time of death in a different state. Further, many states that impose inheritance taxes have "decoupled" their inheritance tax system from the federal estate tax system, meaning that state inheritance taxes might be imposed upon an estate that has no federal estate tax liability (such as because the state inheritance tax exclusion is less than the federal estate tax applicable exclusion). It is therefore of utmost importance for the estate planner advising clients with family homes in other states to research the state inheritance tax rules that will apply and to consider strategies to avoid or minimize the imposition of the state inheritance tax, such as by placing the property in a limited liability company or gifting the property during life (unless the state in which the property is located has a gift tax, as discussed below).

C. Gift Tax. The second most important tax imposed in connection with succession planning for family homes is the federal gift tax. Under current federal tax law, lifetime transfers of real property made out of detached and disinterested generosity (other than a transfer for full and adequate consideration in money or money's worth) will give rise to a federal gift tax unless a transfer qualifies for certain statutory exclusions or deductions. n11 Among the available deductions are the unlimited gift tax marital deduction for transfers to U.S. citizen spouses and the unlimited gift tax charitable deduction for transfers to qualified charitable organizations. n12 Also excluded from gift taxation are gifts of present interests in property, provided that the cumulative amount of all such gifts from one donor to one donee in any one calendar year does not exceed the amount of the gift tax annual exclusion, which is presently \$13,000. n13 Once a donor's cumulative gifts to a donee exceed the gift tax annual exclusion, the donor must begin to consume his or her lifetime applicable exclusion from gift tax, which presently shelters from gift taxation the first \$1,000,000 of such otherwise taxable gifts. n14 To keep the Internal Revenue Service apprised of the use of the donor's gift tax applicable exclusion, a gift tax return is required to be filed for any calendar year in which the donor makes gifts to which the applicable exclusion will apply.

In the case of gifts of real property or real property interests, the federal gift tax is imposed upon the value of the transferred property or property interest on the first date that the transfer is deemed complete for gift tax purposes. n15 In most circumstances, the gift will be complete on the date legal title has been transferred under applicable state law. However, there are circumstances in which a gift will not be "complete" for federal gift tax purposes on the date of legal transfer of title to the gifted property or property interest. For example, a gift will be "incomplete" if the donor has

retained the power to change the beneficial interests of the donees. In such case, the transfer will not be complete, and the gift tax value of the transferred property or property interest will not be determined until the donor relinquishes such power over the gifted interest. n16

The amount of the gift tax imposed upon a taxable property transfer depends upon the cumulative taxable gifts that have been made by the donor. In most cases, the gift tax that will be imposed upon the first dollar of taxable gifts in excess of the \$1,000,000 gift tax applicable exclusion will be 41%. The gift tax then increases gradually as the cumulative amount of the donor's taxable gifts increases, ultimately reaching the current highest marginal gift tax rate of 45% on cumulative gifts in excess of \$2,000,000. n17

In most cases, a transfer of real property will not give rise to a state gift tax. There are very few states that currently impose a gift tax. n18 With regard to family homes situated in such states, attorneys not normally practicing in those states should consult competent legal and tax counsel to seek appropriate methods to minimize or avoid state gift tax on the lifetime transfer of the property.

D. Generation-Skipping Transfer Tax. The generation-skipping transfer tax is a tax imposed upon transfers of wealth to or for the benefit of individuals who are, or are deemed to be, two or more generations younger than the transferor ("skip-persons"). n19 The GST tax is imposed separate and apart from, and sometimes in addition to, the federal gift or estate tax. The purpose of the tax is relatively straight-forward. With certain exceptions, it is to insure that the transfer of wealth is taxed at least once at each generation, whether or not interim generations have the actual possession or use of that wealth.

The GST tax rate is imposed at the highest marginal estate tax rate, n20 which was 45% in 2009 (but will increase to 55% in 2011 without Congressional action in 2010). Therefore, for transfers that are subject to both the highest estate or gift tax rate, as well as the GST tax, the effective combined tax rate in 2009 was 70%.

The GST tax is imposed on transfers made directly to skip-persons and to trusts as to which only skip persons are permissible beneficiaries ("direct skips"). The GST tax is also imposed upon certain trust distributions to skip persons ("taxable distributions") as well as upon the entire value on a non-GST exempt trust at such time as there are no longer any "non-skip-persons" who are permissible beneficiaries ("taxable terminations"). n21

The GST tax is temporarily repealed for a one-year period on January 1, 2010. It had been widely anticipated that Congress would act before the end of 2009 to maintain the GST tax as well as an exemption from the imposition of GST tax. This exemption, as of 2009, sheltered from the GST tax the first \$3,500,000 of generation-skipping transfers taking place either during the donor's lifetime or, to the extent not applied to lifetime transfers, occurring by reason of the donor's death. n22

There is also a GST tax annual exclusion which excludes from the GST tax direct skips that also qualify for the gift tax annual exclusion, discussed above. n23 However, the availability of the GST tax annual exclusion for gifts in trust is substantially more limited than is the gift tax annual exclusion. Specifically, in order for a gift in trust to qualify for the GST tax annual exclusion, (i) the transfer must qualify for the gift tax annual exclusion; (ii) there must be only one current beneficiary of the trust and that beneficiary must be a "skip person;" (iii) during the current beneficiary's lifetime, no part of the trust principal or income may be distributed to or for the benefit of any person other than the current beneficiary; and (iv) if the current beneficiary dies before the trust terminates or is otherwise fully distributed to the current beneficiary, the remaining assets of the trust must be includible in the deceased current beneficiary's taxable estate. n24 Consequently, gifts made in trust which qualify for the gift tax annual exclusion will not qualify for the GST tax annual exclusion unless the trust is administered as individual separate shares for each of the beneficiaries holding a withdrawal right who are skip-persons and the other requirements of the GST tax annual exclusion are satisfied with regard to each such share.

E. Income and Capital Gains Tax. Transfers of real property present challenging income and capital gains tax

considerations as well. While a lengthy discussion of these taxes is outside the scope of this article, there are certain income and capital gains tax issues that bear particular mention.

First, family properties are often held for a long period of time and may therefore be highly appreciated. As a result, any strategy that contemplates *inter vivos* gifts must balance the estate tax savings of the strategy against the loss of the basis step-up that would have been achieved had the property been held until the death of the owner. ⁿ²⁵ Further, any strategy that contemplates a sale of the property, other than to a sale to a defective grantor trust ⁿ²⁶ or a sale taking place during post-mortem administration (when the property has secured as new tax basis), will generate capital gains taxes and possibly the recapture of certain income tax deductions taken by the seller if the property was at any time held for the production of rental income.

Occasionally, estate planning may involve a residence being used by the donor as the donor's principal residence. In such circumstances, the estate planner should carefully consider the impact of any transfer of that residence upon the availability of the \$250,000 capital gains tax exclusion for the sale of a principal residence. ⁿ²⁷

Encumbered property also presents income tax considerations. First, a transfer of encumbered property to a trust, to a partnership, or to a limited liability company could impact the ability of the donor to deduct payments of mortgage interest as the property may no longer be treated as the donor's personal residence. In addition, if the debt is assumed (or deemed to be assumed) by the donee, the transfer could generate capital gains tax to the donor.

A final income tax consideration when planning for a family home is whether the property will be maintained after the transfer as an investment property or a personal use property for purposes of claiming income tax deductions for all or a portion of such ongoing expenses as repairs, maintenance, advertising, cleaning fees, utilities, and depreciation. Although a detailed discussion of the rules concerning these deductions is outside the scope of this article, the planner is encouraged to understand how the donor has treated the property for income tax purposes in the past and to contemplate the implications of the recommended strategy for succession to the property on the future deductibility of the expenses of owning and maintaining the property. ⁿ²⁸

F. Property Tax. In many states, property tax value is neither favorably nor negatively impacted by normal estate planning for real property. However, some states provide exclusions or reductions in property tax value for certain owners (such as senior citizens or disabled individuals) that may be sacrificed if the property is transferred to children, to trusts, or to a family-owned entity, such as a family partnership or LLC. This issue is particularly sensitive with regard to real estate in the state of California, where Proposition 13 constitutionally limits the ability of county tax assessors to revalue property unless and until there is a "change of ownership" in the property or some other event permitting reassessment. ⁿ²⁹ As a result, so long as there is no change of ownership in the property giving rise to reassessment, the property tax value of California real property can be dramatically lower than its actual fair market value. In certain circumstances, it is possible to preserve the favorable property tax basis of California real property, in whole or part, when transfers are made between parents and children. ⁿ³⁰ Therefore, whenever engaging in succession planning for California real property, it is critical to consider the impact of the plan upon the property tax imposed and to consider options that could preserve a favorable property tax basis for the next generation.

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ⁿ¹ As of the date, Congress had failed to take any action to preserve the estate and GST tax, which were repealed for a one-year period as of January 1, 2010. If Congress takes no action at all during calendar year 2010, the estate and GST taxes will be restored on January 1, 2011 to what they would have been under the tax law as it existed in May of 2001. This article, however, assumes for purposes of an organized discussion that the 2009 estate, GST and gift tax exclusions, exemptions and rates are made permanent sometime in 2010.

n2 See Chapter 11 of the Internal Revenue Code.

n3 See I.R.C. §§ 2036(a)(1), 2036(a)(2) and 2038. (26 USCS §§ 2036(a)(1), 2036(a)(2) and 2038)

n4 I.R.C. § 2041. (26 USCS § 2041)

n5 I.R.C. §§ 2055 and 2056A, respectively. (26 USCS §§ 2055 and 2056A)

n6 I.R.C. § 2056A. (26 USCS § 2056A.)

n7 I.R.C. § 2032A. (26 USCS § 2032A)

n8 I.R.C. § 2031(c). (26 USCS § 2031(c))

n9 I.R.C. § 2055(f). 26 USCS § 2055(f))

n10 I.R.C. §2010(c). (For purposes of this article, the 2009 estate tax applicable exclusion and rates are assumed to apply indefinitely, although a proposal of this nature, passed by the House of Representatives on December 4, 2009, was rejected by the Senate. Therefore, it remains unclear whether there will be an estate tax in 2010, and, if so, the amount of the exclusion and the rate of the tax imposed.)

n11 See Chapter 12 of the Internal Revenue Code.

n12 I.R.C. §§ 2523 and 2522, respectively. (26 USCS §§ 2523 and 2522)

n13 I.R.C. § 2503(b) (26 USCS § 2503(b)). The gift tax annual exclusion is indexed for inflation in \$1,000 increments. In addition, I.R.C. §2523(i) provides a gift tax annual exclusion for certain transfers to non-U.S. citizen spouses. The amount of that exclusion is presently \$134,000. Note that there is no lifetime "QDOT" available to shelter from gift taxation transfers to non-U.S. citizen spouses which exceed the annual exclusion (or which do not otherwise qualify for the exclusion).

n14 I.R.C. § 2505(a)(1). (26 USCS § 2505(a)(1))

n15 I.R.C. § 2512. (26 USCS § 2512)

n16 Treas. Reg. §25.2511-2.

n17 Under EGTRRA 2001, the maximum gift tax rate will be capped at 35% in 2010, but will revert to the pre-2001 rate of 55% in 2011. Unless Congress takes some action in 2010, for calendar year 2010 the maximum estate tax rate will be 35%, returning, however, to a maximum rate of 55% on January 1, 2011 for cumulative lifetime gifts exceeding \$3,000,000.

n18 At least four states have a gift tax: Connecticut, Tennessee, North Carolina and Louisiana.

n19 See Chapter 13 of the Internal Revenue Code.

n20 I.R.C. § 2641. (26 USCS § 2641)

n21 I.R.C. § 2612(a),(b),(c). (26 USCS § 2612(a),(b),(c))

n22 I.R.C. § 2631 (*26 USCS § 2631*). Under EGTRRA 2001, the GST tax exemption was \$3,500,000 in 2009, but has been repealed for a one year period in 2010, absent action by Congress to restore the tax. If Congress takes no action in 2010, the GST tax will be restored in 2011 to its pre-2001 exemption amount of \$1,000,000, indexed for inflation. The author believes that, but for EGTRRA 2001, the current GST tax exemption would have been \$1,340,000.

n23 I.R.C. § 2642(c). (*26 USCS § 2642(c)*)

n24 I.R.C. § 2642(c)(2). (*26 USCS § 2642(c)(2)*)

n25 I.R.C. § 1014. (*26 USCS. § 1014*)

n26 I.R.C. §§ 671-677. (*26 USCS §§ 671-677*)

n27 I.R.C. § 121(b). (*26 USCS § 121(b)*)

n28 *See* the deductibility rules under I.R.C. § 280A. (*26 USCS § 280A*)

n29 *See* Cal. Rev. & Tax Code §§ 60-69.5.

n30 *See* Cal. Rev. & Tax Code § 63.1.

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Transferring Family Homes: Family Limited Partnerships, LLCs, and Trusts

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USC Gould School of Law 2010 Tax Institute: Strategies for Transferring Family Homes: Family Limited Partnerships, LLCs, and Trusts

By Nancy G. Henderson

August 5, 2010

SUMMARY: An alternative to gifting direct interests in a family home to children or other family members is to transfer the property to a family limited partnership ("FLP") or a limited liability company ("LLC") and to make gifts of interests in the partnership or LLC to children or other family members.

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ARTICLE: For many families, a family home is among the most cherished assets. The goal of preserving that property as a family asset for the use and enjoyment of successive generations can present significant challenges to the estate planner. An alternative to gifting direct interests in a family home to children or other family members is to transfer the property to a family limited partnership ("FLP") or a limited liability company ("LLC") and to make gifts of interests in the partnership or LLC to children or other family members.

Alternatively, the donor could establish a Trust for the benefit of children or other family members and make gifts of interests in the property to such a trust during life and/or at death. These planning strategies are discussed below. n1

Family Limited Partnerships and LLCs.

There are numerous potential benefits of transferring family homes into a FLP or LLC. First, because title to the property will be held at the entity level, transfers of interests in the partnership or LLC will not negatively impact upon the chain of title to the property. Correspondingly, because no partner or member will have a direct interest in the property, the property will be protected from liens arising from the debts and liabilities of the various partners or members. Further, the partnership agreement or operating agreement ("entity agreement") can be drafted to address a variety of challenges of co-ownership, such as the use of the property by the partners and the members, the management of the property, and the sharing of the expenses related to ownership of the property. Further, if a partner or member fails to contribute his or her agreed share of the expenses of owning and maintaining the property, the penalties imposed will be easier to implement. Specifically, upon the failure of a partner or member to make a required contribution, the entity agreement can dilute such partner's or member's interest in the partnership or LLC in a manner that is essentially self-executing. The entity agreement can also address the transferability of interests in the partnership or LLC to third parties, it can provide for rights of first refusal and other methods to restrict the transfer of entity interests to non-family

members, and it can provide a means for the resolution of disputes between partners or members.

A question that arises when using FLPs and "FLLC"s in the context of estate planning for family homes is whether discounts for lack of control and lack of marketability will apply for purposes of determining the gift or estate tax value of interests in such an entity. n2 Generally, a limited partnership or LLC can be formed under state law to accomplish any business or investment purpose not otherwise prohibited from operating in that form. Even though real property held by a limited partnership or LLC may be made available for the personal use of its partners or members, such property also has significant investment value. The Tax Court has consistently held that, so long as a partnership or limited liability company is validly formed under state law, and if there is no reason to believe that a hypothetical willing buyer would disregard the partnership, then the partnership form should be respected for gift and estate tax valuation purposes. n3 Therefore, an entity should possess a valid business or investment purpose even if the principal asset of that entity is a family home or other family property.

While a family limited partnership or LLC holding a family home should be respected as a valid legal entity so long as it is properly formed under state law, to secure long-term gift and estate tax benefits, it is important that the entity be properly administered. This is particularly crucial if the donor either retains an ownership interest in the entity or if the donor will continue to use property owned by the entity. Specifically, the IRS has had consistent success in including the assets of a family limited partnership in a deceased partner's estate under Section 2036(a)(1) n4 (26 USCS 2036(a)(1)) of the Code where the decedent was the primary source of funding for the partnership, the decedent retained the rent-free use of partnership real property, and the decedent otherwise failed to respect the distinction between the partnership's income, assets and expenses from the decedent's own income, assets and expenses. n5

Some commentators have suggested that inclusion of partnership assets in a decedent's estate under Section 2036(a)(1) can be avoided so long as the decedent gives away his or her entire interest in the partnership. However, in *Estate of Disbrow v. Comm'r.*, n6 a decedent fully divested herself of her entire interest in a general partnership owning a residence. The residence was nevertheless included in her estate under Section 2036(a)(1) of the Code. In that case, the decedent executed a lease agreement for her exclusive retained use of the property for her lifetime, but the rent paid was not its fair rental value. Further, the decedent failed to pay the required rent on a regular basis, and the partnership, in turn, failed to take any action to enforce the lease or to evict the decedent. Consequently, the partnership property was included in the decedent's estate under Section 2036(a)(1) of the Code.

Trusts as Vehicles to Hold Family Homes

Trusts can be established to address some of the disadvantages of gifting direct interests in a family home without creating a limited partnership or LLC. Like Tenancy-in-Common Agreement and Entity Agreements, the trust agreement could establish the rules for the use of the property by the trust beneficiaries as well as a plan for the succession to a beneficiary's interest in the trust upon the beneficiary's death. A significant benefit of holding a family home in a trust is, so long as no beneficiary possesses the right to withdraw the trust property (or other similar powers that constitute a general power of appointment), and so long as the trust instrument includes a spendthrift clause prohibiting the transfer of a beneficiary's interest in the trust or its property, the trust property should be protected from the claims of the beneficiary's creditors. Further, the terms of the trust could insure that, for as long as the trust is permitted to continue under applicable state law, the trust property will remain in the family.

While there are many issues to consider in drafting a trust as an alternative to making outright gifts of fractional real property interests or creating a family partnership or LLC, certain issues bear particular mention in the context of family homes. The first of these issues relates to the practical consideration of who will serve as trustee of the trust and how much power that trustee will hold over the use of the property by the trust beneficiaries. It is inadvisable for the donor to hold such power as it will risk the inclusion of the property in the donor's estate at death. n7 The donor's children or other trust beneficiaries may also be poor choices for the role of trustee as it will place the trustee/beneficiary in a conflict of interest with the other trust beneficiaries. On the other hand, corporate trustees may not be willing to serve as trustee under circumstances where the only trust asset is real property held for the personal use

of the trust beneficiaries. Where they are willing to serve, the corporate trustee's fees may be prohibitive, particularly if the property does not produce income.

Another consideration in the context of trusts as donees of interests in family home is how the trust will acquire the resources to pay its proportionate share of the regular expenses of property ownership and maintenance. There are three options to consider in this regard. The first option is for the donor to make annual gifts to the trust using the gift tax annual exclusion as to each of the trust beneficiaries. Such gifts will, of course, serve to reduce the availability of the gift tax annual exclusion for additional transfers of property interests to the trust. Another alternative is to endow the trust with an upfront gift of cash using the gift tax applicable exclusion, to draw upon that cash as needed to pay the trust's proportionate share of expenses and then to replenish the trust at the donor's death (or the deaths of the donor's children or other beneficiaries) through bequests from the donor's estate or from life insurance proceeds. A third option is to generate income to the trust by charging the beneficiaries, third parties or, in appropriate circumstances, the donor rent for the use of the property.

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n1 A significant assumption for purposes of this article is that there are federal estate and generation-skipping transfer (GST) taxes. As of the date, Congress had failed to take any action to preserve the estate and GST tax, which were repealed for a one-year period as of January 1, 2010. If Congress takes no action at all during calendar year 2010, the estate and GST taxes will be restored on January 1, 2011 to what they would have been under the tax law as it existed in May of 2001. This article, however, assumes for purposes of an organized discussion that the 2009 estate, GST and gift tax exclusions, exemptions and rates are made permanent sometime in 2010.

n2 In 1994, the IRS issued "anti-abuse" regulations in the context of partnerships. *Example 6* of these regulations provided that a potentially "abusive" use of the partnership structure was a family partnership owning a vacation home. This raised concerns that the IRS would seek to disregard the partnership form for estate and gift tax valuation purposes when the only partnership asset was a vacation home. However, on January 23, 1994, the IRS issued *Announcement 95-59*, (1995-7 I.R.B. 56), restricting the anti-abuse regulations to income taxes and deleting *Example 6*.

n3 See, egs, *Estate of Strangi v. Comm'r.*, 115 T.C. 478 (2000), *aff'd in part and remanded in part*, 293 F.3d 279 (5th Cir. 2002), *on remand*, TC Memo 2003-149; *aff'd* 417 F.3d 468 (5th Cir. 2005); *Estate of Knight v. Comm'r.*, 115 T.C. 506 (2000); *Est. of Church v. U. S.*, 2000-1 USTC Parag. 60,369 (W.D. Texas 2000), *aff'd without published opinion* at 268 F.3d. 1063 (5th Cir. 2001). But, see, *Estate of Bongard v. Comm'r.*, 124 T.C. 8 (2005), in which the Tax Court disregarded a validly formed limited partnership because, among other reasons, the Court determined the partnership lacked "a legitimate non-tax purpose" for its creation.

n4 *Id.*

n5 See *Estate of Reichert v. Comm'r.*, 114 T.C. 144 (2000); *Estate of Harper v. Comm'r.*, T.C. Memo 2002-121; *Estate of Thompson v. Comm'r.*, 84 T.C.M 374 (2002), *aff'd* 382 F.3d 367 (3rd Cir. 2004); *Estate of Strangi v. Comm'r.*

n6 T.C. Memo. 2006-34.

n7 See I.R.C. §§ 2036(a)(2) and 2038. (26 USCS §§ 2036(a)(2) and 2038)

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The Importance of Feasibility Studies in Estate Planning

2010 Emerging Issues 5240

USC Gould School of Law 2010 Tax Institute: Feasibility Studies in Estate Planning

By Nancy G. Henderson

August 4, 2010

SUMMARY: Family members may have conflicting feelings about the management and ongoing expenses of family property. If these issues are not considered in the estate planning process, even the best tax plan for the property can ultimately be a wasted effort. It is therefore important to conduct a feasibility study to determine whether it is reasonable or practical to plan to preserve a particular property.

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ARTICLE: Family homes are unique assets in estate planning. They are associated not only with potentially significant monetary value, but they often represent sentimental value to the donor and the donor's family as well. Family homes also carry burdens in the form of management and ongoing expenses. The very use of the property by family members can become burdensome if it creates disputes among family members concerning the use of the property, involves expensive travel to reach the property, or will require working family members to consume limited personal vacation time to make use of the property.

Family members may have conflicting feelings about the property. If these issues are not considered in the planning process, even the best tax plan for the property can ultimately be a wasted effort. It is therefore important to conduct a feasibility study to determine whether it is reasonable or practical to plan to preserve a particular property. A significant assumption for purposes of this article is that there are federal estate and generation-skipping transfer (GST) taxes. n1

THE IMPORTANCE OF A FEASIBILITY STUDY

A feasibility study will help identify planning issues that would otherwise have been overlooked and could be more difficult to address after the donor's death. Of course, the scope of a feasibility study will certainly be driven by the size of the property and its importance in the context of the client's overall estate plan. As its name implies, both the client and the advisor should approach the feasibility study with the understanding that a conclusion could be reached that the preservation of the property for the next generation is not, in fact, a practical objective in light of all the relevant facts and circumstances. First Step: Understand the Significance of the Property as an Estate Asset

The first step in the feasibility study is to determine the relative significance of the property in the overall estate

plan. This will require an examination of all of the assets owned by the donor and a determination of the economic value of the property as compared to the value of the entire estate. Even if the economic value of the property is not significant, the sentimental value of the property needs to be considered. Rather than craft a plan to leave the property to all of the donor's children, a better plan might be to leave the property to those children who have expressed an interest in retaining the property. Such planning can create resentment because the family members to whom the property is being allocated may feel that other family members are receiving more valuable assets. All of these issues need to be discussed with the client and addressed in the feasibility study. Second Step: Identify and Understand the Nature of the Property

The second step in the feasibility study is to understand the nature of the property itself and to determine whether there are any legal impediments to a succession plan. The following summarizes a number of property types or characteristics and certain legal or practical issues that can arise in each case. (1) Single Family Residences and Condominiums. The most common form of family property is the single-family residence. Important in planning for such a property is whether the property is part of a homeowners' association or is subject to a zoning ordinance restricting the use of the property as a vacation home for various family members. (2) Long-Term Leaseholds. Occasionally, a family home will be constructed on land that is not owned by the client, but is on land subject to a long-term leasehold (typically 99 years or more). In planning for such property, it is important to secure a copy of the underlying lease agreement to determine the remaining term of the leasehold as well as the rights and responsibilities of the lessor and the lessee at the end of the lease. Commonly, the lease provides the lessee an option to renew the lease. It could, however, provide a reversion to the lessor, with or without compensation to the lessee for the value of the improvements that were constructed and maintained by the lessee. (3) Cooperatives. A family home could be represented by stock in a cooperative rather than a deed to real property. Planning for co-ops requires a review of the Articles of Incorporation, the Bylaws, the CC&Rs, and other corporate documents to determine whether there are restrictions on ownership and use that could affect the plan for the property. (4) Multi-Parcel Properties. A family property may consist of a residence located on one of several adjoining (or otherwise related) parcels, some of which are undeveloped. Such multi-parcel properties present unique challenges and opportunities.

(a) Can Parcels Be Sold to Pay Expenses and Taxes? An important question multi-parcel properties present is whether one or more of the parcels could be sold to pay estate taxes or expenses without negatively impacting the desired use of the remaining property by the next generation.

(b) Can Different Parcels Be Allocated to Different Children? In some cases, the land represented by a family property has far greater value to the family than the residence that is located on the property. In that case, it might be feasible to gift or otherwise allocate different parcels to different children so that they will each own a parcel independently of the other. The family as a group may wish to agree upon restrictions on development of the parcels in a way that could negatively impact the use and enjoyment of the other parcels. Consideration should be given to providing the family a right of first refusal to buy back a particular child's parcel before it can be sold to a third party.

(c) Securing Easements. Any plan to break up adjoining parcels should contemplate whether access to certain parcels will be required by the owners of other parcels, such as to reach a public road or secure connections to public utilities. If so, it is maybe advisable to survey and record easements that will preserve the viability of each parcel before there is a change of ownership.

(d) Avoiding the Merger of Previously Subdivided Parcels. In some parts of the country, adjoining parcels of land can lose the benefit of subdivision if they have identical ownership; essentially, upon achieving unity of ownership between two or more adjoining parcels, the parcels become "merged" into a single parcel. This can have a dramatic impact upon the value of parcels. Once a merger has occurred, changes in land use law since the original subdivision of the property may preclude approval of a new subdivision. Planning for parcels that are at risk of merger require careful consideration of what constitutes identical ownership under the applicable law (typically at the municipal or county level) and the design of an ownership structure for each of the parcels that is sufficiently different from the others to avoid an unintended merger. (5) Ranches and Other Agricultural Properties. A family property could be subject to

ranching or other agricultural use during the donor's lifetime. In these circumstances, planning for succession to the property can be very similar to planning for succession to any business. Some of the complex issues presented by such properties are outlined below.

(a) Continued Use for Agriculture. An important consideration in property used for ranching or agriculture is whether the expectation is for such use to continue after the donor's death. If so, how will the ranch or farm be managed after the donor's death? Will the agricultural income produce a net cash flow that can help defray the expenses of ownership or could it actually be a net loss?

If the property generates significant business income from ranching or farming, it will be important in estimating the estate tax value of the property to also consider the estate tax value of the ranching or farming operation, as such value will be separate from, and in addition to, the underlying value of the land and improvements.

(b) Plan for Equipment and Livestock. When designing a plan for the succession to real property used in ranching or farming, it is important to include in the plan the passage of title to tangible personal property that is essential to continued operations; specifically livestock and equipment. The value of these tangible assets needs to be factored in to any estate or gift tax projections for the preservation of the property, as well as any plan for equalizing estate value among the children if less than all of them will receive an interest in the farm or ranch.

(c) Property Tax and Other Benefits. Frequently land used in ranching or farming enjoys a reduced property tax value that is contingent upon its continued agricultural use. Properties used in agriculture might also qualify for reduced water rates, or a higher allotment of water in areas where water is scarce. When planning for these properties, consideration must be paid to preserving these important benefits if possible, especially if agricultural use will cease at some point.

(d) Preserving the Availability of I.R.C. Sections 2032A and 6166. Family properties that are used in ranching or farming could qualify for special use estate tax valuation under I.R.C. Section 2032A as well as the deferral of payment of estate taxes under I.R.C. Section 6166. The plan for the succession of the property should consider whether these benefits could be available under the circumstances and, if so, whether the plan can be structured to protect these important tax benefits while still accomplishing the donor's non-tax estate planning objectives. (6) Properties with Significant Natural Habitat. Family properties are sometimes located in areas that have significant natural habitat and could be subject to federal or local use restrictions. Even if a property is not so restricted, it is important to consider whether the client values the property for its natural habitat and would like to see it preserved. It is possible that after they have secured ownership of and control over the property, some (or all) of the donor's children and grandchildren would prefer to maximize the economic value of the property through subdivision and development, by mining, or by harvesting timber. Therefore, if an important goal for the property is to preserve its natural beauty for the enjoyment of future generations, the planner should discuss with the client the possible benefits of imposing perpetual restrictions upon the use and development of the property before it is transferred to the next generation. (7) Historic Properties. A host of special planning issues and opportunities are presented when a donor's property is listed in the National Registry of Historic Places, is located in a recognized historic district, or is otherwise identified as a place of historic significance. Of primary importance in succession planning for such properties is whether the value of the property can be reduced for estate and gift tax purposes by granting an historical society or other qualified charitable organization an historic preservation easement. (8) Family Compounds. Some families have assembled groups of adjoining properties or parcels into a single family compound consisting of multiple residences and appurtenant facilities and structures that are shared and enjoyed by many different family members, often across multiple generations and even different family groups. Planning for these properties may require the joint effort of attorneys and advisors representing the different family groups who share an interest in the property. Careful consideration needs to be given to whether the concept of the family compound will continue to be successful among members of the next generation, or whether dividing (or selling) the property into separate independent properties for each family group would be more practical. (9) Property Susceptible to Natural Disaster. Some cherished family properties are located in regions that are at risk of a significant natural disaster that could destroy or substantially damage the property. Examples include properties located in western

forests susceptible to firestorms, coastal or island properties subject to hurricanes, or properties in river valleys subject to flooding. Insurance for properties of this nature can be very expensive and the deductibles can be as high as 10% of the value of the property. Careful consideration should be made as to whether it is reasonable to establish a plan that contemplates the retention of such properties, or whether the property should be sold in order to pass the cost of insuring the property and the risk of catastrophic loss to a new owner. (10) Encumbered Property. Property that is subject to debt presents significant challenges in the context of succession planning. First, any transfer of the property to children, to a trust, or to a partnership or LLC, whether during the donor's lifetime or upon the donor's death, could trigger the due on transfer clause in the underlying loan documents, potentially causing the debt to be immediately due and payable. To avoid this consequence, it is important to secure the lender's consent to any such transfer before it occurs. Further, a gift of encumbered property to a child or to a trust for a child's benefit could be treated as a bargain sale rather than a gift, potentially triggering capital gains taxes on the transfer. Finally, if the debt is to remain on the property after the transfer, consideration needs to be given to who will be responsible for the loan payments, whether making those payments will be treated as a gifts to the other owners, and also whether the form of ownership will negatively impact the payor's ability to deduct the interest payments on the loan. (11) Co-Owned Property. Individuals will sometimes purchase homes with friends or others as partners or tenants-in-common. Important in planning for these properties is whether it is reasonable for these unrelated owners to co-own the property with the children of a deceased owner. It is also important to know whether there is an understanding or expectation between the owners that the surviving owner will have the right, or even the obligation, to buy out the interest of a deceased owner and, if so, how the value of the deceased owner's interest will be determined, whether fractional interest or other discounts will apply to determine the purchase price, and whether the purchase price will be paid in full or over time in installments, with or without interest. Even if the original co-owners have been able to operate on rather informal terms, it is generally wise to formalize the relationship with a Tenancy-in-Common Agreement or Partnership Agreement to address these issues before bringing in the next generation. Third Step: Create Detailed Expense Projections and Calculate the Required "Endowment"

Once it has been determined that it is otherwise reasonable, practical and legally possible to pass a family home to the next generation, the next step in the feasibility analysis is to determine what financial resources will be required to own, maintain and use the property once it has been transferred. The expenses that must be considered include, but are not necessarily limited to, property taxes, homeowner's fees, utilities, landscape and other regular maintenance, security, housekeeping, and repairs. Further, if the property is in a location that will require significant travel by family members to use it, such expenses should be projected and taken into consideration as an important element in accomplishing the client's goals for the property.

In the ideal succession plan for a family home, the vehicle that is established to own the property should be self-supporting; that is, the owner or owners should have an identifiable and reliable source of revenue to pay all of the expenses of the property over the desired time horizon. This might be accomplished by establishing an endowment that is funded with other assets from the client's estate or from life insurance on the client's life (or the life or lives of others with an interest in the property). As noted above with regard to multi-parcel properties, an endowment to fund the expenses of ownership, maintenance and use of the property could be established by selling one or more of the parcels.

Before a plan can be crafted to establish a source for the payment of expenses, it is important to identify and quantify those expenses. The creation of a spreadsheet that identifies both recurring expenses, such as taxes, utilities, homeowner's fees, insurance, and regular maintenance as well as occasional large expenses for which a reserve should be established, and all such expenses should be indexed for inflation. The spreadsheet should also consider the cost to replace furniture and furnishings as they wear out. Finally, the budget might contemplate the costs to the client's family of using the property, such as airfare, particularly if requiring travel costs to be born by children or other intended beneficiaries would impede the accomplishment of the donor's goals for the use of the property. Fourth Step: Detailed Tax Projections

The estate tax impact of the preservation of a family home is not necessarily intuitive either to the donor or the advisor. It is therefore essential to perform detailed estate tax projections demonstrating not only the amount of estate

tax that would be imposed upon the property but the practical effect of the plan upon the disposition of the entire estate. The projections should not simply be Excel or other spreadsheets, although they are enormously useful in this context. Rather, they should also involve box diagrams or flow charts that can visually demonstrate to the client how the preservation of the property will affect the assets available for distribution in the context of the overall estate plan. The projections and charts should show the impact of the plan based not only on current asset values, but also projected future values determined by applying assumptions for appreciation in the estate's assets over a given time horizon, as well as the possible consumption of the donor's financial assets for the donor's support and health or in connection with other gifting strategies. These projections might well suggest that the plan for the preservation of the property will require the liquidation of more of the balance of the estate than the donor might have intended or anticipated.

Crucial Last Step: Hold a Family Meeting or Conduct Family Interviews

Once all other indications suggest that preserving the property for future generations is economically and legally possible, the last step in the feasibility study is to hold a family meeting or to conduct interviews with individual family members. Such meetings and interviews can provide valuable insight into each child's perspective with regard to the preservation of the property. Often parents will assume that their children share the same sentimentality with regard to the property and will be anxious to preserve the property and the many memories that it represents. The children, on the other hand, may have an entirely different point of view, yet they may feel uncomfortable sharing these sentiments with their parents. Individual interviews could identify rarely discussed family tensions, such as the in-law that nobody wants to be around or the child that has always been a source of discontent, allowing the planner to take these facts into consideration when designing structures for the future use and ownership of the property. In fact, while the first four steps in the feasibility study could suggest that a plan for preserving the property is economically and legally achievable, the information gathered in family meetings and individual interviews could lead to the opposite conclusion, either because most of the members of the next generation do not really want to keep the property or because their perspectives and personalities differ so greatly that co-ownership of the property will inevitably lead to conflicts and disputes.

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n1 As of the date of this article, Congress had failed to take any action to preserve the estate and GST tax, which were repealed for a one-year period as of January 1, 2010. If Congress takes no action at all during calendar year 2010, the estate and GST taxes will be restored on January 1, 2011 to what they would have been under the tax law as it existed in May of 2001. This article, however, assumes for purposes of an organized discussion that the 2009 estate, GST and gift tax exclusions, exemptions and rates are made permanent sometime in 2010.

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QPRTS and PRTS: Planning Strategies for Transferring Family Homes

2010 Emerging Issues 5238

USC Gould School of Law 2010 Tax Institute: Gift and Estate Tax Planning Strategies for Transferring Family Homes -- QPRTS and PRTS

By Nancy G. Henderson

August 3, 2010

SUMMARY: As an alternative to gifting direct interests in a family home to children, a donor can establish an intervivos trust for the benefit of children or other family members and make gifts of interests in the property to such a trust during life. There are many different types of trusts that a donor should consider. This article discusses two: a Qualified Personal Residence Trust (QPRT) and a Personal Residence Trust (PRT).

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ARTICLE: The goal of preserving a family home as a family asset for the use and enjoyment of successive generations can present significant challenges to the estate planner. There are numerous strategies a family should consider when deciding what to do with the family home. From the donor's perspective, the simplest alternative for transferring a family home to children and grandchildren is to make outright gifts of real property interests.

As an alternative to gifting direct interests in a family home to children, the donor could establish an intervivos trust for the benefit of children or other family members and make gifts of interests in the property to such a trust during life. There are many different types of trusts that a donor should consider, but this article will discuss two: a Qualified Personal Residence Trust (QPRT) and a Personal Residence Trust (PRT). A significant assumption for purposes of this article is that there are federal estate and generation-skipping transfer (GST) taxes. n1

(1) Qualified Personal Residence Trusts Qualified personal residence trusts, described under Section 2702 of the Code, can be extremely powerful transfer tax planning devices in the context of family homes. A few of the most important aspects of QPRTs in the context of planning for family homes are set forth below. n2

(a) The QPRT Basics. A QPRT is an irrevocable intervivos trust funded with real property that is a personal residence of the grantor. Under the terms of the trust agreement, the grantor retains the exclusive right to the use of the residence transferred to the QPRT for a stated term of years. n3 At the end of that term, (the "QPRT Term"), the remainder beneficiaries (typically the grantor's children or a continuing trust for their benefit) secures ownership of the trust property.

The principal benefit of using a QPRT is that the gift tax value of the property transferred to the trust is the

actuarial value of the remainder beneficiary's interest in that property. Such gift tax value is fixed on date of a contribution to the QPRT, and no further gift or estate tax is imposed upon the trust assets so long as the grantor survives to the end of QPRT Term. Further, the value of the remainder interest is determined using the "subtraction method" of valuation; that is, by subtracting from the value of the property on the date of contribution to the trust the value of certain of the donor's retained interests in the trust property. The gift tax value of the remainder interest is determined by subtracting from the value of any property contributed to the trust the actuarial value of the donor's right the exclusive use of that property for QPRT Term. Such value is determined by applying the actuarial principles supplied under Section 7520 of the Code and the applicable Treasury Regulations. The gift tax value of the remainder interest can be further reduced if the trust agreement provides that, should the grantor die during the QPRT Term, the trust property will revert to the grantor's estate. In such event, the actuarially determined value of the donor's reversionary interest in the trust, also determined under Section 7520, will further reduce the value of remainder interest.

Based upon the foregoing valuation principles, the older the grantor and the longer the QPRT Term, the lower the gift tax value of the remainder interest. This would suggest that the QPRT Term should be as long a term as possible. However, a critically important aspect of planning with QPRTs is that, should the grantor die during the QPRT Term, the assets held in the QPRT are included in the grantor's taxable estate. Consequently, structuring a QPRT requires a careful balancing of the desire to drive the gift tax value of the remainder interest as low as possible while managing the risk of the grantor's death during the QPRT Term. Occasionally this balancing act can be struck by selecting a relatively long QPRT Term and purchasing term life insurance on the grantor's life to cover the QPRT term.

Selected QPRT Technical Requirements. The following are some of the most notable technical requirements for QPRTs:

(i) A grantor may create QPRTs for no more than two personal residences and one such residence must be the grantor's principal residence.

(ii) Multiple QPRTs may be created to transfer fractional interests in the same residence. n4

(iii) Tangible personal property (such as household furnishings) cannot be held in a QPRT.

(iv) The QPRT property must be used by the grantor as a personal residence.

(v) Using the property in a trade or business will disqualify the QPRT unless the business use of the property is secondary to its use as a personal residence.

(vi) Renting the property to a third party will not necessarily disqualify the QPRT so long as the property satisfies the residence test set forth in Section 280A(d) of the Code. n5

(vii) With regard to properties that consist of multiple parcels or multiple structures, only the portion of the property and structures that is reasonably related to the use of the property as a residence may be transferred to the QPRT.

(viii) The grantor must have the exclusive use of the property for QPRT Term, although this requirement does not preclude the grantor from inviting others to use the property from time to time.

(ix) The grantor of the QPRT is responsible for the costs of ownership and maintenance of the property during the QPRT Term. However, expenses associated with capital improvements to the property, and any repayment of principal on a mortgage that is an obligation of the QPRT, will constitute additional gifts to the QPRT that must be valued using the same principles as those applied to value the initial contribution to the trust. n6

(x) Except in certain very limited circumstances, the trust is prohibited from holding more cash than is needed to

fund six months of expenses for a QPRT property.

(xi) If the residence held by the QPRT is sold, and if the sales proceeds have not been reinvested in a replacement property within two years of the sale, the sales proceeds must either be distributed to the grantor or the QPRT must be converted to a grantor retained annuity trust ("GRAT") within the meaning of Section 2702(b)(1) of the Code, as to the sales proceeds.

(xii) During the QPRT Term, and after the termination of the QPRT Term so long as the grantor continues to be treated as the owner of the trust income and corpus under Sections 671-677 of the Code (the "grantor trust" rules), the grantor must be prohibited under the terms of the trust instrument from purchasing the residence from the trust.

(c) Use of QPRT Property by the Grantor after Termination of the QPRT. Although a QPRT can be a very attractive tax planning device for the passage of a family home, clients may be reluctant to choose a QPRT over a testamentary transfer of the property out of concern of being evicted from the property by the new owners. To address this issue, the trust instrument can provide that the trust will continue after the QPRT Term ends and the Trustee will lease the property back to the grantor for fair market rent. Although such an arrangement could arguably be viewed as an impermissible retained interest in the QPRT property under Section 2036(a)(1) of the Code or an impermissible right to control the beneficiaries' use and enjoyment of the trust property under Sections 2036(a)(2) and 2038 of the Code, the IRS has ruled privately that such arrangements will not result in the inclusion of the QPRT property in the donor's taxable estate under any of these provisions. n7 Importantly, in the context of a vacation home, unless the grantor wishes to retain the right to exclude all other owners from the use of the property, the grantor should only be required to pay rent for the portion of the time that the grantor will actually use the property rather than the rental value of the entire property for the entire year. n8

(d) QPRTs and the GST Tax. As a general rule, QPRTs are inefficient for GST tax planning purposes. This is because the grantor's GST tax exemption cannot be applied to the QPRT until the end of the estate tax inclusion period, or "ETIP." n9 The ETIP is the period during which trust property will be includible in the grantor's estate in the event of the grantor's death. With regard to QPRTs, the ETIP is the QPRT Term. Therefore, the grantor's GST tax exemption cannot be applied until the end of the QPRT Term. Further, it must be applied based upon the value of the trust property at the end of the QPRT Term, which is no longer diminished by the grantor's term or reversionary interests.

If there is a high degree of certainty that the value of the property in a QPRT at the end of the QPRT Term will not exceed the grantor's remaining GST tax exemption, then it may be possible to confidently design the QPRT to pass the property to a Dynasty Trust. n10 On the other hand, if the value of the trust property at the end of the QPRT Term exceeds the grantor's remaining GST tax exemption, then passing the trust property to a Dynasty Trust will cause that Dynasty Trust to suffer a mixed inclusion ratio for GST tax purposes, a consequence that is to be avoided.

Another unfortunate aspect of QPRTs in the context of GST tax planning involves the application of the predeceased parent rule. n11 Under the predeceased parent rule, if the child of a donor is deceased, the child's descendants move up a generation for GST tax purposes. However, the generational move-up applies only to transfers occurring *after* the child's death. Therefore, if all of the donor's children are alive when a QPRT is created and funded, but a child dies during the QPRT Term, the deceased child's descendants will not move up a generation with regard to the QPRT property. Rather, they will continue to be "skip-persons" as to the QPRT. Because the deceased child's descendants will be skip-persons as to the QPRT, a GST tax will be incurred if those descendants succeed to the deceased child's share of the QPRT property unless the grantor's GST tax exemption is applied to the entire value of the trust at the end of the QPRT Term, including the portion of the trust property passing to the grantor's surviving children. To avoid this consequence, it is generally recommended that the remainder beneficiaries of a QPRT be limited to the grantor's children living at the end of the Trust Term. The grantor can then make up the difference to the deceased child's descendants by providing them a disproportionate share of assets from the grantor's estate at his or her death, or by making other gifts to those descendants during the grantor's lifetime. Because such bequests or gifts would occur after the child's death, the children of the deceased child would "move up" a generation for purposes of such bequests or

gifts. n12

(e) The IRS Model QPRT Form (Rev. Proc. 2003-42). In *Rev. Proc. 2003-42*, n13 the IRS announced that it will no longer issue private letter rulings affirming the qualifications of a trust for a single term holder as a valid QPRT. Rather, in *Rev. Proc. 2003-42*, the IRS provided a model QPRT form. Any trust agreement that is substantially similar to the model form, is valid under state law, and is operated consistently with the trust instrument will be a valid QPRT.

As a general rule, estate planning attorneys who are not well versed in the law affecting QPRTs are well advised to use the IRS model QPRT form. However, in doing so, commentators have noted that there are three potential deficiencies in the model form that the drafter might wish to address.

First, the model QPRT form does not provide for a contingent reversionary interest in the grantor should the grantor die during the QPRT Term. There are two potentially important reasons to include such a reversionary interest. First, a reversionary interest reduces the gift tax value of the remainder interest in the QPRT. In fact, for elderly grantors, the reversionary interest can, under certain circumstances, have a greater impact upon the value of the remainder interest than does the grantor's term interest. Second, if the grantor is married at his or her death during the QPRT Term, a reversionary interest will permit the grantor to make a testamentary transfer of the QPRT property to his or her spouse or to a QTIP trust for the spouse's benefit, thereby deferring the payment of estate taxes on the property until the spouse's subsequent death (or, in the case of an outright bequest to the spouse, affording the possibility that the surviving spouse can create a new QPRT).

Second, the IRS model QPRT form requires an independent trustee to determine whether, in the event that the QPRT property should cease to be used as the grantor's personal residence, that property will be distributed back to the grantor or the converted into a grantor retained annuity trust. There is nothing in the Code or the regulations that suggests an independent trustee is required to make this decision, although as a practical matter following the IRS format is for most grantors a safe approach.

Finally, many grantors wish for the QPRT property to remain in trust after the end of the QPRT Term, at least for the grantor's lifetime (to insure that the grantor will not be "evicted" from the property, as discussed above) and possibly after the grantor's death. The IRS model form does not provide for any continuing trusts at the end of the QPRT Term, but rather contemplates outright distribution of the QPRT property to the remainder beneficiaries.

While the foregoing provisions are not included in the IRS model QPRT form, the IRS has privately ruled that a trust agreement created a valid QPRT when it provided the grantor a general power of appointment over the QPRT property in the event that the grantor predeceased the QPRT Term, provided the grantor the sole discretion to determine whether to distribute the QPRT property to himself or convert the QPRT to a GRAT if the residence ceased to be used as the grantor's personal residence, and permitted the QPRT property to be distributed to another trust at the end of the QPRT Term. n14

(2) Personal Residence Trusts (PRTs)

Although QPRTs are the most favored choice, the Code and applicable regulations also exempt Personal Residence Trusts, or "PRTs" (also sometimes referred to as "Non-Qualified Personal Residence Trusts"), from the special valuation rules of Section 2702. The rules governing PRTs are similar, but not identical to those applicable to QPRTs. Therefore, in some specific instances, PRTs are superior to QPRTs for transferring family homes.

PRTs are more restrictive than QPRTs in that they can hold only a personal residence (or an interest in a personal residence). They can hold no cash at all with the limited exception of "qualified proceeds" from the involuntary conversion or destruction of the property by fire or casualty. n15 Like a QPRT, any such "qualified proceeds" must be reinvested in a new personal residence within two years of the date of receipt. n16 In addition, the trust document must prohibit the sale of the residence (other than by destruction or involuntary conversion) and must restrict its use to that of the personal residence of the grantor. n17

The primary benefit of using a PRT as compared to a QPRT is that the Regulations do not expressly prohibit the commutation of the term and remainder interests in a PRT. Thus, if it becomes desirable to terminate the PRT before the end of its term, such as because it appears that the grantor may not survive the trust term (so long as the grantor's condition is not imminently terminal, which could render the mortality tables inapplicable) or because the proceeds of a casualty or involuntary conversion will not be reinvested in a new residence within two years, the grantor and the remainder beneficiaries should be able to agree to the early termination of a PRT and the division of the trust assets in proportion to the actuarial values of the term and remainder interests. n18 As a result of any such termination, the grantor and the remainder beneficiaries would jointly own the property as tenants in common (or in some other form of joint ownership, such as in an LLC).

Finally, although it is beyond the scope of this article, when an individual is purchasing a new property for family use rather than seeking to preserve a property he or she already owns, consideration should be given to a remainder interest purchase in lieu of a QPRT. Under this structure, the individual will purchase a life or term interest and other family members (typically children, grandchildren or trusts for their benefit) will simultaneously purchase the remainder interest. So long as the life or term interest qualifies for one of the exceptions under Section 2702 (that is, it satisfies the requirements of a QPRT or a PRT), and so long as all purchasers contribute to the purchase the actuarial value of their respective interests as determined under Section 7520 of the Code, there should be no gift from the life or term interest hold to the remaindermen.

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n1 As of the date of this article, Congress had failed to take any action to preserve the estate and GST tax, which were repealed for a one-year period as of January 1, 2010. If Congress takes no action at all during calendar year 2010, the estate and GST taxes will be restored on January 1, 2011 to what they would have been under the tax law as it existed in May of 2001. This article, however, assumes for purposes of an organized discussion that the 2009 estate, GST and gift tax exclusions, exemptions and rates are made permanent sometime in 2010.

n2 For an excellent discussion of QPRTs, see "Qualified Personal Residence Trusts - The Shelter for Your Shelter," by Carlyn S. McCaffrey and Pam H. Schneider, 2007 (presented in connection with the 2007 UCLA - CEB Estate Planning Institute).

n3 I.R.C. § 2702(a)(3)(A)(ii) (26 USCS § 2702(a)(3)(A)(ii))

n4 This technique can be useful for staggering the terms of the separate QPRTs to reduce the risk associated with the inclusion of the QPRT property in the grantor's estate if the grantor dies before the end of a QPRT term.

n5 An exception to this rule exists when the grantor has been moved to a convalescent facility. In such circumstances, the QPRT will fail to continue to qualify as a QPRT unless, at all times, the grantor could return to the residence. This has been interpreted to preclude any rental of the property during the grantor's confinement to a nursing home or other similar facility.

n6 If the grantor retains the liability for the mortgage and agrees to indemnify the QPRT for any loss arising from the mortgage, such gift tax consequences may be avoided. Under such circumstances, the gift tax value of the remainder interest will not, of course, be reduced by the mortgage.

n7 *PLRs 9249014, 9425028, 9723021 and 9723030.* Another option for a grantor to retain the ability to use property in a QPRT after the end of the QPRT term is to name the grantor's spouse as the initial remainder beneficiary. The Service has ruled privately that, so long as there is no "implied agreement" that the grantor will retain rent-free use of the property during the spouse's lifetime, the fact that the grantor continues to reside with his or her spouse in the residence will not be an impermissible retained interest in the trust property for purposes of Section 2036(a)(1) of the Code. *PLR 199906014.* Further, occupancy of the property by the grantor and the grantor's spouse will not by itself infer the existence of an agreement that the grantor may continue to occupy the property. *Rev. Rul. 70-155, 1970-1 CB 189.*

n8 See *Wineman Est. v. Comm'r, supra*; *Estate of Powell v. Comm'r, supra*.

n9 I.R.C. §2642(f) (26 USCS §2642(f)).

n10 See Nancy Henderson's Emerging Issues Analysis, GIFT AND ESTATE TAX PLANNING STRATEGIES FOR TRANSFERRING FAMILY HOMES: DYNASTY TRUSTS, 2010 *Emerging Issues* 5239 for a discussion of Dynasty Trusts.

n11 I.R.C. §2651(e). (26 USCS §2651(e))

n12 If the QPRT is not immediately divided at the end of the QPRT Term, but instead is retained for some period of time as a "spray" trust for the collective benefit of the grantor's descendants, it might be possible to pursue a qualified severance of the trust under the final GST tax regulations.

n13 2003-23 I.R.B. 993 (6/9/2003)

n14 PLR 200604045.

n15 Treas. Reg. § 25.2702-5(b).

n16 Treas. Reg. § 25.2702-5(b)(3).

n17 Treas. Reg. § 25.2702-5(b)(1).

n18 Some scholars believe the failure to include a prohibition of commutation was inadvertent, but an error that is difficult to fix. One suggestion is to create a PRT that neither prohibits nor expressly authorizes commutation, thereby leaving the door open without placing the trust in jeopardy should the law evolve unfavorably on this issue.

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Tax Planning Strategies for Transferring Family Homes: Dynasty Trusts

2010 Emerging Issues 5239

USC Gould School of Law 2010 Tax Institute: Tax Planning Strategies for Transferring Family Homes-- Dynasty Trusts

By Nancy G. Henderson

August 3, 2010

SUMMARY: If a property owner intends for property to remain in trust for the use and enjoyment not only of the owner's children, but for future generations of descendants, a "dynasty trust" can be an excellent vehicle to accomplish this objective. Careful consideration must be made as to the effect of the generation-skipping transfer tax upon the donor, the trust, and the trust beneficiaries.

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ARTICLE: For many families, a family home is among the most cherished assets. Whether a family home is a beach front condominium in Florida, a ranch in Montana, a cabin on Lake Michigan, or a historic Victorian home in San Francisco, the goal of preserving that property as a family asset for the use and enjoyment of successive generations can present significant challenges to the estate planner. There are numerous strategies a family should consider when deciding what to do with the family home and properties. From the donor's perspective, the simplest alternative for transferring a family home to children and grandchildren is to make outright gifts of real property interests.

An alternative to gifting direct interests in a family home to children, the donor could establish a Trust for the benefit of children or other family members and make gifts of interests in the property to such a trust during life and/or at death. In many cases, it is the intent of the donor that the property will remain in trust for the use and enjoyment not only of the donor's children, but for future generations of the donor's descendants. A trust of this nature, sometimes referred to as a "dynasty trust", can be an excellent vehicle to accomplish this objective so long as careful consideration is provided to the effect of the generation-skipping transfer tax upon the donor, the trust and the trust beneficiaries. A significant assumption for purposes of this article is that there are federal estate and generation-skipping transfer (GST) taxes. n1

General Gifting of Property Interests in Trust

While there are many issues to consider in drafting a trust as an alternative to making outright gifts of fractional real property interests or creating a family partnership or LLC, certain issues bear particular mention in the context of family homes. First, the trust agreement should establish the rules for the use of the property by the trust beneficiaries, as well as a plan for the succession to a beneficiary's interest in the trust upon the beneficiary's death. In this respect, a

significant benefit of holding a family home in a trust is, so long as no beneficiary possesses the right to withdraw the trust property (or other similar powers that constitute a general power of appointment), and so long as the trust instrument includes a spendthrift clause prohibiting the transfer of a beneficiary's interest in the trust or its property, the trust property should be protected from the claims of the beneficiary's creditors. Further, the terms of the trust could insure that, for as long as the trust is permitted to continue under applicable state law, the trust property will remain in the family.

A practical consideration in the context of dynasty trust planning is who will serve as trustee of the trust and how much power that trustee will hold over the use of the property by the trust beneficiaries. It is inadvisable for the donor to hold such power as it will risk the inclusion of the property in the donor's estate at death. ⁿ² The donor's children or other trust beneficiaries may also be poor choices for the role of trustee as it will place the trustee/beneficiary in a conflict of interest with the other trust beneficiaries. On the other hand, corporate trustees may not be willing to serve as trustee under circumstances where the only trust asset is real property held for the personal use of the trust beneficiaries. Where they are willing to serve, the corporate trustee's fees may be prohibitive, particularly if the property does not produce income.

A further consideration in the context of trusts as donees of interests in family home is how the trust will acquire the resources to pay its proportionate share of the regular expenses of property ownership and maintenance. There are three options to consider in this regard. The first option is for the donor to make annual gifts to the trust using the gift tax annual exclusion as to each of the trust beneficiaries. Such gifts will, of course, serve to reduce the availability of the gift tax annual exclusion for additional transfers of property interests to the trust. Another alternative is to endow the trust with an upfront gift of cash using the gift tax applicable exclusion, to draw upon that cash as needed to pay the trust's proportionate share of expenses and then to replenish the trust at the donor's death (or the deaths of the donor's children or other beneficiaries) through bequests from the donor's estate or from life insurance proceeds. A third option is to generate income to the trust by charging the beneficiaries, third parties or, in appropriate circumstances, the donor rent for the use of the property.

Dynasty Trusts

When transferring a family home to a trust, unless the donor's GST tax exemption is applied to the transfer, or the transfer qualifies for the GST tax annual exclusion, ⁿ³ the GST tax will be imposed upon the initial transfer if that transfer is a "direct skip." The transfer of a residence to a trust will be a "direct skip" only if the trust is a "skip-person" for GST tax purposes. A trust that will hold a residence for the collective benefit of the donor's children and grandchildren will not be a "skip-person" and, therefore, the GST tax will not be imposed upon the initial transfer of the residence to the trust. On the other hand, unless the donor's GST tax exemption is applied to each transfer that is made to the trust (or a late allocation of the exemption is properly made), and unless the portion of the donor's GST exemption so applied is sufficient to render the "inclusion ratio" of the trust zero (0) for GST tax purposes, ⁿ⁴ a GST tax will be imposed upon each distribution from the trust to a "skip-person" (a "taxable distribution"). Further, a GST tax will be imposed upon the entire trust upon the first date that the only remaining beneficiaries of the trust are skip-persons (a "taxable termination"). In either case, the amount of the GST tax imposed will depend upon the inclusion ratio of the trust. If the trust has an inclusion ratio one (1), meaning no portion of the donor's GST tax exemption was applied to the trust, then the GST tax will be imposed at the maximum estate tax rate, which, applying 2009 tax rates, is 45%. If, however, the inclusion ratio of the trust is, for example, .4, meaning the donor's GST tax exemption was only sufficient to exempt 60% of the value of the trust from the imposition of GST tax (a "mixed inclusion ratio"), the GST tax will be imposed at 40% of the highest marginal estate tax rate, which, applying 2009 tax rates, would be 18% (40% of 45%).

In an ideal planning environment for a family home, a "dynasty trust" will have an inclusion ratio of zero. If that is not possible, however, then careful consideration must be given to structuring the trust to postpone the imposition of the GST tax for as long as possible.

(1) Creating GST Exempt and Non-Exempt Trust Shares. If the donor's GST tax exemption is insufficient to

fully exempt the trust from the imposition of the GST tax, rather than create a trust with a mixed inclusion ratio, the trust should be divided into GST exempt and non-exempt shares. The beneficiaries of the non-exempt share should be limited, for as long as possible, to the donor's children and other non-skip persons. On the other hand, the beneficiaries of the exempt share can include grandchildren and more remote descendants. Importantly, if the trust is funded with a cash endowment to fund the expenses of owning the family home, that cash endowment should be allocated proportionately between the exempt share and non-exempt share to match their respective interests in the property. Otherwise, the use of funds from the non-exempt share to pay expenses for the exempt share could be deemed a constructive addition to the exempt share, causing the exempt share to lose its zero inclusion ratio. Conversely, the use of funds from the exempt share to pay expenses for the non-exempt share would waste the exempt share.

(2) Postponing a "Taxable Termination" on Non-Exempt Trust Assets. If a trust holding a family home has been divided into exempt and non-exempt shares, or if the trust has a mixed inclusion ratio, then the planner should consider strategies for postponing a taxable termination of the non-exempt trust for as long as possible. For example, the class of beneficiaries who are permissible users of property held in the non-exempt trust and who are discretionary beneficiaries of trust income, could be expanded to include the donor's nieces and nephews, or the spouses of the donor's children, thereby postponing a taxable termination until the death of the last to die of this class of beneficiaries (as well as the donor's children). It has also been suggested that a taxable termination can be postponed indefinitely if charitable organizations, which are by definition non-skip persons, are permissible income beneficiaries of a non-GST exempt trust or are entitled to an annuity payment from the trust. n5

Even if a taxable termination of a non-exempt trust holding a family home is postponed indefinitely, this begs the question of whether the rent-free use of trust property by a skip-person will constitute a deemed taxable distribution that will give rise to the imposition of the GST tax and, if so, the amount of the GST tax that will be imposed upon any such deemed distribution. There is, unfortunately, little or no direct authority concerning the GST tax consequences of the rent-free use of real property by skip-persons, whether the subject property is held in trust or owned by the deemed transferor. On the other hand, the *gift tax* consequences of the rent-free use of real property was discussed in dicta by the U.S. Supreme Court in *Dickman v. Comr.* n6 The issue before the Court in *Dickman* was not the gift taxation of the use of real property; rather, the question before the Court was the gift taxation of interest-free loans between family members prior to the enactment of the imputed interest rules under Section 7872 of the Code. In concluding that the interest-free use of a donor's capital was a deemed gift to the donee of the donor's foregone interest, the Court in *Dickman* acknowledged that the same rationale could be used to tax the rent-free use of real property. However, the Court stated that, until the IRS actually sought to treat the rent-free use of real property as a taxable transfer, the Court would not address the issue. n7

While there is no direct authority for the imposition of the GST tax upon the rent-free use by a skip-person of real property held in a non-GST exempt trust, the rationale applied by the U.S. Supreme Court in *Dickman* would suggest that such use is a taxable distribution. It is therefore advisable, when drafting a non-GST exempt trust to hold family real property, to contemplate a means for skip-persons to use the property in a manner that is arguably something other than a taxable distribution. One option is to charge a grandchild or other skip persons rent for the use of the property in some amount that is reasonable. The amount of rent charged might take into consideration, for example, whether the grandchild's use of the property is non-exclusive or otherwise limited in scope, and be reduced appropriately. Another option might be to provide the Trustee the discretion to permit only non-skip persons to use the property rent-free, but, under the terms of the trust agreement, to permit such non-skip persons the ability to assign such rights to other family members, including skip-persons. n8 Arguably, if the non-skip person had the right to use the property, but assigned that right to a member of the next generation, the non-skip person/beneficiary should become the transferor for GST tax purposes. The deemed transfer between the non-skip person beneficiary and the skip-person would be a gift. If, however, the right to use the property is a gift of a present interest, the gift tax annual exclusion could apply to shelter this transfer from gift taxation. Otherwise, immediate taxation can be avoided by the application of the deemed transferor's gift tax applicable exclusion.

(3) Including Non-Exempt Trust Property in the Taxable Estate of a Non-Skip Person. Another option for

avoiding a taxable termination of a non GST-exempt trust is to provide one or more of the trust beneficiaries who are non-skip persons a testamentary general power of appointment over a portion of the non-exempt share of the trust (such as the power to appoint trust property to the beneficiary's estate with the consent of a non-adverse party). n9 There are several possible benefits to this approach to avoiding GST tax. First, if the deceased beneficiary's estate is relatively modest, it is possible that his or her estate tax applicable exclusion will be sufficient to fully shelter the trust assets subject to the general power of appointment from estate taxation. Second, if the deceased beneficiary's estate plan does not otherwise employ the use of his or her GST tax exemption, that exemption can be applied to the assets subject to his or her general power of appointment, to be recirculated as GST exempt assets under the terms of the dynasty trust. n10 Finally, if there will be an estate tax imposed upon the assets subject to the general power of appointment, it is possible to plan for the payment of that estate tax by acquiring life insurance on the life of the beneficiary holding the power. In an ideal setting, that insurance would be owned by the GST-exempt share of the original dynasty trust (if any), which could use those insurance proceeds to purchase the property (or a portion of the property) from the non-exempt trust. n11

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n2 See I.R.C. §§ 2036(a)(2) and 2038. (26 USCS §§ 2036(a)(2) and 2038)

n3 Which, as noted in the discussion of the GST tax, requires the trust be divided into separate trust shares for each skip-person for whom the GST tax annual exclusion is to apply and which also requires that the separate share be included in the taxable estate of the skip-person beneficiary upon his or her death.

n4 Meaning that no non-exempt property is held in the trust.

n5 In order for a charity to have an interest in the trust for GST tax purposes, it must have the right (other than a future right) to receive income or corpus from the trust. I.R.C. § 2652(c)(1). Importantly, for this technique to work, among other requirements, the charity's interest has to be significant enough in relation to the trust that it will not be disregarded for GST tax purposes under the principles of I.R.C. § 2652(c)(2). Further, that charities' rights must not be deemed a separate share of the trust under I.R.C. § 2654(b). To avoid the separate share limitation, it is generally advisable for the charities to become permissible beneficiaries *after* the

trust has been created rather than at inception (but, of course, *before* a taxable termination has occurred).

n6 465 U.S. 330 (1984).

n7 Specifically, the majority opinion in Dickman stated, "[I]t is not uncommon for parents to provide their adult children with such things as the use of cars or vacation cottages, simply on the basis of the family relationship. We assume that the focus of the Internal Revenue Service is not on such traditional familial matters. When the government levies a gift tax on routine neighborly or familial gifts, there will be time to deal with such a case."

n8 This will require a modification of the standard "spendthrift clause" of most trust forms, which otherwise preclude the assignment of beneficial interests in the trust.

n9 I.R.C. § 2041(b)(1)(c). (26 USCS § 2041(b)(1)(c)).

n10 If, however, the trust has a situs in a jurisdiction that has a rule against perpetuities, it will be advisable to segregate these assets into a separate trust that will restart the perpetuities period.

n11 This plan can also be employed to pay the GST tax upon a taxable termination. However, if there are multiple non-skip persons, it will not be possible to predict whose death will give rise to the taxable termination. A survivorship policy might be contemplated under these circumstances.

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States Use Jeopardy Assessments as Effective Collection Mechanism

2010 Emerging Issues 5223

In Extraordinary Circumstances, States Use Jeopardy Assessments as Effective Collection Mechanism

By Andrew Swain

July 27, 2010

SUMMARY: There are situations in which state tax authorities determine that ordinary assessment and collection efforts will be ineffective. Although most practitioners do not experience application of the jeopardy assessment provisions often, it is important to maintain an awareness of the provisions, since the circumstances in which they are applied contain many pitfalls for practitioners.

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ARTICLE: States and local jurisdictions commonly impose taxes, or assessments, on businesses and individuals. Normally, after conducting an audit, a jurisdiction issues a proposed assessment on a business. The assessment is deemed preliminary until the taxpayer has either (1) administratively and judicially challenged it and lost, or (2) failed to challenge it within the statutorily prescribed period. The assessment then becomes a final judgment. After it is filed with the court, it becomes, through operation of law, an automatically collectable lien on the taxpayer's property. While this is the normal method in which assessments arise and proceed, there is a different and faster way for a revenue department to get a tax judgment against a taxpayer--the jeopardy tax assessment.

Taxing jurisdictions use jeopardy assessments only when they consider an assessment or collection at risk. Generally, jeopardy assessment statutes authorize state revenue departments to make an immediate assessment without following the procedures required for an ordinary assessment, and to collect the tax in any legally prescribed manner without delay. Jeopardy assessments are authorized on both a federal and state level, with every state tax authority having the power to use jeopardy assessments.

Two common forms of statutes govern jeopardy assessments

Almost all of the states statutorily provide for some kind of jeopardy assessment (see attached chart). As stated previously, jeopardy assessments are not the usual method of assessing a taxpayer's obligation to the state. They require a "finding" by the state that the collection of the tax will be difficult. The type of finding necessary appears in statutory codes in two common forms. The first form of statutory language, adopted by slightly more than half the states, grants states the authority to issue a jeopardy assessment whenever normal efforts to collect taxes owed to the state would "be jeopardized by delay." The second type of statutory language provides that jeopardy assessments may be issued when a specifically listed statutory finding exists. States that have taken this approach usually provide that a jeopardy

assessment is proper when any one of the following is true:

- (1) The taxpayer is about to depart the state.
- (2) The taxpayer is about to remove property from the state.
- (3) The taxpayer intends to stop doing business.
- (4) The taxpayer has concealed or is going to conceal property in the state.
- (5) The taxpayer is about to do any other act tending to prejudice the collection of the tax in whole or in part.

Although some states do not require that notice of a jeopardy assessment be given a taxpayer, most have some kind of notice requirement. n2 The notice usually contains: (1) a statement that collection of the taxes is in jeopardy; (2) the amount determined to be in jeopardy; and (3) a demand for immediate payment. Certain states, such as California, Minnesota, North Carolina, and South Carolina, require that, within five days of the issuance of jeopardy assessment, the revenue department must provide taxpayers with the information on which the department relied in order to conclude that a jeopardy assessment was warranted. n3 Some states, such as Connecticut, Maryland, and Nevada, demand immediate payment of the assessed amount, but give taxpayers ten days to pay before the collection process begins. n4 Illinois and New Mexico make the same demand, but give taxpayers five days within which to comply. n5

Collection procedures pursuant to jeopardy assessment vary from state to state.

Generally, states are able to begin the collection process as soon as the notice of demand has been made and refused. Processes typically available to states include the issuance of a tax warrant, filing of a lien, garnishment, attachment-distress sales, and the levy and sale of seized property. Often, states have the option of pursuing more than one of these remedies.

In certain states, in situations involving jeopardy assessments, there is no waiting period between the time property is seized and the time that the state has the right to sell the property. n6 In Alabama, for example, seizure and sale of the taxpayer's property may take place without regard to the 30-day waiting period for non-jeopardy cases. n7 Iowa has a similar right to sell seized property immediately. n8 Certain states, including Indiana, Iowa, Kentucky, and North Carolina, provide that the state may use its garnishment and attachment procedures to immediately reach a taxpayer's intangible property such as bank accounts, rental payments, salaries and other wages. n9 Some states, such as Kansas, require that the state give a taxpayer a specified number of days within which to pay taxes after they become due before it can issue a warrant for their collection. n10

The seizure and sale provisions of certain states, such as New Jersey, New York, and Utah, allow for the immediate sale of seized property, but only under certain circumstances. n11 Normally, in these states, property seized due to a jeopardy assessment may not be sold until: (1) the state issues a notice of deficiency, and (2) the time for filing a petition for redetermination of the assessment (ranging from 30 to 90 days from notice of deficiency) has expired. In all three states, however, seized property may be sold immediately if: (1) the taxpayer consents, (2) the state determines that the expense of storing and maintaining the property will greatly reduce the net proceeds brought about by a delayed sale, or (3) the property is perishable.

Although the collection process can begin immediately in most states, some states do not allow their revenue departments to immediately sell property seized pursuant to a jeopardy assessment. For example, in Mississippi, although the state is not required to give notice of the jeopardy assessment to the taxpayer, and the state may immediately seize "any property" of the taxpayer's, state law prohibits the sale of seized real property: (1) on Sundays, (2) on any legal holiday, and (3) unless the sale is advertised by the state in a newspaper published in the county, once a week for three successive weeks. In cases of seized personal property, Mississippi law requires that sales be advertised by the state ten days before the sale, in three public places in the county. One of such places must be the local

courthouse.

Regardless of the specific laws of the state regarding jeopardy assessments, it is important for the practitioner to remember that, because of the extraordinary nature of the procedures, often the situation requires a time-is-of-the-essence approach. Because the state taxing authorities generally have wide latitude where collection efforts may be in doubt, the law allows for more leeway than in ordinary collection situations. Therefore, it is imperative that the practitioners with clients facing jeopardy assessment must familiarize themselves with the requisite statutory and regulatory provisions, and make sure to meet any relevant deadlines when attempting to challenge application of those provisions.

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n1 See, e.g., Ind Code § 6-8.1-5-1(a).

n2 See, for example, Ark Code § 26-35-201, Ky Rev Stat Ann § 131.050, Miss Code Ann § 27-41-105, NH Rev Stat Ann § 76:10-a; SD Codified Laws § 10-59-10.

n3 See Cal Rev & Tax Code § 19084; Minn Stat Ann § 270C.36; NC Gen Stat Ann § 105-241.23; SC Code Ann § 12-60-910.

n4 See Conn Gen Stat Ann §§ 12-729a, 12-417; Md Code Ann, Tax-Gen § 13-821; Nev Rev Stat § 360.414.

n5 See 35 Ill. Comp Stat Ann 5/1102 (lien filed after 5-day period); NM Stat Ann § 7-1-59.

n6 See, for example, Ind Code Ann § 6-8.1-5-3; Iowa Code Ann §§ 422.30, 422.26.

n7 See Ala Code § 40-29-23.

n8 See Iowa Code Ann §§ 422.30, 422.26.

n9 See Ind Code Ann § 6-8.1-5-3; Iowa Code Ann §§ 422.30, 626.29; Ky Rev Stat Ann § 131.050; NC Gen Stat Ann § 105-242.

n10 See Kan Stat Ann § 79-3235

n11 See NJ Stat Ann § 54A:9-14; Utah Code Ann § 59-1-703; NY Tax Law §§ 694

RELATED LINKS: For further information, see

■ 2-30 Bender's State Taxation: Principles and Practice § 30.04

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Determining Passive Activity Loss Taxpayer Groupings

2010 Emerging Issues 5196

Determining Passive Activity Loss Taxpayer Groupings

By Gerald Paulukonis Esq.

July 13, 2010

SUMMARY: The cornerstone for the proper application of the passive activity rules is the determination of what constitutes an "activity." The determination of an "activity" is critical because virtually every passive activity rule is applied on an activity-by-activity basis.. In practical application, the regulations lack clarity and certainty.

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ARTICLE: Losses and certain tax credits n1 arising from passive activities are subject to the passive activity limitations. n2 The purpose of the passive activity limitations is to prevent certain taxpayers from artificially reducing taxable income or tax liability. Under the passive activity loss limitations, deductions from a passive activity may not be claimed in excess of the income from that activity for the taxable year. n3 Income and loss within each passive activity can be netted, but any aggregate net loss from passive activities cannot be used to offset net income from other sources. n4

Specified credits arising from a passive activity may not be taken in excess of the regular tax liability attributable to that activity for the taxable year. n5 Furthermore, tax credits arising from passive activities can be used only to reduce the regular tax (not alternative minimum tax) attributable to passive activity income. n6

How Separate "Activity" Information Is Used

The cornerstone for the proper application of the passive activity rules is the determination of what constitutes an "activity." The determination of an "activity" is critical because virtually every passive activity rule is applied on an activity-by-activity basis:

- material, active, and significant participation by a taxpayer is based upon the degree of involvement in the activity n7
- passive income or loss is measured with respect to the specific activity n8
- disposition of the activity may trigger suspended losses; n9 and
- the passive activity limitations are applied separately with respect to each passive activity in which a taxpayer owns an interest. n10

"Activity" Is Defined Using Facts and Circumstances Test

IRC Section 469, 26 USCS 469, does not define the term "activity" for purposes of the passive activity limitations, but authorizes the Treasury to do so in regulations. n11 Regulations do not define the term directly either, n12 but set forth a facts and circumstances approach for defining an activity. n13 The general rule is that one or more activities may be treated as a single activity if they constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC Section 469, 26 USCS 469. n14 Whether activities constitute a single economic unit depends on all the relevant facts and circumstances. n15 The facts and circumstances inquiry comes into play primarily in grouping multiple activities. n16 In practical application, the regulations lack clarity and certainty.

Any Reasonable Method Generally May Be Used to Group Activities

Taxpayers may group multiple activities to constitute a single economic unit for the measurement of gain or loss for purposes of IRC Section 469, 26 USCS 469. By doing so, activities within the single economic unit can be treated as a single activity under IRC Section 469, 26 USCS 469. Taxpayers have significant leeway in making groupings, and may use "any reasonable method" of applying relevant facts and circumstances in grouping activities to do so. For example, in one case, a partnership in which the taxpayer was a partner rented an entire building to two corporations that were the sole tenants. The taxpayer was also a shareholder in each corporation. The court ruled that the two rentals were properly considered as one economic unit under the regulations and could therefore be treated as a single activity. n17

The following factors, however, are given the greatest weight in determining whether activities are an appropriate economic unit: n18

- similarities and differences in the types of business;
- the extent of common control;
- the extent of common ownership;
- geographical location; and
- interdependencies between the activities (for example, the extent to which the activities purchase or sell goods between themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

Not all of the above factors need to point to treating more than one activity as a single activity. n19 Furthermore, apart from these factors, n20 several grouping rules and limitations may apply to restrict particular groupings. n21 Regulations provide examples that indicate the discretion that taxpayers may use in grouping different activities. n22

Example:

Steve has a significant ownership interest in a bakery and a movie theater in a shopping mall in Baltimore, and in a bakery and a movie theater in Philadelphia. Relevant facts and circumstances could indicate more than one reasonable method for grouping Steve's activities. For instance, depending on relevant facts and circumstances, four possible groupings are possible:

- 1) one activity encompassing all four businesses;
- 2) two activities: a bakery activity and a movie theater activity;
- 3) two activities: a Baltimore activity and a Philadelphia activity; or
- 4) four separate activities.

Once Steve groups the activities into appropriate economic units, however, he must continue to use that grouping in later tax years unless a change in the facts and circumstances makes it clearly inappropriate. n23

Practice Tip:

Large non-passive losses from passthrough entities on a Schedule E may be a red flag of an improper grouping. The IRS will view the grouping closely, to ascertain whether many activities have been grouped into a single activity, so that the taxpayer can meet the material participation standards and bypass the passive loss limitations altogether. The IRS will regroup the activities if the grouping does not reflect an appropriate economic unit.

Another possible audit trigger based on groupings occurs when a return deducts losses as non-passive and reports gains as passive. This can indicate that the taxpayer is treating an activity with gains as passive when it should be part of a non-passive activity. If so, the IRS may reclassify these into different groupings. n24

Reporting Activities Groupings

Taxpayers must report their groupings and regroupings, and the addition of specific activities within their existing groupings of activities, under IRC Section 469, 26 USCS 469.

The IRS may regroup a taxpayer's activities if any of the taxpayer's groupings are not an appropriate economic unit, and a principal purpose of the taxpayer's grouping (or a failure to regroup) is to circumvent the passive activity limitations. n25

A taxpayer who has grouped activities generally may not regroup them in later taxable years. n26 In the event of a material change in relevant facts and circumstances, or if it is later determined that the original grouping was clearly inappropriate, the taxpayer not only may, but must, regroup the affected activities and comply with any disclosure requirement prescribed by the IRS. n27 (The IRS, however, always has power to regroup activities in order to prevent tax avoidance.) n28

The required disclosures must be made with the return for the tax year in which the changes occur. n29 The disclosure requirements vary, depending on the type of change. Special rules apply for groupings by partnerships and S corporations. n30 Failure to make a proper disclosure may result in each trade or business activity or rental activity being treated as a separate activity. n31

Practice Tip:

If a taxpayer's activities are fluctuating back and forth between passive and non-passive categorization from year to year, an audit is likely. On audit, an IRS examiner will probably do a three-year or longer comparison of passive and non-passive income and losses on an entity-by-entity basis to look for inconsistencies in treatment. Fluctuation between active and passive categorization may be acceptable, if due to the annual test for material participation in each activity. n32 For the IRS, however, it can also indicate inconsistent regroupings that seek to deduct the greatest amount of losses each year. If the taxpayer has not been consistent or has used inappropriate groupings, the examiner will regroup the activities and apply material participation standards to the regroupings, to determine the proper amount of passive losses. n33

IRC Section 469, 26 USCS 469. n34

Practice Tip:

No disclosure or statement needs to be filed if an activity within a particular grouping is disposed of. Although a prior notice indicated that disclosure might be required in this circumstance. *Rev. Proc, 2010-13* dropped the requirement. n35

Statement Required for Addition of New Activities to Existing Groupings

A taxpayer who adds a new trade or business activity or a rental activity to an existing grouping for a taxable year

must file a written statement with the taxpayer's original income tax return for that taxable year. The statement must identify the names, addresses, and employer identification numbers, if applicable, for the new trade or business activity or rental activity that is being added to the existing grouping, as well as the names, addresses, and employer identification numbers, if applicable, for the activity or activities within the existing grouping. In addition, the statement reporting an addition to an existing grouping must contain a declaration that the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC Section 469, 26 USCS 469. n36

Statement Required for Regroupings

If it is determined that the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred, the taxpayer must regroup the activities. n37 If such a determination and regrouping is made, the taxpayer must file a written statement with the taxpayer's original income tax return for the taxable year in which the regrouping occurs. The statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business or rental activities that are being regrouped. If two or more activities are regrouped into a single activity, the statement reporting a regrouping must also contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of IRC Section 469, 26 USCS 469. Furthermore, the statement reporting a regrouping must contain an explanation of why the taxpayer's original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate. n38

Special Rules for Groupings by Partnerships and S Corporations

Partnerships and S corporations are not subject to the above disclosure requirements. Instead, they must comply with the disclosure instructions for grouping activities provided for on Form 1065, U.S. Return of Partnership Income and Form 1120S, U.S. Income Tax Return for an S Corporation, respectively. Generally, compliance with the applicable form requires disclosing the entity's groupings to the partner or shareholder by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the entity's annual Schedule K-1. A partner or shareholder who does any of the following, however, is required to make a separate disclosure of the groupings disclosed by the entity. n39

- Groups together any of the activities that the entity does not group together;
- Groups the entity's activities with activities conducted directly by the partner or shareholder; or
- Groups the entity's activities with activities conducted through other entities.

Practice Tip:

A shareholder or partner may not treat activities grouped together by a C corporation, S corporation, or partnership as separate activities. n40

Disclosure With Respect to Pre-Existing Groupings

A taxpayer is not required to file a written statement reporting the grouping of the trade or business activities and rental activities that have been made for tax years beginning before January 25, 2010 (pre-existing groupings) until the taxpayer makes a change to the grouping. n41

Effect of Failure to Report

If a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity in accordance with *Rev. Proc. 2010-13*, then each trade or business activity or rental activity will be treated as a separate activity. A timely disclosure will be deemed made by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required

disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer. If the failure to disclose is first discovered by the IRS, however, the taxpayer must also have reasonable cause for not making the required disclosures. n42

Although the above "default" rule will generally result in unreported activities being treated as separate activities, the IRS may still regroup a taxpayer's activities to prevent tax avoidance. n43 Furthermore, because *Rev. Proc. 2010-13* provides alternative relief for untimely filing of the required disclosures, administrative extensions for relief for untimely disclosures are not available. n44

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n1 See IRC §§ 27-30D, 38-45Q.

n2 IRC § 469(d)(1), (2)(A).

n3 IRC § 469(a)(1).

n4 IRC § 469(d)(1).

n5 IRC § 469(a)(1).

n6 IRC § 469(d)(2).

n7 IRC § 469(h),(i)(1); Treas Reg §§ 1.469-4, 1.469-5; Temp Treas Reg § 1.469-5T.

n8 IRC § 469(d), (e).

n9 IRC § 469(g).

n10 IRC § 469(a).

n11 IRC § 469(l)(1).

n12 Treas Reg § 1.469-4.

n13 Treas Reg § 1.469-4(c)(2).

n14 Treas Reg § 1.469-4(c)(1).

n15 Treas Reg § 1.469-4(c)(2).

n16 IRC § 469(a).

n17 *Kucera v Commr, TC Summary Opinion 2001-18*

n18 Treas Reg § 1.469-4(c)(2).

n19 Treas Reg § 1.469-4(c)(2).

n20 See Treas Reg § 1.469-4(c)(2).

n21 See Treas Reg §§ 1.469-4(d)-(f).

n22 Treas Reg § 1.469-4(c)(3).

n23 Treas Reg §§ 1.469-4(c)(3), Example 1; 1.469-4(e).

n24 See Treas Reg § 1.469-4(c).

n25 See Treas Reg § 1.469-4(f)(1).

n26 Treas Reg § 1.469-4(e)(1).

n27 Treas Reg § 1.469-4(e)(2).

n28 See Treas Reg § 1.469-4(f)(1).

n29 *Rev Proc 2010-13, 2010-4 IRB 329* , effective for tax years beginning on or after Jan 25, 2010 [*Rev Proc 2010-13, 2010-4 IRB 329* , § 5].

n30 *Rev Proc 2010-13, 2010-4 IRB 329* , § 4.05.

n31 *Rev Proc 2010-13, 2010-4 IRB 329* , § 4.07.

n32 See IRC § 469(h).

n33 See Treas Reg § 1.469-4(e).

n34 *Rev Proc 2010-13, 2010-4 IRB 329* , § 4.02.

n35 *Rev Proc 2010-13, 2010-4 IRB 329* ; see *Notice 2008-64, 2008-31 IRB 268*.

n36 *Rev Proc 2010-13, 2010-4 IRB 329* , § 4.03.

n37 Treas Reg § 1.469-4(e)(2).

n38 *Rev Proc 2010-13, 2010-4 IRB 329* , § 4.04.

n39 *Rev Proc 2010-13, 2010-4 IRB 329* , § 4.05.

n40 Treas Reg § 1.469-4(d)(5)(i).

n41 *Rev Proc 2010-13, 2010-4 IRB 329* , § 4.06.

n42 *Rev Proc 2010-13, 2010-4 IRB 329* , § 4.07.

n43 Treas Reg § 1.469-4(f).

n44 *Rev Proc* 2010-13, 2010-4 *IRB* 329 , § 4.07; Treas Reg § 301.9100-1(d)(2).

RELATED LINKS: For a discussion of limitations on losses from real estate, see
■ 1-13 Federal Taxes Affecting Real Estate 13.syn

and

■ LexisNexis Tax Advisor -- Federal Topical § 1I:14.03

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Click, Buy, Report: Colorado's Use Tax Reporting Law for Out-of-State Retailers

2010 Emerging Issues 5184

Click, Buy, Report: What the Colorado Use Tax Reporting Law Means to Out-of-State Retailers, a Colorado Tax Practice Insight

By Kelley C. Miller and Katie Crenshaw

July 8, 2010

SUMMARY: Internet retailer protection from sales tax collection, reporting and payment requirements is commanding increased attention of state departments of revenue. Colorado HB 1193 is the most recent state legislation to focus on out-of-state Internet retailers. HB 1193 imposes strict reporting requirements on out-of-state sellers, creating administrative duties for retailers, as well as constitutional issues. Similar California legislation is pending.

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ARTICLE: The tremendous growth in electronic commerce in the past decade--and the ability of most "mega" Internet retailers to seek the shelter of constitutional limits which release them from the obligation to charge and remit sales tax on those transactions-- has finally caught the attention of the states. Faced with unprecedented budget crises, some state lawmakers and governors are drawing notice--and from some constituencies, outrage--for their support and, in the case of Colorado, enactment, of legislation that imposes use tax notice and reporting requirements on retailers with no physical presence otherwise in those states. These laws, which are squarely aimed at out-of-state, Internet retailers, do more than impose arduous and arguably, unconstitutional, reporting requirements on sellers. They mark a notable foray by the states into new territory that allows them to circumnavigate the constitutional limits set forth in *Quill v. North Dakota* n1.

HB 1193: A Rocky Mountain Pass Around *Quill*?

Colorado House Bill 1193 n2 was signed into law by Governor Bill Ritter in February 2010: Colorado's sales and use tax laws are amended to require each "retailer that does not collect sales tax" to "notify Colorado purchasers that sales or use tax is due on purchases made from the retailer and that the State of Colorado requires the purchasers to file a sales and use tax return." n3 The accompanying Emergency Regulation 39-21-112.3.5 specifies the notifications that retailers must make with respect to their Colorado sales. First, at the time of purchase, the retailer must provide notice that:

- (1) the purchase is subject to Colorado sales tax (unless specifically exempt);
- (2) the purchase is not exempt from tax because it was sold via the Internet;

(3) the taxpayer is required to file a sales and use tax return at the end of the year reporting all purchases that were not taxed (and pay use tax on those purchases) and;

(4) non-collecting retailers are required to provide purchasers--and the Department of Revenue--with a year-end-summary of all of their purchases for the year. n4

In addition to these initial reporting requirements, the new Colorado law also requires that every non-collecting retailer n5 mail an additional notice to each Colorado purchaser each year containing the following information:

(1) the total amount paid by the purchaser for Colorado purchases from the retailer during the previous calendar year;

(2) purchase details (including dates, amounts, and categories for all purchases) and;

(3) a notice to the purchaser that Colorado requires that a use tax return be filed for all purchases. n6

Retailers must provide this end-of-year information by way of first-class mail, and cannot include it in any shipment.

Finally, and perhaps most notably, all non-collecting retailers must provide the Department of Revenue with an end-of-year statement providing a report of the total amount of all of a purchaser's purchases for the calendar year at the end of the year. n7 The Department of Revenue has "reserved for permanent rulemaking" the right to determine the content and form of the end-of-year notice to be provided to the state. The Colorado law applies to any non-collecting retailer with more than \$100,000 in annual sales.

Penalties for non-compliance include a penalty of \$5 for each failure to provide the purchaser with notice that sales or use tax is due on the purchase and a penalty of \$10 for each failure to provide the state with the end-of-year statement. Notably, these penalties apply to each and every sale. This means that if a person purchased ten different items at different times and the non-collecting retailer failed to provide the purchaser and the state with the ten notices each, the non-collecting retailer would potentially be subject to \$150 in penalties (\$5 X 10 + \$10 X 10).

Revenue projections for the bill issued by the Colorado Senate Appropriations Committee indicate estimated that revenue from the bill will produce approximately \$4.7 million in fiscal year 2010-2011 and approximately \$4.6 million in fiscal year 2011-2011. Many critics of the law believe that there will be no net revenue to the state after accounting for decreased revenues from out-of-state retailers declining to send products to Colorado or internet retailer like Amazon pulling their affiliates.

While some retailers for whom the use reporting requirements apply may elect to comply with HB 1193, it is anticipated that many of these retailers will simply to "turn on" sales tax collection with respect to sales made into Colorado. In doing so, these retailers would mitigate the otherwise onerous reporting requirements. In the alternative, the non-collecting retailer may attempt to avoid the reporting requirements through changing shipping practices, such as FOB shipping point. Due to the nascent nature of the bill, it being the first of its kind, and the fact that most of the reporting requirements will not kick-in until the beginning of 2011, we will have to wait and see what alternative solutions will be engaged.

HB 1193 raises significant constitutional issues. Namely, by "imposing" a sales tax obligation on retailers with no physical presence otherwise in the state, the Colorado law bypasses the limits set forth under two important Constitutional cases invoking the dormant Commerce Clause--*Quill* and *National Bellas Hess*. n8 In *Bellas Hess v. Illinois* the Supreme Court held that states could not require companies without either property or employees in the state to collect sales and use tax (i.e., physical nexus). The Court's subsequent decision in *Quill v. North Dakota* went further than *Bellas Hess*, holding that not only is physical presence necessary but that a state may not enact a tax which places an undue burden on interstate commerce. Specifically, the Court in *Quill* held that mandating an out-of-state company's

compliance with the laws of thousands of local taxing jurisdictions across the country would discriminate against businesses and burden interstate commerce. This burden is raised by the multi-tiered reporting requirements of the Colorado law.

Adding to the burdens arguably imposed by HB 1193 is the fact that the Colorado Constitution authorizes cities and counties to be "home rule jurisdictions." Home rule jurisdictions are authorized to enact their own tax schemes which may be, and often are, dramatically different from the State of Colorado's tax laws as well as the tax schemes of other home rule jurisdictions. Thus, the possibility for even more and complex requirements could exist.

Along with the burden that out-of-state companies might incur in complying with HB 1193, opponents have raised a host of significant problems with Colorado's new reporting scheme. Notably, that Colorado has essentially enacted a law to impose a use tax reporting requirement only on out-of-state retailers and that the end-of-year notification to the state of all purchases made into Colorado is a violation of consumers' First Amendment right to privacy. Accordingly, the constitutional issues and ramifications of HB 1193 will likely result in several judicial challenges to the law.

The first of those challenges was filed on June 30, 2010. New-York based Direct Marketing Association has recently filed a lawsuit challenging the law based on several of the points mentioned above. Direct Marketing Association's website indicates that its lawsuit challenges HB 1193 because the law:

- Discriminates against interstate commerce;
- Exceeds the permissible scope of state regulatory authority over out-of-state companies;
- Violates the right to privacy of Colorado consumers;
- Infringes upon the free speech and due process rights of both consumers and retailers; and
- Exposes confidential consumer information to the risk of unauthorized disclosure.

AB 2078: California, Here We Come?

Following in the wake of recently enacted laws in New York, North Carolina, and Colorado that impose a use tax collection obligation on out-of-state, online retailers, California Assembly Member Charles Calderon recently introduced Assembly Bill 2078. n9 Commonly known as the Online Tax Bill, AB 2078, if enacted as proposed, would require online retailers making sales into California to notify their California customers of their obligation to pay use tax to the state. With budget projections for the legislation reported between \$100 million and \$150 million annually n10, supplemented by strong support among the Senate majority, passage of AB 2078 is considered likely. If AB 2078 as introduced in the Assembly is passed, it would make California only the second state (after Colorado) to impose a notice requirement on online retailers.

As introduced by Assembly Member Charles Calderon, the Online Tax Bill would:

1. amend California law to create a rebuttable presumption that any retailer member of a controlled group of corporations that has a component member retailer in California, is presumed to be engaged in business in the state and is obligated to collect California sales and use tax.
2. add a new provision requiring each retailer not obligated to collect California use tax to provide notification on its website or catalogue that any California purchaser is obligated to remit use tax to California on its purchases.
3. amend California law, requiring all retailers making sales into California that are subject to use tax to provide the Board of Equalization (BOE) with the names of the purchasers and a listing of items purchased. n11

The Online Tax Bill version ultimately passed by the Assembly omitted Calderon's proposed California law amendments ((1) and (3) above), leaving in place the new purchaser notification requirement n12 ((2) above). However, there is a strong movement among Democratic Senators to restore the other two provisions included in Assembly Member Calderon's original proposal. Notably, the most recently voted-on version of the AB 2078 reinstated the controlled group requirement. However, it eliminated the provision that compels out-of-state retailers to report to

BOE regarding customers who purchase tangible personal property from them, citing the provision's conflict with *Quill* and likely constitutional preemption. n13

The large Democratic majority in the California Senate makes passage of some version of the Online Tax Bill likely. (The Senate currently has 25 Democrats, 13 Republicans, and two vacancies.) However, more than half of all Senators are facing re-election this fall, which makes the passage of any measure to raise taxes uncertain. That said, with few alternatives available to make up for the budget shortfall, legislators may feel they have no choice but to pass an Online Tax Bill.

[Return to Text](#)

n1 504 U.S. 298 (1992).

n2 C.R.S. section 39-21-112.

n3 Id.; C.R.S. section 39-21-112 (3.5) (C) (I).

n4 Colo. Emerg. Regs. 39-21-112.3.5.

n5 Interestingly, Colorado released Emergency Regulation 39-21-112.3.5 defines "retailer that does not collect Colorado sales tax" as a "retailer that sells taxable property or services to customers who are not exempt from sales and use tax but does not collect Colorado sales or use tax." This definition is in conflict with the definition of "retailer" found in the Colorado statute. The Colorado statute definition includes retailers that are part of a controlled group of corporations with at least one retailer having physical presence in Colorado. It is anticipated that this point will be clarified when forthcoming, final Regulations are released by the state.

n6 C.R.S. section 39-21-112(3.5) (d) (I) (A).

n7 C.R.S. section 39-21-112(3.5) (d) (II).

n8 386 U.S. 753 (1967).

n9 A.B. No. 2078, California Legislature 2009-10 Regular Session, Legislative Counsel's Digest, p. 97.

n10 Transcript, Hearing of the Assembly Committee On Revenue and Taxation (April 19, 2010, page D).

n11 A.B. No. 2078.

n12 Assembly Record, California Legislature 2009-10 Regular Session, p. 5049.

n13 Bill Analysis, Senate Revenue & Taxation Committee (AB 2078, Amended 2078).

RELATED LINKS: For more information and further discussion, see

■ 1-12 Bender's State Taxation: Principles and Practice 12.04

For more information and further discussion, see

■ 1-16 Bender's State Taxation: Principles and Practice 16.02

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Reporting Foreign Financial Assets

2010 Emerging Issues 5175

Rhoades on Reporting Foreign Financial Assets Under 26 USCS 6038D

By Rufus Rhoades

July 6, 2010

SUMMARY: Rufus v. Rhoades, Esq., co-author of the treatise Rhoades & Langer, U.S. International Taxation and Tax Treaties, reviews the new rules under 26 USCS 6038D relating to disclosing and reporting foreign financial assets as recently adopted by Congress.

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ARTICLE: Congress was really busy in the tax field in 2010. One of the many changes that it adopted was to require taxpayers to report on their tax returns any "foreign financial assets" that the taxpayer may have held during the tax year.

As virtually every practitioner who does not reside on Mars now knows, a U.S. person who holds a foreign bank account or foreign securities account must report that account (unless it is under \$10,000 at all times during the year) on Form TD F 90-22.1 - the infamous FBAR return. Failure to file that form carries with it potentially Draconian penalties.

Congress, however, has concluded that FBAR data are not enough. The FBAR rules are not a part of the Internal Revenue Code, so Congress has added a similar - but broader in scope - reporting requirement to the Code (see 26 USCS 6038D). The taxpayer is to report on a form attached to his income tax return certain information when the taxpayer holds any interest in a "specified foreign financial asset" if the aggregate value of such asset(s) exceeds \$50,000 during the tax year. The most important point to note about the phrase "specified foreign financial asset" is that it includes far more than just foreign bank accounts or securities accounts.

(1) ***Specified Foreign Financial Assets.*** These assets are:

(a) Any "financial account" maintained by a "foreign financial institution." A "financial account" is a deposit account or a custodial account maintained by a foreign financial institution, as well as any equity or debt interest in such institution, unless those items are publicly traded. A "foreign financial institution" (i) is any foreign entity that accepts deposits (that is, it acts like a bank); (ii) holds, as a substantial part of its business, financial assets for the account of others (that is, it acts like a trust company), or (iii) has, as its primary business, trading in securities (e.g., stocks, commodities, debt, partnership interests, etc).

(b) [Here is the requirement that is going to cause the problems] The taxpayer must report other assets that are *not* held in an account maintained by a foreign financial institution, which are: (i) any foreign stock or securities (stock of a foreign corporation; bonds issued by a foreign corporation, for example); (ii) any financial instrument or contract held for investment that has an issuer or counterparty that is other than a U.S. person (an interest in a swap or derivative contract that involves, at some point, a foreign person, for example), and (iii) any interest in a "foreign entity" (a beneficiary of a foreign trust; a partner of a foreign partnership, for example); a "foreign entity" is any entity that is not a U.S. person.

Note that under that list of items, Congress wants U.S. taxpayers to tell Treasury about virtually any foreign asset, with certain exceptions, that a taxpayer owns. Assets that do *not* require reporting under the rules include foreign real estate, foreign intangibles that normally generate royalties (e.g., patents, trademarks, etc.) and foreign-based tangible personal property.

Example: Susan Peterson has \$500,000 invested in the stock market through an investment counselor. Her counselor spreads her portfolio among domestic and foreign investments. He makes the following investments for her: (a) \$25,000 in Barclay's Bank in London in a U.S. dollar denominated account; (b) 2,200 shares of Helen of Troy at \$25 per share (\$55,000) (Helen of Troy is a Bermuda corporation that trades on NASDAQ); (c) \$30,000 in an Indonesian partnership that holds Indonesian oil interests, and (d) \$35,000 worth of Toyota American Depository Receipts (ADRs).

As a result of those investments, Susan is required to file both an FBAR (Barclay's bank account) and report under the new financial asset reporting rules. If she is unaware of those investments (or she does not know that Helen of Troy is a foreign corporation) and her advisor does not specifically tell her about them, she may not be aware of her responsibility and fail to file. The ADRs are a red herring - they need not be reported since they are U.S. issued securities.

(2) **Data to be Reported.** The information that the taxpayer is to report is rather basic, such as identifying the account or the entity issuing the stock or other security, the type of contract involved, and the maximum value during the year of each asset. Overall, reporting is not required when the aggregate value of all such assets does not exceed \$50,000 (not adjusted for inflation). Note that the new section allows the Service to presume the value to be over that amount when the taxpayer does not provide enough information to prove the value of the assets in question.

The most difficult element of the required data is, potentially, value. Assume a taxpayer owns stock of a closely-held foreign corporation and needs to determine value. The question he faces is how he is to do that. The answer is that, in many cases, he will not be able to determine value, leaving the only reasonable answer being that he should file a report on the asset to avoid any future question. An unresolved question is whether a U.S. person who qualifies as a "U.S. shareholder" under the controlled foreign corporation rules will still be required to file IRS Form 5471 as well as the information required by the new rules. A taxpayer who has a foreign account will very likely be required to report under both the FBAR rules and the new rules discussed above.

(3) **Penalty for Failure to Report.** The penalty for failure to furnish the required information is \$10,000. The usual "reasonable cause" exception applies to the penalty provision, however. In addition to that penalty, though, Congress amended the understatement penalty section to provide for a 40 percent penalty on any tax that is due to any "undisclosed foreign financial asset understatement" (26 USCS 6662(b)(7)). That quoted phrase refers to any understatement of tax that is attributed to a transaction involving an undisclosed foreign financial asset.

(4) **Statute of Limitations.** To add the final exclamation point to Congress's feelings about undisclosed foreign financial assets, Congress extended the six-year statute of limitations (the statute of limitations for most tax matters is three years) to include an omission from gross income of any item that is attributable to a foreign financial asset.

(5) **Effective Date.** Except for the statute of limitations extension, the reporting rules apply to taxable years beginning after March 18, 2010, the date of enactment of the Hiring Incentives to Restore Employment Act, 111th

Cong, 2d Sess § 511(c) (March 18, 2010). For the statute of limitations provision, the effective date is any open year for the taxpayer as of that date.

Example: Chris Rho is a Korean citizen but a resident of New York, where he has lived for some time. In 2008, Chris created a corporation in the British Virgin Islands that, in turn, created a NY corporation that purchased a shopping center for \$5 million. The center generated \$150,000 in after-tax income that the NY corporation distributed to the BVI corporation in 2012 (and which the BVI corporation deposited in a bank in the BVI). Chris was ill advised and never did file IRS Form 5471 (ownership of a foreign corporation form) or Form TD F 90-22.1 (the FBAR form). Further, he did not cause the NY corporation to withhold tax on the dividend nor did he pick the dividend up in his own personal return as subpart F income. Finally, he did not disclose ownership of the BVI corporation as a foreign financial asset.

A couple of years later, Chris is audited and all of those facts are revealed. Here is what Chris is looking at.

- (a) \$10,000 per year for failure to file IRS Form 5471.
- (b) \$10,000 per year for failure to disclose his foreign financial asset (the BVI corporate stock).
- (c) 30 percent of the dividend, plus interest and failure to file and failure to pay penalties (imposed on the NY corporation).
- (d) Tax on his understated income (constructive distribution from the BVI corporation) plus, probably, a penalty for underreporting.
- (e) An FBAR penalty which *might* be as high as \$75,000 per year (50 percent of the highest amount in the foreign bank account).
- (f) Forty percent of the dividend on the theory that such amount is attributed to the undisclosed foreign financial asset.

That is a rather staggering list of penalties, not all of which will necessarily be imposed on Chris, but even the threat of such penalties should be disturbing enough to Chris.

Cash Transaction Reporting. Although taxpayers have long been required to report cash receipts of more than \$10,000 in the course of the taxpayer's business (*26 USCS 6050I*), it deserves mention here because we are talking about reporting. The cash-receipts report is to be made on IRS Form 8300 within 15 days of receipt of the cash. Reporting is not required, however, when the entire transaction (including receipt of the cash) occurs outside of the United States (including U.S. possessions).

Example: Susan Peterson is a lawyer in Los Angeles. On May 1, 2009, Susan goes to Hong Kong to engage in legal work, for which she is paid \$15,000 in cash on May 10, 2009. She promptly opens an account with the Hong Kong Shanghai Bank into which she deposits the cash so that she will not carry it on her person when she flies home. Assuming that she was paid for legal work, some of which was performed in California, she is required to file IRS Form 8300 on or before May 25, 2009. Failure to timely file the form or to complete it properly subjects Susan to a fine of \$50 - although the penalty gets a bit worse if the failure is intentional. Note, that Susan will need to report the bank account she opened under both the FBAR and the new disclosure rules.

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Online Travel Companies and Hotel Occupancy Tax Litigation

2010 Emerging Issues 5153

Charles J. Moll III on Online Travel Companies and Hotel Occupancy Tax Litigation, a California Tax Practice Insight

By Charles J. Moll III

July 1, 2010

SUMMARY: Cities nationwide are taking legal action against online travel companies to recover purported uncollected and unpaid transient occupancy taxes. With states and cities struggling with budget deficits, transient occupancy tax has arisen as a potential source of "lost," or additional, revenue. There are cases pending nationwide with respect to this issue and billions of dollars are at stake.

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ARTICLE: Over the past several years, a spate of litigation has arisen throughout the country concerning the application of hotel occupancy taxes to online bookings. The cases focus on whether online hotel reservation and travel companies are required to collect and remit transient occupancy tax ("occupancy tax") on the amount they charge a customer when reserving a hotel room.

Travel booking companies, like Hotels.com, Orbitz, Expedia, Travelocity, and Hotwire, typically negotiate directly with hotels for discounted hotel room rates and then offer bookings at the hotels to internet customers at marked up rates. The local governments assert that these companies have an obligation to collect, and remit to the local taxing authority, occupancy tax on the marked up rate paid by the customer for the room. As the arrangement currently exists, the companies generally are remitting occupancy tax only on the discounted rate they negotiate with the hotel.

This commentary provides a discussion of several of the issues presented in the occupancy tax cases and highlights a specific California case as an example. It also explains the efforts of the Multistate Tax Commission to craft a compromise approach between the corporate taxpayers and the taxing jurisdictions, and addresses the potential consequences of a decision in this case for the cities, counties, and travel industry players involved in the lawsuits.

Transient occupancy taxes may be imposed at the state or local level.

State and local governments impose a variety of taxes on overnight accommodations. The types of taxes and how they are calculated vary widely from state to state. While some states levy statewide taxes on hotel accommodations, other states permit local governments to do so.

California, for example, authorizes cities and counties to levy a tax on the privilege of occupying a room or living

space as long as the occupancy is for less than 30 days. See CA Rev & Tax. Code 7280(a). Local occupancy tax ordinances generally set forth, among other things, the rate of tax due to be paid by the transient traveler, to whom the transient traveler should pay the tax, and what administrative remedies are available in the event of nonpayment. See, e.g., Los Angeles Municipal Code, Ch. 2 (Licenses, Permits, Business Regulations), Article 1.7 Occupancy Tax, available on Lexis.com via the CCH California State Tax Reporter.

Many of the occupancy tax ordinances at issue in the pending occupancy tax cases were enacted before the introduction of the internet or, at least, before online travel reservations became popular. The ordinances focus on the obligations of owners, operators, and managers of hotels, or on sellers and re-sellers of hotel rooms. The online travel companies assert that they do not fall into any of these categories, but instead are intermediaries providing a service between hotel owners or operators and customers. The online travel companies also refute claims that they should be held liable for the tax as agents for the hotel operators or owners.

The Los Angeles occupancy tax applies to "rent charged by the operator" of a hotel. The travel companies argue that under the ordinance's definition of the terms, they do not charge "rent" and they are not "operators" of hotels.

It is helpful to analyze the ordinance at issue in a particular occupancy tax case to gain a greater understanding of what is involved in these suits. One case pending in California is *City of Los Angeles v. Hotels.com, L.P., et al.*, No. BC 326693 (Cal. Super. Ct. Dec. 30, 2004). Los Angeles revised its occupancy tax ordinance in July 2004, just months before the *Los Angeles v. Hotels.com* lawsuit was filed. Because the city also is seeking a recovery of back taxes, in addition to proving that the tax should be imposed prospectively, the previous ordinance and the amended ordinance are both at issue in the case.

The former Los Angeles occupancy tax ordinance. Both the previous and current Los Angeles ordinances impose occupancy tax collection and remittance obligations equal to a percentage of the "rent charged by the operator" of a hotel. See Section 27.7.3 of the Los Angeles Municipal Code, Ch. 2 (Licenses, Permits, Business Regulations), Article 1.7 Occupancy Tax (hereinafter referred to by section number only).

The defendant companies argue that the ordinance limits the levy of tax to a percentage of the "*rent charged by the operator*" of a hotel (emphasis added). First, with respect to the term "rent," the online travel companies assert that they are not charging rent according to the limited definition in the ordinance. "Rent" is defined under both the original and previous ordinance as "the consideration charged ... for the occupancy of a space in a hotel." Section 21.7.2(e). The travel companies insist that they are not charging rent for space in hotels, nor are they serving as sellers or resellers of rooms. Instead, they maintain that they serve as intermediaries to facilitate sales of rooms between the hotels and the customers. n1 The companies note that the city already receives full payment of tax on the amount charged by the hotel operator. While the customers pay a marked up rate, as well as a service fee for the booking, the companies argue that the marked up rate and fee do not fall under the ordinance's definition of rent.

Pointing to the California statute that gives the cities a general grant of authority to enact legislation to levy a tax "on the privilege of occupying a hotel room" (Cal. Rev. & Tax. Code § 7280), the city asserts that this language means that the city must levy its tax on what a consumer paid for the privilege of occupying a hotel room, regardless of whether this amount is "rent charged by the operator" of the hotel. The online travel companies reject this interpretation and argue that the enabling statute was not intended to be the authority with respect to *who* should be required to pay the tax, *what* the tax should be based on, or *how* the tax would be determined. They assert that these necessary specifics were left up to the cities to decide through the ordinances that they chose to enact, and that the statute makes clear that the only taxing authority it conferred was the ability for the legislative bodies of cities and counties to levy such a tax through a properly enacted ordinance. The companies argue that as a result, the city is bound by the language of its enacted ordinance. See Joint Reply Memorandum in Support of Defendants' Demurrer to the City of Los Angeles's Third Amended Complaint, No. BC 326693 (Cal. Super. Ct. May 30, 2007). (Plaintiff's Opposition to Demurrer of Defendants to the City of Los Angeles's Third Amended Complaint; Memorandum of Points and Authorities in Support

Thereof is available at 2007 CA Sup. Ct. Motions LEXIS 237.)

The companies argue that in addition to the fact that they are not charging "rent" according to the ordinance, they are similarly not "operators" under the former ordinance's limited definition. The previous ordinance defined "the operator" as "the proprietor" of the hotel. Proprietor is further defined under the previous ordinance as the owner or the managing agent of the hotel. The city has attempted to impose liability upon the travel companies through an agency theory, alleging that the companies serve as agents for the hotels. n2 The travel companies counter that the only agent subject to collection and remittance obligations under the previous ordinance is the "managing agent" of the hotel, which they clearly are not. See Joint Reply Memorandum in Support of Defendants' Demurrer to the City of Los Angeles's Third Amended Complaint, No. BC 326693 (Cal. Super. Ct. May 30, 2007). n3

The amended Los Angeles occupancy tax ordinance. The amended ordinance expands the definition of "operator" to include not only a "principal operator" (the owner or proprietor of the hotel) but also a "secondary operator." The definition identifies the types of entities to be considered "secondary operators" and includes references to online service providers. See Section 21.7.2(f). The secondary operator is vested under the ordinance with the same duties and obligations as the principal operator, "including collection and remittance of the full amount of tax owed." See Section 21.7.2(f). The secondary operator may satisfy the obligation for collection and remittance under the ordinance either directly or through the principal operator. See Section 21.7.2(f).

While the amended ordinance's expanded definition of "operator" may lend support to the city's argument that the online service providers are subject to the collection and remittance requirements of the amended ordinance, the online reservation companies allege that the amendments to the Los Angeles ordinance are unconstitutional because the city did not obtain the necessary public approval for the changes under Proposition 218 ("Prop. 218"). Known as the "Right to Vote on Taxes Act," Prop. 218 was enacted in 1996 to give taxpayers the ability to approve or reject local government tax increases. Los Angeles contends that Prop. 218 does not apply in this situation because the changes to the ordinance did not specifically involve a tax rate increase. The travel companies argue that the entire purpose of the revision was to increase the tax paid under the ordinance, which amounts to a tax increase, and which requires public approval under Prop. 218. See Joint Reply Memorandum in Support of Defendants' Demurrer to the City of Los Angeles's Third Amended Complaint, No. BC 326693 (Cal. Super. Ct. May 30, 2007).

In addition to the threshold issues related to liability under the occupancy tax ordinance, there is also the obstacle of nexus.

Even if the travel companies are found substantively liable under the local ordinances for the collection and remittance of occupancy tax, there still must be constitutional authority to impose the tax. Pursuant to U.S. Const., Art. I, § 8, cl. 3, the Commerce Clause empowers Congress "to regulate Commerce ... among the several states." Courts have inferred from this grant of power a restriction on state regulation, termed the "Dormant Commerce Clause," and have prohibited states from improperly burdening, or discriminating against, interstate commerce. Several factors must be considered in determining whether a state's imposition of tax will pass Commerce Clause scrutiny. See *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977). The first of these factors, and the one most relevant here, is the requirement that the activity being taxed have "substantial nexus" with the taxing state.

In the context of sales tax, the Court has held that substantial nexus means a state can exert sales tax jurisdiction over a remote seller only if the seller has a physical presence in the state. *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). Applying this in the context of occupancy tax, unless the online travel companies have a physical presence in the taxing jurisdiction, there may be no ability to impose the tax. (For example, the fact that Hotwire has its principal place of business in San Francisco, California may provide the requisite physical presence for San Francisco, but not necessarily for Los Angeles). On the other hand, physical presence could be established if the travel companies are found to be resellers of the hotel rooms. Or, if the travel companies are found to be serving as agents for the hotels, the hotels could be liable for the tax due on the travel companies' bookings.

If liability under the ordinance can be established, and the limitations associated with nexus can be overcome, the next issue is what tax base to use in imposing the occupancy tax on the travel companies.

Assuming that the travel companies are found to have collection and remittance obligations, and assuming that the obstacle of nexus can be overcome, the issue that remains is how to determine what amount is subject to occupancy tax when a hotel room is booked online via a discount travel broker. To understand what is at stake in this determination, we can utilize the example presented in the plaintiff's original complaint in the *Los Angeles v. Hotels.com* case. See Class Action Complaint, No. BC326693 (Cal. Super. Ct. Dec. 30, 2004).

Example: Suppose that a customer books a room in a Los Angeles hotel for one night through Hotels.com for \$100. Suppose also that Hotels.com has previously negotiated with the hotel for the room rented to the customer at a rate of \$70. Los Angeles County imposes occupancy tax on hotel room rent at a rate of 14%. Using the \$70 discounted room rent as the base, the amount of tax due would be \$9.80 (14% of \$70.00). On the other hand, if the 14% rate is applied to the marked up rent charged to the customer, then the amount of tax due would be \$14.

Specifically, the issue is whether to impose the occupancy tax on the rate negotiated with the hotel or on the actual amount charged to a customer. The difference may only be a few dollars and cents on each individual transaction, but cumulatively the potential tax could add up to a considerable sum. n4

In addition to the mark up, the online travel companies also impose a charge on the customer for what they often term "taxes and fees." The travel companies maintain that this bundled charge represents a service fee as well as the occupancy tax due, although because the receipt issued to the customer is generally not itemized, it is unclear what portion of the "taxes and fees" is attributable to local occupancy tax. Some plaintiffs, including the City of Los Angeles, assert that the companies already are collecting occupancy tax on the higher marked up rate and that the companies have breached their fiduciary duty to deliver the entire amount of tax to the local taxing authority. Los Angeles asked the court to impose a constructive trust on the taxes paid by customers but retained by the companies. The companies, through their representatives, dispute that they have collected any excess tax. They maintain that the "taxes and fees" charged to the customer represent only the occupancy tax due on the discounted rate and that any excess represents services fees only. Whether these service fees are subject to tax also is an unsettled issue.

Administrative remedies are provided under the Los Angeles ordinance and per the California Superior Court, must be exhausted before the lawsuit may proceed.

The Los Angeles ordinance provides that if occupancy taxes due are not remitted, the Director of Finance may perform a tax assessment. The ordinance also provides a right to a hearing on the findings. See Section 27.7.10. The City of Los Angeles did not undertake an assessment or administrative hearing prior to initiating the lawsuit against the travel companies. See Joint Reply Memorandum in Support of Defendants' Demurrer to the City of Los Angeles's Third Amended Complaint, No. BC 326693 (Cal. Super. Ct. May 30, 2007). In other jurisdictions, the failure to exhaust administrative remedies has proven to be a formidable obstacle. See *City of Oakland v. Hotels.com, L.P., et al.*, 2007 U.S. Dist. LEXIS 86548 (Nov. 6, 2007) (U.S. District Court dismissed lawsuit brought by city against online hotel room booking service due to failure to deliver occupancy tax assessment or initiate local or state administrative case), affirmed in part and reversed in part by the 9th Circuit U.S. Court of Appeals, 2009 U.S. App. LEXIS 18889 (July 16, 2009) (appeals court determined that dismissal should have been without prejudice); see also *County of Nassau, New York v. Hotels.com, L.P., et al.*, 2007 U.S. Dist. LEXIS 85808 (Aug. 17, 2007) (dismissing the county's class action lawsuit against 17 online travel companies for failure to exhaust administrative remedies) (Note: This decision was vacated and remanded by *County of Nassau v. Hotels.com, L.P.*, 2009 U.S. App. LEXIS 17748 (2nd Cir., Aug. 11, 2009)). But see *Louisville/Jefferson County Metro Government v. Hotels.com, L.P.*, 2007 U.S. Dist. LEXIS 59070 (Aug. 10, 2007) (ruling that the county did not need to exhaust administrative remedies because it would have been "an exercise in futility") (Note: This decision has been superseded by *Louisville/Jefferson County Metro Gov't v. Hotels.com, L.P.*, 2008 U.S. Dist. LEXIS 76415 (W.D. Ky., Sept. 26, 2008)) and *City of Goodlettsville, Tenn. et al. v. Priceline.com Inc.*, Dkt. No. 3:08-0561 (U.S. District Court, Middle District of Tennessee, Apr. 8, 2009).

In the *Los Angeles v. Hotels.com* case, the judge did not dismiss the case for failure to exhaust administrative remedies but instead stayed the proceedings and ordered the plaintiff cities and counties to exhaust their administrative remedies. At this point the parties are pursuing these administrative avenues for collection.

On July 12, 2006, the court granted a motion by the defendant travel companies to coordinate the *Los Angeles v. Hotels.com* case with another case filed in San Diego County: *City of San Diego, California v. Hotels.com, L.P., et al.*, No. GIC 861117 (Cal. Super. Ct. Feb. 9, 2006). The consolidated case is Judicial Council Coordination Proceeding No. (JCCP) 4472. Both cases are therefore subject to the court's current ordered stay of proceedings. Once the stay is lifted, the court will eventually make a decision regarding whether the cities' suits may proceed as class actions. If the court denies the class action status, it will be up to California's cities and counties to bring their own individual suits against the companies. In order to do so, the administrative collection procedures may first need to be exhausted.

The Multistate Tax Commission is working towards a potential compromise solution.

The ultimate resolution of these occupancy tax cases is unclear. Several states have determined that the travel companies do not meet the definition of hotel operator under the relevant local occupancy tax ordinance, and as such are not responsible for the tax on the marked up retail cost. See *Pitt County, NC v. Hotels.com, L.P., et al.*, 2009 U.S. App. LEXIS 552 (4th Cir. N.C., Jan. 14, 2009); Arizona Private Taxpayer Letter Ruling LR02-015 (Sept. 12, 2002) (AZ St. Tax. Rep. (CCH) P 300-397); *Massachusetts Department of Revenue Letter Ruling 05-6 (June 20, 2005)* 2005 Mass. Tax LEXIS 45; NY Advisory Op. TSB-A-04(6)S (Mar. 17, 2004), 2004 N.Y. Tax LEXIS 68 (N.Y. Tax 2004). On the other hand, other rulings have held in favor of the local governments. See *Orbitz LLC v. City of Anaheim*, Cal. Super. Ct. No. 00244240, petition for writ of mandamus filed Feb. 11, 2009; n5 *Columbus, Georgia v. Orbitz LLC*, Ga. Super. Ct., No. SU-06-CV-1895-05, affirmed by Georgia Supreme Court, June 2009); *Travelscape LLC v. South Carolina Dept. of Revenue*, So. Cal. Admin. Law Ct., No. 08-ALJ-17-0076-CC, filed Feb. 12, 2009; *City of San Antonio v. Hotels.com, L.P., et al.*, 2007 U.S. Dist. LEXIS 39757 (D. Tex. 2007), class certification granted by *City of San Antonio v. Hotels.com*, 2008 U.S. Dist. LEXIS 58793 (W.D. Tex., May 27, 2008); *Leon County, Florida v. Hotels.com, L.P., et al.*, No. 06-21878-CIV-Huck/Simonton (S.D. Fla. Dec. 6, 2006) (dismissed on Feb. 22, 2007); and *City of Gallup, New Mexico v. Hotels.com, L.P.*, U.S. District Court, District of New Mexico, No. CV 07-644 JC/RLP (Mar. 1, 2010). In a case decided by the Georgia Supreme Court in 2009, Expedia was deemed to be a third-party tax collector because of private agreements with a city's hotels to specifically collect funds earmarked for payment of local occupancy tax. See *Expedia Inc. v. Columbus*, 285 Ga. 684 (2009). A subsequent case in Georgia rejected the argument that online travel companies are not hotel "operators" and followed the rationale of the Georgia Supreme Court in the Expedia case to similarly find other online travel companies liable as third-party tax collectors in Atlanta. See *Atlanta v. Hotels.com*, Ga. Super. Ct., No. 2006CV114732 (July 22, 2010).

In July 2009 the Multistate Tax Commission presented a draft model statute that essentially creates a two-step process. n6 It requires the companies to pay occupancy tax on the discounted rate they pay to the hotel, and then to collect and remit a sales tax on what the statute terms the "facilitation fee," the service fee charged to the customer for facilitating an online booking. A number of issues have been raised in response to this approach, including the obstacle of nexus as well as compliance problems for the online travel companies. Although the companies had submitted their own proposal to the MTC's drafting group, the drafters chose to pursue a different approach. There is still considerable controversy surrounding the approach taken in the draft model statute, which the companies contend is unduly burdensome. n7

One potential outcome of a decision in favor of the cities could be higher rates for the customer.

The online travel companies argue that a decision in favor of the cities would have the result of increasing hotel room rates passed on to the customer. The Interactive Travel Services Agency (ITSA), an industry group for internet-based travel providers that works to promote the interests of online travel providers, has been outspoken with respect to its opinion that the disclosure of service fees, which would be necessary from an enforcement perspective, would hinder competition and ultimately produce higher rates for travelers. The ITSA claims that the increased gain to

the cities as a result of greater occupancy tax collected would be offset by a loss of tourism to cities that impose occupancy tax obligations. Specific information regarding the ITSA's arguments may be found on the ITSA's website: <http://www.interactivetravel.org>.

In addition to potentially higher rates, cities that prevail in their occupancy tax lawsuits often find that online travel companies stop contracting with hotels in their cities, thus limiting the customer's choices in that city and perhaps lost revenue from fewer bookings in general. n8 Earlier this year, San Francisco amended its occupancy tax ordinance to clarify that hotel taxes apply to the amounts paid by the customer for the hotel room. The online travel companies responded by removing San Francisco hotels from their websites and the city quickly agreed to not tax travel booking services. n9 The travel companies have similarly removed other cities from their websites when the results of litigation was not in their favor.

Legal action has also been initiated on behalf of the customer. A notice of class action was sent to some \$3 million addresses alleging claims of breach of contract and violation of a state's consumer protection act by Expedia, Inc. See *In re Expedia Hotel Taxes and Fees Litigation*, Wash. Super. Ct., No. 05-2-020601 SEA, notice issued Oct. 22, 2008. Unlike the cases filed by local governments alleging the underpayment of occupancy tax, the complaint seeks monetary damages for millions of customers. On May 28, 2009, the judge in the Washington case issued a summary judgment order granting the customers relief on the breach of contract claim, and awarding \$184 million in damages to the Class, but denied relief based on the consumer protection act claim, which cleared the road for the consumer protection claim to go to trial. n10

Despite the many developments across the country, an ultimate resolution of these issues may be several years away.

The *Los Angeles v. Hotels.com* case is one of many occupancy tax cases being addressed in administrative venues and courtrooms nationwide. Given the amount of money involved, and the potential consequences to all interested parties, these cases are likely to continue receiving significant attention as they progress through the administrative, judicial, and , legislative, n11 review processes.

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n1 The companies distinguish their services from those of a retail reseller specifically because of the way they operate their business. Rather than purchasing a block of rooms from a hotel and then offering the rooms for sale to customers, the companies say they serve only as facilitators, assisting in the transactions between the hotels and the customers. See ITSA City of Los Angeles Questions and Answers Document, <http://interactivetravel.org/IndustryBackground/Attachments/FrequentlyAskedQuestionsaboutTaxesandFees.pdf>. Generally there is a prior contract between the hotel and the online travel company. The hotel agrees to accept a discounted rate in return for the companies finding customers for the hotel's rooms. Under the negotiated-rate model, "[t]he OTCs are [generally] under no obligation to sell rooms, do not have an ownership or legal right to the rooms, suffer no loss for failure to rent the rooms, and ... may not even have a guaranteed right that a room will be available." See John Healy and Bruce Nelson, *Sales Tax Corner: There's Room at the Inn, But How to Tax It?*, 25 J. St. Tax'n 11 (2006).

n2 Arguments may also be made that the online travel companies serve as agents for the customer. The companies disclaim agency liability with respect to both hotel and customer. See John Swain, *From Behind the Tree: Internet Travel Companies--Taxing the Middleman*, 2005 STT 29-3 (January 18, 2005).

n3 Taxing authorities in other states have been hesitant to find liability for occupancy tax on the basis of agency, but also have mentioned that their opinion could be different if the travel company and hotel were related in some way, so that together they were seeking to avoid tax by increasing the customer's markup but only paying tax on a lower wholesale price. See N.Y. Advisory Op. TSB-A-04(6)S (Mar. 17, 2004), available via the N.Y. Dept. of Revenue's website at: http://www.tax.state.ny.us/pdf/advisory_opinions/sales/a04_6s.pdf.

n4 Los Angeles claims that intermediary travel companies are remitting approximately \$10 million less annually than what they should for occupancy tax. See Class Action Complaint, No. BC326693 (Cal. Super. Ct. Dec. 30, 2004).

n5 The Supreme Court of California agreed on August 26, 2009 to review the City of Anaheim's question of whether as a matter of public policy taxpayers, including online travel companies located out of state, must first pay hotel occupancy taxes before they may contest tax assessments in court. See *Anaheim v. Superior Court of Los Angeles County (Priceline.com)*, Cal. S. Ct., Dkt. No. S173946. On November 24, 2009, the Second Appellate District of California ruled against the City of Anaheim on this matter, stating that the pay first rule applies only to actions against the state or an officer of the state and the local ordinance did not contain a similar requirement. See *Anaheim v. Superior Court of Los Angeles County*, California Court of Appeal, Second Appellate District, No. B216250 (Nov. 24, 2009)..

n6 See Nicole White, *MTC Holds Hearing on Hotel Intermediary Taxation*, 53 *State Tax Notes* 206 (July 27, 2009).

n7 See Joseph Henchman, *Cities Pursue Discriminatory Taxation of Online Travel Services*, 55 *State Tax Notes* 631 (Mar. 1, 2010).

n8 William Hays Weissman, *Taxing the Internet, Sort of*, 54 *State Tax Notes* 261 (Oct. 26, 2010).

n9 See Joseph Henchman, *Cities Pursue Discriminatory Taxation of Online Travel Services*, 55 *State Tax Notes* 631 (Mar. 1, 2010).

n10 The judge ruled held that Expedia had breached its contractual obligations to consumers by charging service fees under false pretenses. See the website of the lawyers for the consumer class for further information: <http://www.hbsslaw.com/cases-investigations/expedia>.

n11 Online travel companies have also been seeking enactment of federal legislation to halt state and local taxation of hotel room rentals when booked through an intermediary online booking service. See Michael Mazerov, *Banning Taxation of Online Hotel Reservations is Unwarranted*, 53 *State Tax Notes* 879 (Sept. 28, 2009).

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- Bender's State Taxation: Principles and Practice 29.05

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Recognition of Accountant-Client Privilege for Federal and State Tax Purposes

2010 Emerging Issues 5145

Recognition (or Non-Recognition) of Accountant-Client Privilege for Federal and State Tax Purposes

By Andrew Swain

July 1, 2010

SUMMARY: The issue of federal or state recognition of privilege in protecting communications between tax practitioners and their clients has raised warning flags. In light of recent cases, such as *U.S. v. Textron, Inc.* and *Comm. of Revenue v. Comcast Corporation & Continental Teleport, Inc.*, practitioners, particularly accountants, are advised to remain current on the applicability of privilege to communications between themselves and their clients.

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ARTICLE: In light of recent cases, such as *U.S. v. Textron, Inc.*, 577 F. 3d 21 (1st Cir. 2009), cert. den. No. 09-750, May 24, 2010, and *Comm. of Revenue v. Comcast Corporation & Continental Teleport, Inc.*, 453 Mass. 293; 901 N.E.2d 1185; 2009 Mass. LEXIS 31 (March 3, 2009), practitioners are faced with the reality of determining the extent to which privilege, whether attorney-client privilege or work product privilege or accountant-client privilege, will be recognized. Because courts will generally construe issues of privilege as narrowly as possible and statutes allowing for privileges are often strictly interpreted, understanding when privilege may be claimed and will be recognized can seriously impact the outcome of a case. For this reason, practitioners, particularly accountants, are advised to remain current on the applicability of privilege to communications between practitioner and client.

Tax professionals, and in particular, accountants, maintain a significant amount of information and documentation that is used to communicate the tax consequences of transactions to their clients. Because of the extent of this information and documentation, these practitioners provide one of the best sources of evidence with respect to the substance of a transaction for federal and state tax and criminal authorities. When the federal government or a state government wants access to those documents prepared and communicated by a tax professional, however, a question arises as whether the relationship between the tax professional and his or her client needs to be protected by a privilege of confidentiality.

Federal law allows for a limited accountant-client privilege.

On a federal level, prior to 1998, the issue of accountant-client privilege was determined by case law. The U.S. Supreme Court had held that an accountant-client privilege does not exist under federal law, and, therefore, the communications between a tax professional and his or her client are not protected by a privilege of confidentiality. n1 The Court had further held that an accountant could not protect a client's secrets by transferring work papers prepared

on the client's behalf to the client so that the client could deliver those papers to his attorney. n2

The situation on a federal level changed substantially in 1998. The IRS Restructuring and Reform Act of 1998 included provisions allowing for a limited accountant-client privilege. The statutorily authorized privilege under IRC § 7525 protects federally authorized tax practitioners, including CPAs, attorneys, enrolled agents, and enrolled actuaries, against compulsory disclosure of tax advice. As a result of the enactment of IRC § 7525, the same common law privilege of confidentiality that protects communications between an attorney and client applies to communications between a taxpayer and his "federally authorized tax practitioner." The taxpayer-advisor privilege does, however, have significant limits. The privilege extends only to advisors authorized under federal law to practice before the IRS, and is restricted to non-criminal (*i.e.*, civil) tax matters litigated in federal court. It does not apply to any communications regarding corporate tax shelters. n3 However, distinguishing between protected tax advice and unprotected business advice can be difficult.

States laws vary with respect to recognition of accountant-client privilege.

Unlike the federal law, which provides consistent treatment across all states for practitioners, the states provide varying levels of protection or recognition of privilege. The application or scope of the privilege is determined based on individual state law and policy. Some states have recognized an accountant-client privilege for many years. For example, Colorado has provided an accountant-client privilege since 1929. Other states that recognize the privilege include Arizona, Colorado, Florida, Georgia, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Michigan, Missouri, Nevada, New Mexico, Pennsylvania, Tennessee, Texas, and Vermont. Certain states, however, such as New York, Ohio, and Utah among them, have made it clear that they do not recognize the accountant-client privilege.

An example of how state courts may interpret the accountant-client privilege can be found in Indiana's treatment of privilege. Ind Code § 25-2.1-14-1 provides that the accountant-client pertains to services provided by a certified public accountant, a public accountant, an accounting practitioner, or any of these accountant's employees. The privilege does not apply to a return preparer who does not fit one of these categories. As provided in the law, a practitioner to whom the privilege applies is not required to divulge information relative to and in connection with any professional service as a certified public accountant, a public accountant, or an accounting practitioner. The privilege does not prohibit a party from disclosing data requiring disclosure according to the standards of the profession in order to render an opinion on the presentation of financial statements; comply with ethical investigations conducted by private professional organizations; undergo a quality review; or make a disclosure in which the financial statements or the professional services of an accountant are contested. n4

It is important to remember, when invoking privilege, that the privilege is held by the client, not the practitioner. n5 An assertion of privilege must be made on a document-by-document basis, and the trial court must consider each item individually, rather than making a blanket determination of the privilege's applicability. n6 The privilege is generally limited to information acquired by the accountant in that capacity. n7 This includes information learned by the accountant during an audit. n8 Privilege does not generally extend to documents prepared independently of the audit and given to the accountant.

Because the accountant-client privilege was unknown at Common Law, the courts will generally limit the application of the privilege via strict construction. n9 Unlike the attorney-client privilege, which derives from an attorney's duty to be a zealous advocate for his or her client and is recognized at common law, the accountant does not owe a similar legally recognizable duty of zealous advocacy to his or her client. The obligation to ensure confidentiality derives only from the intrinsic value of confidentiality to the client. For this reason, the taxpayer can easily make the mistake of taking an action that waives the privilege.

Even in states that recognize the accountant-client privilege, some specifically provide that, like the federal privilege, the privilege does not apply to criminal prosecutions. In *State v. O'Brien*, for example, the Arizona Court of

Appeals held that the statutory language specifically prohibits its application to criminal prosecutions. n10 The states vary in their interpretation of this restriction. States such as Florida and Nevada adhere to a "knew or should have known" standard to prohibit assertion of the privilege. The actual knowledge is not relevant and the law provides that the privilege does not apply when the accountant was consulted or hired "to enable or aid anyone to commit or plan to commit what the client *knew or should have known* was a crime or fraud." n11

In some states, the laws specifically provide that the privilege does not protect a disclosure to law enforcement if the accountant has a reasonable basis for believing that the client violated federal, state, or local laws. n12 In *People v. Paasche*, for example, the Michigan appellate court held that the purpose behind the accountant-client privilege, the protection of the substance of the information conveyed by the client to the accountant, ceases to exist when the advice that the client sought pertains to ongoing or future wrongdoing. n13 Other states, such as Indiana, Georgia, Missouri, Pennsylvania, Tennessee, and Texas, do not specifically restrict the application of privilege to non-criminal (*i.e.*, civil) tax matters litigated in Indiana's courts. In Georgia, however, even though the accountant-client privilege is not specifically excluded from criminal investigations and proceedings, the Court of Appeals of Georgia has held that the privilege does not apply to certain criminal situations. Using the attorney-client privilege as an analogy, the court extended the privilege to communications between the client and the accountant that occurred after a fraud or a crime had been committed, but held that the privilege does not apply to those communications that occur before the perpetration of a fraud or commission of a crime and relate to the crime. n14

Using the attorney-client privilege as a springboard for accountant-client privilege.

In light of the importance of the accused taxpayer's accountant or other tax professional to state tax investigators, and the limits and uncertainty attendant to taxpayer-advisor privileges, contact with the return preparer by the taxpayer should cease once the taxpayer is contacted by a state criminal tax investigative team. Contact should end because the preparer might be compelled to testify about conversations with the taxpayer. The taxpayer's attorney should consider whether to suggest that another attorney be retained by the preparer to ensure the preparer's truthful testimony, free of coercion or threats. n15

In *US v Kovel*, 296 F2d 918 (2d Cir 1961), the Second Circuit extended common law attorney-client privilege to an accountant through an agency relationship between the attorney and accountant. The taxpayer's attorney may, through use of the *Kovel* doctrine, attempt to interpose himself or herself between the client and the preparer by retaining the preparer as an expert. In this way, the taxpayer's attorney may be able to extend the taxpayer's attorney-client privilege to the preparer through an agency relationship between the attorney and the preparer. The accused taxpayer's attorney attempts to do this by presenting the accountant or tax professional with a *Kovel* letter. The letter indicates that all of the work product generated by the accountant or tax professional is prepared at the direction of the attorney, and that all supporting work papers belong to the attorney's law firm and must be surrendered to the firm at its request. The letter provides that the accountant or tax professional is prohibited from maintaining copies of the work product. State appellate courts have adopted the *Kovel* doctrine in state criminal proceedings. n16

Needless to say, however, even when invoking the decision of the court in *Kovel*, practitioners must be cautious when relying on privilege in client communications. Care must be taken in attempting to extend the attorney-client privilege to the taxpayer's return preparer. Successful extension of the privilege depends to a great extent on the circumstances under which the attorney retains the preparer. Regardless of the circumstances, it is important to remember that the inability to meet the narrowly construed specific requirements of privilege can result in the disclosure of documents or other communications that can adversely impact the position of the client in a tax matter.

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n1 See *Couch v US*, 409 US 322, 335-36 (1973).

n2 See *Fisher v US*, 425 US 391, 397 (1976).

n3 IRC § 7525(b).

n4 See Ind Code § 25-2.1-14-2.

n5 See *Orban v Krull*, 805 NE2d 450, 453 (Ind Ct App 2004).

n6 See *Airgas Mid-America, Inc v Long*, 812 NE2d 842, 845 (Ind Ct App 2004).

n7 See *Miller v. State*, 593 NE2d 1247, 1252 (Ind Ct App 1992).

n8 See *Landau v Bailey*, 629 NE2d 264, 267 (Ind Ct App 1994).

n9 See, eg, *First Community Bank and Trust v Kelley, Hardesty, Smith & Co*, 663 NE2d 218, 221, 222 (Ind Ct App 1996).

n10 601 P2d 341 (Ariz Ct App 1979).

n11 See Fla Stat § 90.5055(4)(a).

n12 See Mich Stat Ann § 339.732(2)(c).

n13 525 NW2d 914 (1994).

n14 *In re Hall County Grand Jury Proceedings* 333 SE2d 389 (Ga Ct App 1985), vacated on other grounds, 338 SE2d 864 (1985).

n15 See, eg, Horn, *supra* note 195, at 31.

n16 See, eg, *State v Paasche* 525 NW2d 914, 917 (Mich Ct App 1995) (holding that, because the defendant's accountant had been hired by his attorney pursuant to a *Kovel* agreement, any communications between the defendant and the accountant that occurred after the hiring were protected by the attorney-client privilege).

RELATED LINKS: See

■ Bender's State Taxation: Principles and Practice § 30.03

and

■ LexisNexis Tax Advisor -- Federal Topical § 5B:4.04

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Like Your Health Plan? You Can Keep It (Maybe)

2010 Emerging Issues 5149

Like Your Health Plan? You Can Keep It(Maybe)

By Dorinda DeScherer Esq.

June 29, 2010

SUMMARY: "You can keep your health plan." That phrase, in the debate on the 2010 Health Reform Act, was to reassure participants and employers that health reform would not mean ending existing plans. Many plans are "grandfathered health plans" and the law's provisions do not apply. This is not a blanket exception. Some changes to a group health plan initiated by the sponsoring employer will cause it to lose its grandfathered status.

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ARTICLE: "If you like your health plan, you can keep it." That phrase, repeated mantra-like throughout the lengthy debate over the 2010 Health Reform Act, was intended to reassure participants and sponsoring employers that health reform would not require the dismantling of existing plans. And, in fact, the 2010 Health Reform Act (Patient Protection and Affordable Care Act, *111 P.L. 148* (March 23, 2010) as amended by the Health Care and Education Affordability Reconciliation Act of 2010, *111 P.L. 152* (March 30, 2010)), [PPACA] specifically provides that nothing in the new law "...shall be construed to require that an individual terminate coverage under a group health plan or health insurance coverage in which such individual was enrolled on the date of enactment..." [PPACA §1251(a)(1)]

Group health plans in existence on the date of enactment (March 23, 2010) are "grandfathered health plans." [PPACA §1251(e)] The law provides that, as a general rule, the provisions of the PPACA do not apply to grandfathered plans. [PPACA §1251(a)(2)] However, this is far from a blanket exception. Many new coverage requirements and other standards in the law are specifically applicable to grandfathered plans, and will require changes in the terms and operations of existing plans.

Moreover, interim final regulations from the Departments of Treasury, Labor, and Health and Human Services, make it clear that certain changes to a group health plan initiated by the sponsoring employer will cause it to lose its grandfathered status, and become subject to the full range of the Act's requirements. [TD 9489, *75 FR* 34538, 26 C.F.R. § 54.9815-1251T; 29 C.F.R. § 2590.715-1251; 45 C.F.R. § 147.140]

Background. The PPACA imposes numerous new requirements on employer-provided group health plans, ranging from new prohibitions on preexisting condition exclusions, and dollar limits on coverage, to new requirements for benefit explanations.

These new requirements were enacted as amendments to Part A of Title XXVII Public Health Services Act (PHSA), a law that generally applies to plans maintained by state and local governments. However, the PPACA adds new IRC Section 9815, 26 USCS 9815, which provides that the PHSA provisions apply to group health plans and health insurance issuers *as if included* in the Code. [PPACA §1562] As a result, the new requirements generally apply to private-sector group health plans and health insurance issuers providing group health coverage. Moreover, violations of the new requirements are subject to the excise tax for failure to meet group health plan requirements under IRC Section 4980D, 26 USCS 4980D.

Excise tax impact. The excise tax is \$100 *per day per individual* affected by a violation for each day of the noncompliance period, which begins on the date the violation first occurs, and ends on the date the violation is corrected.

Example: A violation that affects 10 plan participants for 10 days would carry an excise tax of \$10,000. In the case of a single employer plan, the excise tax for all failures during a tax year is capped at the lesser of (a) the total amount paid or incurred by the employer during the preceding year for group health plans, or (b) \$500,000. Certain insured small employer plans will not be penalized for violations due solely to the health insurance coverage offered by its insurance issuer. In addition, the tax will not be imposed for unintentional violations that are corrected within 30 day of discovery.

Exceptions: As noted above, the Act provides generally that its provisions do not apply to grandfathered plans. [PPACA §1251(a)(2)] However, the law carves out some significant exceptions to that general rule.

The law provides that the following PHSA requirements *do apply* to grandfathered group health plans:

- Prohibition of preexisting condition exclusions (effective for individuals under age 19 for plan years beginning on or after September 23, 2010; effective for all individuals for plan years beginning on or after January 1, 2014) [PHSA §2704]
- Prohibition of waiting periods for coverage in excess of 90 days (effective for plan years beginning on or after January 1, 2014) [PHSA §2708]
- Prohibition of lifetime or annual limits on coverage for essential health benefits (effective for plan years beginning on or after September 23, 2010; "restricted" annual limits permitted for plan years beginning before January 1, 2014) [PHSA §2711]
- Prohibition of rescission of coverage except in the case of fraud or misrepresentation (effective for plan years beginning on or after September 23, 2010) [PHSA §2712]
- Extension of coverage for adult children until age 26 (effective for plan years beginning on or after September 23, 2010; for plan years beginning before January 1, 2014, grandfathered plans may exclude children eligible for other employer-provided coverage) [PHSA §2714]
- Development and utilization of uniform explanation of coverage documents and standardized definitions (standards to be published no later than March 23, 2011) [PHSA §2716]
- Annual cost reports and premium rebates for insured plans (effective for plan years beginning after March 23, 2010) [PHSA §2718]

The following PHSA provisions *do not apply* to grandfathered plans:

- Premium rating restrictions for insurance in the small group market (effective for plan years beginning on or after January 1, 2014) [PHSA §2701]
- Guaranteed availability of coverage (effective for plan years beginning on or after January 1, 2014) [PHSA §2702]
- Guaranteed renewability of coverage (effective for plan years beginning on or after January 1, 2014) [PHSA §2703]
- Prohibition of discrimination based on health status (effective for plan years beginning on or after January 1, 2014)

[PHSA §2705]

- Prohibition of discrimination against health care providers (effective for plan years beginning on or after January 1, 2014) [PHSA §2706]
- Comprehensive coverage requirements for health insurance in the small group market (effective for plan years beginning on or after January 1, 2014) [PHSA §2707]
- Coverage requirements for individuals participating in approved clinical trials (effective for plan years beginning on or after January 1, 2014) [PHSA §2709]
- Mandated coverage for specified preventive health service on a first-dollar basis (effective for plan years beginning on or after September 23, 2010) [PHSA §2713]
- Prohibition of discrimination in favor of highly compensated employees by insured plans (effective for plan years beginning on or after September 23, 2010) [PHSA §2716]
- Quality of care reporting requirements (reporting requirements to be implemented by March 23, 2012) [PHSA §2717]
- Implementation of internal and external appeals processes for review of coverage determinations and claims (effective for plan years beginning on or after September 23, 2010) [PHSA §2719]
- Patient protections for designation of primary health care provider and coverage of emergency services (effective for plan years beginning on or after September 23, 2010) [PHSA §2719A]

Note, however, a grandfathered health plan must comply with the requirements of the IRC, including mental health parity and nondiscrimination requirements, as in effect prior to the changes enacted by the Act.

In addition, the applicability of other provisions of the Act will also hinge on a plan's status as a grandfathered plan. Most notably, starting in 2014, so-called "pay or play" requires that large employers that do not offer employees "minimum essential health coverage" face potential excise tax penalties. [IRC §4980H 26 USCS 4980H as added by PPACA §1513 and amended by PPACA Reconciliation §1003] And, for this purpose, a grandfathered plan will qualify as minimum essential health coverage. [IRC §4980H(a)(1) 26 USCS 4980H(a)(1); IRC §5000A(a)(f)(2) 26 USCS 5000A(a)(f)(2), as added by PPACA §1501 and amended by PPACA Reconciliation §1002]

Grandfathered health plans. Under the statute, a grandfathered health plan is defined cryptically as a plan in which an individual was enrolled on March 23, 2010.

The statute does not, however, address at what point changes to a group health plan in which an individual was enrolled on March 23, 2010, will be significant enough to cause the plan or health insurance coverage to lose its grandfathered status and be treated as a new plan.

According to the preamble to the interim final regulations, some commentators suggested that *any change* after March 23, 2010, should cause a plan or health insurance coverage to be considered different coverage and thus cease to be a grandfathered health plan. By contrast, others suggested that *any continuous legal relationship* to a plan in existence on March 23, 2010, should ensure continued grandfathered status regardless of degree of changes to the plan. [TD 9489, 6/14/2010]

The interim final regulations do not go to either extreme, but make it clear that certain changes to a grandfathered plan will cause it to lose its grandfathered status. For this purpose, the grandfathered status of each benefit package (e.g., an HMO or a PPO) under a group health plan will be tested separately.

Changes in enrollees. Under the regulations, a plan need not continue to cover the same individual or individuals to maintain its grandfathered status. A group health plan or group health insurance coverage will not cease to be grandfathered health plan coverage merely because one or more (or even all) individuals enrolled on March 23, 2010, cease to be covered, provided the plan or group health insurance coverage has continuously covered some individual since March 23, 2010 (not necessarily the same individual, but at all times at least one individual).

A grandfathered health plan can also add enrollees. If an individual was enrolled in a group health plan on March 23, 2010, grandfathered health plan coverage includes coverage of family members of the individuals who enroll after March 23, 2010 in the grandfathered health plan coverage of the individual. A group health plan (including health insurance coverage provided in connection with the group health plan) that provided coverage on March 23, 2010, and has retained its status as a grandfathered health plan counts as grandfathered health plan coverage for new employees (whether newly hired or newly enrolled) and their families who enroll in the plan after March 23, 2010.

However, the interim final regulations contain two anti-abuse rules to prevent employers from circumventing the grandfather plan rules by switching employees from one plan to another:

Mergers and acquisitions. If the principal purpose of a merger, acquisition, or other business restructuring is to cover new individuals under a grandfathered health plan, the plan will cease to be a grandfathered health plan. According to the regulation preamble, the goal of this rule is to prevent grandfathered plan status from being bought and sold as a commodity in commercial transactions.

Plan-to-plan transfers. Routine transfers of employees from one plan or benefit option to another won't affect a plan's grandfathered status. For example, if an employee switches coverage from one benefit package to another during an open enrollment period, the switch won't affect the grandfathered status of either plan. However, if employees are transferred from one grandfathered health plan to another for no valid business purpose other than to make changes to their coverage that could not be made directly (as discussed below), the transferee plan will lose its grandfathered status. The determination of whether the coverage changes result in loss of grandfathered status will be made by treating the transferee plan as an amendment to the transferor plan. Changing the terms or cost of coverage is not a valid business reason for a plan-to-plan transfer.

Example 1. As of March 23, 2010, Mega Corp's group health plan offered employees two benefit options: Options A and B. For cost reasons, Mega eliminates Option A, and transfers enrolled employees to Option B. If, instead of eliminating Option A, Mega had amended the terms of Option A to match those of Option B, the changes would have resulted in a loss of grandfathered status for Option A. *Result:* Because the coverage changes could not have been made directly to Option A and Mega had no valid business purpose for transferring the employees, the transfer results in a loss of grandfathered status for Option B.

Example 2. As of March 23, 2010, Maxi Corp's group health plan offered two options: Options X and Y. Option X covered only employees of one manufacturing facility. Maxi Corp closes the manufacturing facility and transfers some of the employees to another facility. In connection with the move, Maxi eliminates Option X. The transferred employees are switched to Option Y. *Result:* If made directly to Option X, the change in the transferred employee's coverage would have resulted in a loss of grandfathered status. However, Maxi had a valid business reason for the transfer of the employees to Option Y. Therefore, the transfer does not result in a loss of grandfathered status for Option Y.

Changes to insurance. Renewing existing insurance will not in itself cause a loss of grandfathered status, unless the renewal involves changes in the cost or scope of coverage. However, if an employer or employee organization enters into a new policy, certificate, or contract of insurance after March 23, 2010 (because, for example, a previous policy, certificate, or contract of insurance is not being renewed), then that policy, certificate, or contract of insurance is not a grandfathered health plan with respect to the individuals in the group health plan.

Example 1. On March 23, 2010, Alpha Corporation's group health plan provides coverage through a group health insurance policy from ABC Insurance Company. For the plan year beginning January 1, 2012, Alpha enters into a new policy with XYZ Insurance. *Result:* For the plan year beginning January 1, 2012, the group health insurance coverage issued by XYZ is not a grandfathered health plan because the policy did not provide coverage on March 23, 2010.

Example 2. As of March 23, 2010, Beta Company's group health plan offered three benefit packages: A

self-insured option (Option A) and two insured options (Options B and C). Beginning July 1, 2013, the plan replaces the insurance for Option C with a new policy. Result: Coverage under Option C ceases to be grandfathered health plan coverage as of July 1, 2013. Whether the coverage under Options A and B continue to be grandfathered health plan coverage is tested separately.

Special rules apply to insured collectively bargained plans (see below).

Benefit and cost changes. The regulations take a participant-friendly approach to benefit and cost changes to grandfathered plans. Increasing benefits or reducing participants' costs will not cause a plan to lose its grandfathered status. However, certain benefit reductions or cost-sharing increases will cause the plan to be treated as a new plan.

Benefit reductions. A plan will lose its grandfathered status if all or substantially all benefits to diagnose or treat a particular condition are eliminated after March 23, 2010. For this purpose, the elimination of benefits for any necessary element to diagnose or treat a condition is considered the elimination of all or substantially all benefits to diagnose or treat the condition. For example, if a plan eliminates all benefits for cystic fibrosis, the plan will cease to be a grandfathered health plan—even if the condition affects relatively few plan participants. In addition, an example in the regulations illustrates that if a plan provides benefits for a particular mental health condition, the treatment for which is a combination of counseling and prescription drugs, and subsequently eliminates benefits for counseling, the plan will be treated as having eliminated all or substantially all benefits for that mental health condition and will lose its grandfathered status.

Cost-sharing increases. If a plan imposes a *percentage* cost-sharing requirement (such as a percentage coinsurance requirement), *any increase* from March 23, 2010 will cause a loss of grandfathered status.

Example 1. On March 23, 2010, Gamma Company's health plan has a coinsurance requirement of 20% for inpatient surgery. The plan is subsequently amended to increase the coinsurance requirement to 25%. *Result:* The increase causes the plan to lose its grandfather status.

If a plan imposes a *fixed-amount co-payment* (for example, a fixed charge per doctor visit), a plan will lose grandfather status plan, if the total increase in the copayment measured from March 23, 2010 exceeds the greater of (1) an amount equal to \$5 increased by medical inflation (that is, \$5 times medical inflation, plus \$5), or (2) a maximum percentage increase.

An increase in a *fixed-amount cost-sharing requirement other than a copayment* (for example, a deductible or out-of-pocket limit) will cause a plan to cease to be a grandfathered health plan, if the total percentage increase in the cost-sharing requirement measured from March 23, 2010 exceeds a maximum percentage increase.

For purposes of these rules, the maximum percentage increase equals medical inflation since March 2010, expressed as a percentage, plus 15 percentage points.

Example 2. On March 23, 2010, Delta's grandfathered health plan imposes a copayment of \$30 per office visit for specialists. The plan is subsequently amended to increase the copayment to \$40. The change represents a 33.33% increase in the copayment. Assuming medical inflation since March 2010, expressed as a percentage is 22.69%, the maximum allowable percentage increase is 37.69% (22.69% + 15%). Thus, the maximum percentage increase (about \$11) is greater than \$5 increased by medical inflation (about \$6). Result: Because the 33.33% increase in the copayment does not exceed the maximum percentage increase of 37.69%, the change in the copayment requirement does not cause the plan to cease to be a grandfathered health plan.

Example 3. Same facts as Example 2, except Delta increases the \$40 copayment requirement to \$45 for a later plan year. The change represents a total percentage increase of 50% and a total dollar increase of \$15 total dollar increase in the copayment since March 23, 2010. At the time of the increase, medical inflation since March 2010 is 25.27%, so the maximum percentage increase is 40.27% (25.27% + 15%), while \$5 increased by medical inflation is

\$6.26. Result: Because the total increase since March 23, 2010 exceeds both the dollar limit and the maximum percentage limit, Delta's plan loses its grandfathered status.

Example 4. As of March 23, 2010, Epsilon's group health plan does not impose a copayment requirement for doctor visits. Epsilon subsequently imposes a copayment requirement of \$5 per doctor visit. At the time, medical inflation is 7.2%. Result: Because the maximum dollar increase allowable is \$5.36 (\$5 x 7.2% plus \$5), the \$5 increase in the copayment does not cause the plan to lose its grandfathered status.

Decreases in employer contributions. A plan will lose its grandfather status if the sponsoring employer or employee organization decreases its contribution rate for the cost of any tier of coverage for any class of similarly situated individuals by more than 5 percentage points below the contribution rate for the coverage period that includes March 23, 2010.

Example. On March 23, 2010, Omega Corporation's self-insured group health plan provides two tiers of coverage -- self-only and family. The employer contributes 80% of the total cost of self-only coverage and 60% of the total cost of family coverage. For the 2011 plan year, Omega reduces the contribution to 50% for family coverage, but keeps the same contribution rate for self-only coverage. Result: The 10 percentage point decrease in the contribution rate for family coverage causes the *entire plan* to cease to be a grandfathered health plan. The fact that the contribution rate for self-only coverage remains the same does not change the result.

Changes in annual limits. If a plan imposed an overall annual limit on plan benefits on March 23, 2010, *any* decrease in the dollar value of the annual limit will cause the plan to lose its grandfather status. In addition, if a plan did not impose an overall annual or lifetime limit on benefits as of March 23, 2010, the adoption of an annual limit will cause the plan to lose its grandfather status.

However, if the plan in effect on March 23, 2010, imposed an overall lifetime limit but no overall annual limit, imposition of an annual limit will cause the plan to lose its grandfather status only if the overall annual limit is *lower* than the lifetime limit in effect on March 23, 2010.

Note: For plan years beginning on or after September 23, 2010, group health plans-including grandfathered plans-are prohibited from imposing lifetime limits on plan benefits. Plans-including grandfathered plans-may impose only "restricted" annual limits on essential benefits for plan years beginning before 2014, and are prohibited from imposing annual limits on essential benefits thereafter. Under temporary regulations implementing the Act, plans issued or renewed beginning September 23, 2010, will be allowed to set annual limits no lower than \$750,000. This minimum limit will be raised to \$1.25 million beginning September 23, 2011, and to \$2 million beginning on September 23, 2012. For plans issued or renewed beginning January 1, 2014, all annual dollar limits on coverage of essential health benefits will be prohibited.

Collectively bargained plans. An insured group health plan subject to a collective bargaining agreement ratified before March 23, 2010, is grandfathered at least until the date on which the last agreement relating to the coverage that was in effect on March 23, 2010, terminates. Collectively bargained plans may make changes to the benefit structure before the agreement terminates and remain grandfathered. After the termination date, grandfather status will be determined by comparing the plan, as it existed on March 23, 2010, to the changes that the plan made before termination under the rules established by the interim final regulations.

Caution: Under the interim final regulations, this special grandfather treatment for collectively bargained plans applies only to *insured* plans. According to the preamble to the regulations, the statutory language of the special grandfather provision for collectively bargained plans refers only to "health insurance coverage" and does not refer to a group health plan; therefore, the interim final regulations apply the provision only to insured plans maintained pursuant to a collective bargaining agreement and not to self-insured plans. Thus, presumably, the grandfather status of a self-insured collectively bargained plan must be tested under the general rules discussed above.

The regulations also make it clear that the special grandfather rules for insured collectively bargained plans do not create a blanket exemption from the Act requirements. Thus, the provisions that apply to grandfathered health plans apply to collectively bargained plans before and after termination of the last of the applicable collective bargaining agreement.

Maintaining grandfathered status. A group health plan or health insurance coverage must take active steps to maintain its status as a grandfathered health plan.

Disclosure. The plan must include a statement in any plan materials provided to a participant or beneficiary that the plan or coverage believes it is a grandfathered health plan within the meaning of the Act and must provide contact information for questions and complaints. The following model statement will satisfy the disclosure requirement:

This [group health plan or health insurance issuer] believes this [plan or coverage] is a "grandfathered health plan" under the Patient Protection and Affordable Care Act (the Affordable Care Act). As permitted by the Affordable Care Act, a grandfathered health plan can preserve certain basic health coverage that was already in effect when that law was enacted. Being a grandfathered health plan means that your [plan or policy] may not include certain consumer protections of the Affordable Care Act that apply to other plans, for example, the requirement for the provision of preventive health services without any cost sharing. However, grandfathered health plans must comply with certain other consumer protections in the Affordable Care Act, for example, the elimination of lifetime limits on benefits.

Questions regarding which protections apply and which protections do not apply to a grandfathered health plan and what might cause a plan to change from grandfathered health plan status can be directed to the plan administrator.

For ERISA plans, you may contact the Employee Benefits Security Administration, U.S. Department of Labor at 1-866-444-3272 or www.dol.gov/ebsa/healthreform. This website has a table summarizing which protections do and do not apply to grandfathered health plans. For individual market policies and nonfederal governmental plans, you may also contact the U.S. Department of Health and Human Services at www.healthreform.gov.]

Documentation of plan or policy terms on March 23, 2010. The plan must maintain records documenting the terms of the plan or health insurance coverage in effect on March 23, 2010, and any other documents necessary to verify, explain, or clarify its status as a grandfathered health plan; and must make such records available for examination upon request.

If you like your health plan, should you keep it? Tens of thousands of employer plans will be grappling with that very question in coming months. According to the preamble to the interim final regulations, there are approximately 72,000 large group health plans and 2.8 million small group health plans covering nearly 40 million participants and beneficiaries that potentially qualify for grandfathered health plan status. And, many of those plans are currently, or will be, contemplating plan changes that could impact that status. According to a survey conducted by PricewaterhouseCoopers, 42 percent of surveyed employers plan to increase employee contributions for health coverage, while 41 percent plan to increase medical cost-sharing. [PricewaterhouseCoopers Health & Well-Being Touchstone Survey (June 2010)]

However, plans that wish to retain their grandfathered status may have to rethink those plans in light of the new regulations.

While the new regulations allow limited cost-sharing increases or decreases in employer contributions, plans that contemplate larger increases or decreases will need to weigh the benefits of such cost control measures against the cost of increased compliance responsibilities under the PPACA.

Transition rules. Of course, changes to a plan do not happen overnight. Many plans may have had changes in the works when the PPACA was enacted or may have implemented changes after enactment but before the issuance of the grandfather plan rules.

The interim final regulations provide a series of transition rules to deal with plan changes that might cause a plan to lose its grandfather status.

Changes made prior to March 23, 2010. The following changes will be considered part of the terms of a plan or health insurance coverage on March 23, 2010, even though they were not effective at that time, and will not cause a loss of grandfather status:

- Changes effective after March 23, 2010 pursuant to a legally binding contract entered into on or before March 23, 2010;
- Changes effective after March 23, 2010 pursuant to a filing on or before March 23, 2010 with a State insurance department; or
- Changes effective after March 23, 2010 pursuant to written amendments to a plan that were adopted on or before March 23, 2010.

Changes made after March 23, 2010 and prior to regulations. If a group health plan or insurer made changes to the terms of a plan after March 23, 2010, and before June 14, 2010, the changes will not cause the plan or health insurance coverage to lose its grandfathered health plan status if the changes are revoked or modified effective as of the first day of the first plan year beginning on or after September 23, 2010. For this purpose, changes will be considered to have been adopted prior to June 14, 2010, if:

- The changes are effective before that date;
 - The changes are effective on or after that date pursuant to a legally binding contract entered into before that date;
 - The changes are effective on or after that date pursuant to a filing before that date with a state insurance department;
- or
- The changes are effective on or after that date pursuant to written amendments to a plan that were adopted before that date.

Enforcement policy. Finally, for purposes of enforcement, the Departments of Treasury, Labor, and HHS will take into account good faith efforts to comply with a reasonable interpretation of the statutory requirements and may disregard changes to plan and policy terms that were made before June 14, 2010, and that only modestly exceed those changes permitted under the regulations.

RELATED LINKS: For further information, see

- LexisNexis Tax Advisor -- Federal Topical § 1D:19.04

For further information, see

- LexisNexis Tax Advisor -- Federal Topical § 1D:19.02

For further information, see

- 1-12 Employee Benefits Guide § 12.10

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Structuring Alternatives for Buying and Selling Privately Held Businesses

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USC Gould School of Law 2010 Tax Institute: Structuring Alternatives for Buying and Selling Privately Held Businesses

By Andy Torosyan and Marc Yassinger

June 24, 2010

SUMMARY: With an eye to the day that scheduled tax increases breathe life into mergers and acquisitions activity, this article explores two possible structuring alternatives available to those planning a taxable acquisition or disposition of a privately held business, and the concomitant federal income tax consequences.

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ARTICLE: Scope

The tax increases scheduled to occur after December 31, 2010 should help breathe life back into the area of mergers and acquisitions. n1 With an eye to that day, this article explores two possible structuring alternatives available to those planning a taxable acquisition or disposition of a privately held business, as well as their concomitant federal income tax consequences. The first alternative involves the sale of the stock of an S corporation pursuant to an election under IRC Section 338(h)(10) (26 USCS Sec. 338) (the "338 Election"). In such situations, the stock sale will be treated as an asset sale for federal income tax purposes. In the second scenario, the sale of the units of a limited liability company ("LLC") will be analyzed (the "LLC Transaction"). As we shall see, the LLC transaction can provide significant advantages over a stock acquisition that is treated as an asset sale.

The Deal Terms

As with most deals, the buyer would like to buy assets while the seller would like to sell stock. An asset purchase provides the buyer with several advantages while the stock purchase provides the seller with several advantages. Some significant advantages the buyer achieves by buying assets include getting a cost basis in tangible and intangible assets for tax purposes, and leaving behind unwanted corporate liabilities. n2 Some significant advantages the seller achieves by selling stock include treating the gain on the sale as capital gain, n3 not being primarily responsible for historic liabilities, and not having to transfer and re-title each asset and license. n4

The buyer and seller have different goals when negotiating a transaction. Because each transaction represents its own set of facts, it is important to have all members of the advisory team involved in reviewing the terms of a memorandum of understanding, letter of intent, and purchase agreement.

Tax and Accounting Considerations

Some important tax and accounting considerations in negotiating a transaction include:

- Is the transaction a stock purchase or an asset purchase?
- Is the buyer responsible for making the selling group economically whole for any added taxes that result from an asset sale compared with a straight stock sale?
- Will the seller have to represent that the financial statements follow GAAP? n5
- What is in working capital and EBITDA n6 and how will we calculate an adjustment?
- Which party is responsible for any transfer taxes?
- Which party is responsible for paying tax on the interest that accrues in escrow? n7
- Which party should benefit from any tax refunds related to prior year taxes?
- Which party is responsible to prepare, file, and pay for the short period tax returns?
- How will the parties allocate the purchase price?
- Which party will file necessary election forms (for example, Form 8023, *Elections Under Section 338 for Corporations Making Qualified Stock Purchases*)?

The Fact Pattern

Joe owns 100 percent of the stock of Dynamics, Inc. ("Dynamics"), which has been an S corporation since formation. Dynamics is in California and provides software solutions to its customers through the Internet. When necessary, employees travel to customer locations to help train them on the software, and to other states to solicit sales. Joe is ready to monetize a portion of his investment. Global Fund I, LP ("Fund I") is a private equity firm that invests in technology companies. Fund I wants to buy a controlling interest in Dynamics. Joe and Fund I agree that Fund I will buy 80 percent of the stock and Joe will retain 20 percent. Joe will continue to manage the business. Joe is willing to treat the stock sale as an asset sale for income tax purposes if he receives more cash for the additional tax cost resulting from an asset sale. Fund I agrees to make both Joe and Dynamics whole for added taxes resulting from the deemed asset sale compared with a straight stock sale.

Structuring the Transaction to Qualify for a 338 Election

The 338 Election treats the sale of stock as the sale of assets for federal income tax purposes without triggering double tax provided the entity was always an S corporation. n8 With the 338 Election, the legal transaction is the sale of stock, but the income tax treatment is a sale of assets. This structure is important because it allows licenses and intangibles to stay intact. To qualify, the seller must be an S corporation shareholder and the target must be a valid S corporation. n9 We meet these requirements in our facts; however, the buyer and seller should not take this lightly and should ensure the S corporation status remains intact. If the company is not a qualified S corporation, the 338 Election is void - causing the buyer to fail to obtain a step-up in the basis of the assets, and the seller to breach its representations and warranties under the sale contract. n10

The stock purchase must be a "qualified stock purchase" to be eligible for the 338 Election. A qualified stock purchase is a purchase of stock constituting 80 percent (or more) of the vote and value of the target corporation over a twelve month period. n11 The statutory definition of "purchase" uses transactions that are not "purchases" to set the boundary. Such nonpurchases are carryover basis transactions, acquisitions where the basis is determined under IRC Section 1014, exchanges to which IRC Sections 351, 354, 355, or 356 apply; and acquisitions from a related party under IRC Section 318(a). n12 In addition, the buyer must be a corporation. n13

Selling the Stock

Fund I forms a new corporation ("Newco") to buy the stock and funds it with cash. n14 Next, Joe would transfer his stock in Dynamics to Newco in exchange for cash and nonqualified preferred stock ("NQPS"), as defined in IRC Section 351(g). The use of NQPS causes Joe's stock transfer to not be a transfer under IRC Section 351. Therefore, the

transaction qualifies as a "purchase" for a 338 Election. n15

The buyer and seller must make a joint election on Form 8023 to qualify for asset sale treatment. n16 This joint election must be made by the 15th day of the ninth month beginning after the month in which the purchase occurs. n17 The IRS will provide relief in certain cases where an election is late. n18

The Effect of the 338 Election

The 338 Election creates a series of fictional transactions for federal income tax purposes. n19 First, Dynamics sells its assets and transfers its liabilities to New Dynamics, an unrelated party, n20 receiving cash. n21 Joe then adjusts his basis by the flow-through items from Dynamics, including the sale gain. Dynamics then liquidates, distributing the cash from the sale to Joe for his Dynamics stock. n22 Finally, Newco buys the stock of New Dynamics, replete with a new cost basis in the assets. n23 Because Dynamics is an S corporation, the gains flow-through to Joe, who recognizes the income and pays the tax. n24 It is, therefore, important to determine the character of the gain, which in turn, depends on what was sold, and for how much, and requires an allocation of the purchase price among assets: n25

- We first allocate the purchase price to Class I assets up to their fair market value (FMV). Class I assets include cash and general deposit accounts. n26
- Next, we allocate the purchase price to Class II assets up to their FMV. Class II assets include actively traded personal property, certificates of deposit, and foreign currency. n27
- Next, we allocate the purchase price to Class III assets up to their FMV. Class III assets include accounts receivable, some debt instruments, and certain marked-to-market assets. n28
- Next, we allocate the purchase price to Class IV assets up to their FMV. Class IV assets include inventory, stock-in-trade, and the like. n29
- Next, we allocate the purchase price to Class V assets up to their FMV. Class V assets include all assets other than those in Classes I, II, III, IV, VI, and VII, and include furniture, fixtures, etc. n30
- Next, we allocate the purchase price to Class VI assets up to their FMV. Class VI assets include all intangible assets listed under IRC Section 197, except goodwill and going concern value. n31
- Last, allocate the residual purchase price to Class VII assets, goodwill and going concern value. n32

If there is not enough allocated purchase price to assign up to the fair value of all assets in a particular class, the allocation is proportional among the assets in such class. n33 If the price changes, the allocation is re-determined using the residual method. n34 After dividing the purchase price, Joe uses the basis in each asset to determine the amount and character of the gain from the fictional sale by Dynamics.

Making the Seller Whole for Added Taxes that Result

In our transaction, Fund I has agreed to make the seller whole for incremental taxes that result from the 338 Election. n35 In a straight stock sale, Joe would recognize long-term capital gain from the sale of 80 percent of his stock in Dynamics and the 20 percent he did not sell would not trigger any gain. Some of the important items to consider when comparing a stock sale to an asset sale include:

- Because Dynamics is a California S corporation, the gain from the fictional asset sale is subject to California S corporation income tax at 1.5 percent (as of the writing of this article); n36
- The gain on the sale of assets can result in ordinary income; n37
- The 338 Election triggers full gain recognition and full basis increase for the buyer;
- Liabilities assumed increase the amount realized and may also result in a deduction; n38
- Built-in gain taxes may apply if the company was previously a C corporation or it acquired assets of a C corporation in a tax-free manner; n39
- Transfer taxes may result; n40
- Local taxes may apply;
- Any future consideration may be eligible for installment sale treatment; n41

- If future consideration does not bear enough interest, some of the capital gain would become interest income under the imputed interest rules; n42
- If future consideration is more than \$5,000,000 there is an interest charge on the deferred tax; n43
- The seller may be in alternative minimum tax and may not be able to deduct state taxes;
- Seller may have a higher outside basis than inside basis. n44

The buyer and seller will have to agree on a method to calculate the amount needed to make the seller whole for the 338 Election, an effort that will require good faith negotiations.

The Buyer's Motivation

A buyer agrees to make the seller whole because, in a straight stock purchase, it would inherit the historic tax basis, without a step-up. As a result of the 338 Election, the buyer can amortize and depreciate the cost basis of the assets, which will help shield future income from tax.

One barrier to the buyer's enjoyment of tax benefits is the "anti-churning" rule of IRC Section 197(f)(9). When buying goodwill of a business that began before August 11, 1993, these rules can apply to prevent amortization of the basis in goodwill and going concern value resulting from the purchase. n45

How to Use LLCs to Achieve More Tax Efficiency than a 338 Election

While the 338 Election can work well in certain transactions, it does present certain tax inefficiencies. As noted, a sale of less than all the stock triggers all the gain. Also, Fund I is an ineligible shareholder under Subchapter S, and Joe owns a second class of stock, so income and loss from the business operations of Dynamics, and the future appreciation of goodwill occurs inside a C corporation and is subject to double taxation.

Often, the use of an LLC can help achieve more tax efficiency than the use of a 338 Election. Conversely, LLC agreements are difficult to draft and LLCs need more effort to manage than a C corporation does.

To explain the LLC Transaction using our facts above, Dynamics would form an LLC and transfer all the business assets to the LLC ("New LLC"). n46 Then, Fund I would buy 80 percent of New LLC units from Dynamics. n47

There are some key differences in tax treatment between this LLC transaction and the 338 Election:

- The LLC Transaction triggers only 80 percent of the gain. The gain on the twenty percent undivided interest in assets contributed by Dynamics to New LLC is likely tax deferred. n48
- In the LLC Transaction, the business stays in a flow-through entity. There will be just one tax layer imposed at the owner level. Also, the owners can offer a step-up in basis to a future buyer.
- Historic income tax liabilities stay with the seller. n49 However, other liabilities that attach to the business under general corporate laws do carry over. n50
- In the LLC Transaction, the buyer and seller do not have to make an election to get a step-up in basis for the assets, because the buyer bought them from the seller in a *Revenue Ruling 99-5* fictional transaction.

The LLC Transaction does not eliminate the need for a gross-up payment to the seller. But it does help with other tax issues present in a 338 Election, and keeps the business a flow-through entity. These benefits may outweigh the added time and cost of working through the complexities presented by LLCs. n51

Conclusion

As noted, the parties should consider an LLC in any business acquisition since it can provide significant tax advantages for both the buyer and seller. Major disadvantages of the 338 Election include full gain recognition, even if selling less than all the stock, and the business operations are in a C corporation, subject to double taxation. By using an LLC, the business remains in a flow-through entity, which enjoys only one layer of taxation, and the seller defers gain

recognition if selling less than all of the ownership.

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n1 Absent new legislation, several changes occur on January 1, 2011, including the increase of the maximum federal tax rate on net long term capital gain from 15 to 20 percent. See IRC Sections 1(h)(1), 1(h)(11), and 1374(d)(7). All "IRC Section" references herein are to the Internal Revenue Code of 1986, as amended, ("IRC") and all "Treas. Reg. Section" references are to the regulations thereunder. All "IRS" references are to the Internal Revenue Service.

n2 Certain liabilities may carry over in a bulk sale. A buyer should consult an attorney.

n3 If the sale was an asset sale, there may be ordinary income.

n4 In addition, transfer and sales taxes may result from an asset sale.

n5 Unless a reputable accounting firm has audited the financial statements, this representation will be difficult to provide. In some transactions, a GAAP representation with an exceptions list is fitting.

n6 The usual meaning of EBITDA is earnings before interest, taxes, depreciation, and amortization.

n7 Prop. Reg. Section 1.468B-8(c) provides the buyer should report the interest income.

n8 Entities that convert from a C corporation to an S corporation, or acquire assets from a C corporation in a tax-free transaction, are subject to the built-in gains tax of IRC Section 1374.

n9 Treas. Reg. Sections 1.338(h)(10)-1(c)(1) and -1(b)(4).

n10 Treas. Reg. Section 1.338(h)(10)-1(c)(5).

n11 IRC Section 338(d)(3).

n12 IRC Section 338(h)(3).

n13 IRC Section 338(d)(1).

n14 The acquirer's existence must be respected.

n15 There are several other ways to "fail" IRC Section 351 (26 USCS Sec. 351) . See, e.g., *Revenue Ruling 84-44, 1984-1 C.B. 105*.

n16 All S corporation shareholders must consent. Treas. Reg. Section 1.338(h)(10)-1(c)(3).

n17 Treas. Reg. Section 1.338(h)(10)-1(c)(3). Form 8023 is filed with the Internal Revenue Service, Submission Processing Center, P.O. Box 9941, Mail Stop 4912, Ogden, UT 84409.

n18 See Revenue Procedure 2003-33, 2003-1 C.B. 803. Some states do not recognize federal S corporation status.

n19 See IRC Section 338(a); Treas. Reg. Section 1.338(h)(10)-1(d)(4); Treas. Reg. Section 1.338(h)(10)-1(d)(4); and Treas. Reg. Section 1.338(h)(10)-1(e), *Example 10*.

n20 However, new target is a continuation of the old target for certain purposes. Treas. Reg. Section 1.338-1(b).

n21 Although selling only 80 percent of the stock, the fictional asset sale considers 100 percent of the assets and liabilities transferred.

n22 Treas. Reg. Section 1.338(h)(10)-1(d)(4).

n23 Treas. Reg. Section 1.338(h)(10)-1(d)(2); Treas. Reg. Section 1.338(h)(10)-1(e), *Example 5(v)* and *(vi)*.

n24 IRC Section 1366(a).

n25 The Treasury Regulations require this division using a residual method, Treas. Reg. Section 1.338(h)(10)-1(d)(2); Treas. Reg. Section 1.338(h)(10)-1(d)(3).

n26 Treas. Reg. Section 1.338-6(b)(1).

n27 Treas. Reg. Section 1.338-6(b)(2)(ii).

n28 Treas. Reg. Section 1.338-6(b)(2)(iii).

n29 Treas. Reg. Section 1.338-6(b)(2)(iv).

n30 Treas. Reg. Section 1.338-6(b)(2)(v).

n31 Treas. Reg. Section 1.338-6(b)(2)(vi).

n32 Treas. Reg. Section 1.338-6(b)(2)(vii).

n33 Treas. Reg. Section 1.338-6(b)(2)(i).

n34 See Treas. Reg. Section 1.338-7.

n35 Although Joe has sold stock, the tax fiction is that Dynamics has sold assets and liquidated. Therefore, any amount needed to make the seller whole should include added tax that results to both Joe and Dynamics.

n36 Not all states tax S corporations. Therefore, one should analyze the state apportionment rules.

n37 This determination primarily depends on the purchase price allocation and the seller's method of accounting.

n38 See Treas. Reg. 1.461-5; *James M. Pierce Corporation*, 326 F.2d 67 (8th Circuit 1964).

n39 IRC Section 1374 (26 USCS Sec. 1374)

n40 Under California law, the transaction is a stock sale and therefore the transaction does not result in sales tax withholding. CA SBE Sales and Use Tax Counsel Annotation 395.0074. Note that real property taxes must be evaluated when there is a change in ownership.

n41 However, in the deemed liquidation that results from the 338 Election, the shareholder must allocate his basis in the S corporation stock among the assets received (cash and installment note). This causes the gross basis to be split between cash and the installment note and triggers gain. Also, taxpayer's cannot defer gain under the installment sale method for purposes of computing the 1.5 percent California S corporation tax. California Rev. and Tax Code Sec. 24672.

n42 IRC Section 483 (26 USCS Sec. 483)

n43 IRC Section 453A.

n44 For example, seller may have bought the stock of a C corporation and then converted it to an S corporation.

n45 The rules will apply if the business began before August 11, 1993 and the seller is related to the buyer (a 20 percent test) the seller continues to use the intangible post-closing, or the buyer grants the right to use the intangible to the seller. IRC Section 197(f)(9)(C); IRC Section 197(f)(9)(A). For businesses that began after August 10, 1993, the anti-churning rules do not apply.

n46 If re-titling assets is a problem, Joe can form a new corporation ("Newco Inc"). Next, Joe will transfer all the Dynamics stock to Newco Inc and immediately convert Dynamics to a state law limited liability company using a Certificate of Conversion ("Dynamics LLC"). This likely qualifies as a reorganization under IRC Section 368(a)(1)(F). The S corporation election carries over to Newco Inc. Revenue Ruling 64-250, 1964-2 C.B. 333. The Employer Identification Number carries over to Dynamics LLC. Revenue Ruling 2008-18, 2008-13 I.R.B. 674. See also, *Revenue Ruling 2004-59, 2004-24 I.R.B. 1050*; and Treas. Reg. Section 301.7701-3.

n47 The IRS has ruled on this transaction. Under the ruling, the purchase of the LLC units by Fund I is, for

income tax purposes, a series of fictional transactions. *Revenue Ruling 99-5*, Situation 1, 1999-1 C.B. 434.

n48 IRC Section 721. However, one must analyze the debt allocation and the impact of the disguised sale rules.

n49 Note that while Public Law 86-272 does protect sales solicitation for tangible goods, it does not protect sales solicitation of intangible goods.

n50 For example, environmental liability, product liability, payroll tax liability. In a consolidated group, the joint and several liability of Treas. Reg. Section 1.1502-6 also carries over.

n51 The LLC Transaction can be modified by inserting blocker C corporations for tax exempt and foreign investors.

RELATED LINKS: For additional information, see

■ LexisNexis Tax Advisor -- Federal Topical § 2C:15.05

and

■ LexisNexis Tax Advisor -- Federal Topical § 2D:12.01

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Valuing Privately Held Assets in Troubled Times

2010 Emerging Issues 5135

USC Gould School of Law 2010 Tax Institute: Valuing Privately Held Assets in Troubled Times

By Lance Hall ASA

June 23, 2010

SUMMARY: The Dow Industrial Average lost one-third of its value in 2008. Examining the drop in value of large to smaller public companies, the valuation professional can better understand how much more a private company's value can fall. Private company equity interest valuations from autumn 2008 through the spring of 2009 suggest that amended returns and refund filings may be in order. Such filings are not likely to impact the already high audit rate.

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ARTICLE: On September 15, 2008, Lehman Brothers, the storied investment bank with a history dating back to 1850, did the unthinkable - they filed for Chapter 11 bankruptcy. It marked the largest bankruptcy to date and sent the already weak stock market into a tailspin. By November 20, 2008, the Dow Industrial Average (Dow) had dropped 34 percent in value. For many assets, there were no trades. Investment banking activity dried up. Even if you wanted to buy, unless you had cash, you were out of luck because financial institutions stopped lending.

The Dow is made up of 30 of the largest and most respected companies in the United States. However, the vast majority of companies in America are neither large nor publicly traded. So, if the Dow dropped 34 percent in value, what happened to the value of small private companies? Not only were they impacted by the overall decline in values, but there was overwhelming investor flight to quality and liquid assets - neither possessed by private equity. These two factors demolished most private companies' minority interest values - sending them down over 75 percent.

This article will explore how private equity, in general, was impacted by the Great Recession, and provide concrete methodologies for valuing privately held assets during troubled times.

A Flight to Quality

2008 is the year that changed America. Not since the Great Depression had investors seen such massive declines in their investment portfolios. Worse, the percentage of Americans owning public stocks had never been higher, so the panic that defined late 2008 affected almost all Americans. Baby boomers saving for retirement suffered a dramatic drop in their retirement assets that likely will require them to work well beyond the time of their initial retirement plans. Simultaneously, federal and state governments witnessed unparalleled declines in tax revenue and responded with record spending resulting in massive deficits that can only force them to raise taxes, making it even more difficult for

people to save for their retirements. The Dow Industrial Average began 2008 at 13,044 and ended 2008 below 8,800, a drop in value of approximately one third. n1

The Dow is made up of 30 of the largest and most respected companies in America. Did smaller companies fare worse? The simple answer is "yes" and the implication for small private equity is profound.

While the Dow dropped 33.9 percent between September 15, 2008 and November 20, 2008, the Standard & Poor's 500 index (representing, on average, smaller companies than those in the Dow but, still much larger than private companies, having market values in the billions of dollars) dropped 39.9 percent. Even smaller companies, such as those on the NASDAQ composite index, dropped even more (41.8 percent). If we look at the smallest public companies, as represented in the Russell 2000 index, the drop in value was an astounding 46.5 percent over the same time period.

During troubled times, investors will punish smaller companies more than larger companies as they seek the relatively greater stability and safety that larger companies provide. Since most private equity is considerably smaller in value than the companies found in the Russell 2000 index (which has a median market cap of \$383,000,000), the drop in value of the average privately held company during 2008 was likely dramatically larger than the 46.5 percent drop in the Russell 2000 index.

Merger-and-Acquisition Activity

Merger-and-acquisition activity dropped significantly during the fall of 2008. One of the primary reasons for the drop in activity was (and continues to be) the lack of lending, at all levels, for target acquisitions. The acquisitions getting done during this time frame were more strategic, in nature, and driven by synergisms and existing cash balances. As a result, the number of private company purchases by private equity buyers, who depend on ready access to debt financing, dropped dramatically. Independent research firm GF Data Resources, n2 which collects transaction data from selected private equity groups on completed deals in the \$10-250 million value range, recorded 38 transactions in the first nine months of 2009 (51 on an annualized basis). As a comparison, the same groups completed 155 deals in 2006, 173 in 2007 and 120 in 2008. n3 According to PitchBook Data, Inc., "U.S. private equity deal flow for 2009 was down 50% from 2008 and 65% from 2007 to 979 completed deals, a level not seen since 2003." n4 In terms of pricing, "Mid-market purchase price multiples in the third quarter hit their lowest point in at least six years.... Buyout shops... paid an average multiple of just 5.1x trailing 12-month [Earnings Before Interest, Taxes, Depreciation and Amortization] EBITDA, the lowest quarterly average since... 2003." n5 GF Data's research suggests the average EBITDA multiple had previously peaked at 6.0 during 2005-07. n6 PitchBook's pricing data suggests that the median deal value during the first and second quarters of 2009 was only \$20 million, versus a peak of \$74 million in 2007 - a 73 percent decline.

Collectively, the data confirm that smaller private companies experienced a greater decline in value due to (a) investors increased preference for quality, liquid assets, and (b) the lack of buyers for small private companies as a result of the lack of financing available to complete such transactions.

Discounts for Lack of Control and Lack of Marketability

Clearly, for small private companies with values of less than \$50 million, the decline in value in 2008, on average, easily exceeded 50 percent. The Great Recession's impact on private equity values is only part of the equation, however. The second part of the equation is how the Great Recession has impacted discounts for lack of control and lack of marketability of minority interests in small private equity.

Lack of Marketability

The level of fear in the market during the fall of 2008 was unprecedented. An index called the "VIX" [Chicago Board Options Exchange Volatility Index] actually measures that fear. n7 When the VIX is 20 or below, it is generally

assumed to be a calm and favorable investing environment. However, when the VIX is 30 or more, this is interpreted to reflect high levels of investor fear and panic. n8 As late as August of 2008, despite the earlier problems with Bear Stearns and the general decline in stock market prices, the VIX was still a relatively calm 20. But, with the bankruptcy of Lehman Brothers, the VIX shot up to a frightening 31.7, a level historically associated with a high level of investor fear and panic. By November 20, 2008, the VIX hit a historic record high of 80.9. n9 Since this level had never been seen in the past, it begged the question, "If a score of 30 implies investor fear and panic, what does 80.9 represent?"

Not only is this level of fear reflected in the sell-off of public equities, it is also reflected in the heightened investor demand for liquidity. At the beginning of 2008, investors received a return of over 3 percent annualized for making a 3-month loan to the federal government. However, by the end of 2008, investors were giving the government money in return for only a nominal amount of interest. This is the equivalent of hiding your money under your mattress!

This overwhelming demand for liquidity enhanced its value, resulting in historically low interest rates. Likewise, the converse also held true, the lack of liquidity further diminished the value of illiquid assets (i.e., it increased the discount for lack of liquidity, or marketability). This is evidenced by the 118 private placements of restricted stock in 2008. n10 The vast majority of these private placement sales came with 30- to 45-day registration rights. Once the stock was registered it could be sold in the public marketplace. In the first half of 2008, there were 72 private placements that took place at an average discount of 8.5 percent. But, the 46 transactions that occurred in the second half of 2008 had an average discount of 14.0 percent, a 65 percent increase. Importantly, the VIX in the first half of 2008 averaged a slightly elevated 23.4, while the second half VIX averaged a frightening 41.9. This suggests that if the normal private equity discount for lack of marketability was 30 percent in the first half of 2008, in the second half of 2008, the discount should have been 65 percent higher, or approximately 50 percent.

Another example of the value of liquidity during calm times and during troubled times, is the 2008 private placement transactions of Western Alliance Bancorporation ("WAL"). On June 27, 2008, WAL sold an 11.2-percent block of unregistered common stock in a private placement. The investors were able to negotiate a 45-day registration window, after which the investors could begin to sell their WAL shares, if they so desired. On that date, the VIX was at a slightly uneasy 23.4. The discount from the publicly traded price was a mere 2.1 percent, not unusual for banking institutions during normal times. On September 30, 2008, WAL sold another similarly sized block (11.3 percent) of unregistered shares in a private placement. This time the investors were able to negotiate a 30-day registration time frame, instead of the 45-day window in the former transaction. Importantly, WAL stock had increased 91 percent from the June 27 transaction date, and other financial institutions such as Wells Fargo and Bank of America also experienced dramatic increases in their stock prices over the same time frame. On the other hand, the VIX had shot up to a very unhealthy and fearful 41.9 on September 30. Despite the improved financial condition of WAL and the dramatically shorter registration window, the transaction took place at a 25.6-percent discount from the publicly traded price, aptly reflecting the greater investor concerns about liquidity (surrendered for only 30 days) as reflected in the VIX.

In fact, when examining historical restricted stock transactions as they relate to the average VIX score for the six-months preceding the transaction date, the data shows that discounts were 5.1 percentage points higher when the VIX reflected a score of 26.7 (the highest historic VIX quintile average), then when the VIX read 20.7 (the median VIX score for all of the restricted stock transactions). This suggests that when the VIX averaged 56.6 in the fall of 2008, instead of a normal private equity discount of 30 percent, the discount should have been closer to 60 percent.

Lack of Control

One way to determine a discount for lack of control is to examine the premium above the publicly traded price that an acquirer pays to obtain control of a public company. This is difficult for 2008, since many transactions just dried up and others were faced with the choice of being forced into the arms of a suitor, or going bankrupt. As such, what control premiums there are, are all over the board. Another way to look at the value of control, however, is to look at domestic equity closed-end mutual funds. A domestic equity closed-end mutual fund is a mutual fund whose stock is publicly traded and, like other mutual funds, invests in U.S. publicly traded stocks. However, a shareholder of the mutual fund

may not withdraw and receive his or her pro-rata share of the underlying Net Asset Value ("NAV"). The only recourse the shareholder has is to sell his or her shares at the prevailing market price. Because investors lack control over the investment policies and decisions of the mutual fund, most often, closed-end mutual funds trade at a discount from NAV. In other words, there is a discount for "lack of control." Keep in mind, the closed-end mutual fund lack of control discounts will be smaller than normal lack of control discounts, because the underlying stock investments are minority interests, thus, such minority interest prices already reflect a larger lack of control discount.

For 2008, domestic equity closed-end mutual fund companies' publicly traded stock prices began the year at normal discounts to NAV of 4 to 7 percent. However, by year-end the closed-end discounts more than doubled to 15 percent. The following table displays the average closed-end discount for each of the four quarters of 2008.

In the first half of 2008, the average closed-end fund discount was 5.9 percent. The first quarter discount was higher than the second quarter largely due to the Bear Stearns debacle. By July, closed-end mutual fund discounts actually settled below 4 percent. However, in September, with the bankruptcy of Lehman Brothers the average discount shot up to 15.6 percent and hit 15.6 percent again in November when the Dow bottomed out at 7,552.

What is readily apparent from the data is that when the VIX is above 30 for an extended period of time, a period of prolonged fear in the marketplace, discounts for lack of control increase. In the first half of 2008, when the VIX was below 30, the average closed-end mutual funds traded at a 5.9 percent discount to NAV. However, in the second half of 2008, when the VIX averaged 41.9, the closed-end mutual funds traded at an average discount to NAV of 10.2 percent, a 73 percent increase.

As is readily apparent, when the VIX increases, so does the closed-end mutual fund discount, and vice versa.

Summary and Conclusion

When valuing private equity during troubled times, valuation professionals must keep in mind that it is during these times that investors place a premium on safety and liquidity. Relative to large and public companies, during uncertain times, private companies do not provide a safe haven. By examining the drop in value of a spectrum of large to smaller public companies (but still larger than most private companies), the valuation professional can get a better understanding of how much more the overall value of the private company should drop. The drop in value will be further exacerbated by the diminished merger-and-acquisition activity as financing for such transactions dries up and buyers are reluctant to risk investment dollars in such volatile times.

The drop in value of private equity will further be compounded by the fact that we are generally looking at minority interests. Discounts for lack of control and lack of marketability will increase. During times of economic uncertainty, the value of control is enhanced. Investors want to control their own destiny instead of relying on others during a crisis. Likewise, the value of liquidity commands a premium. This is evidenced by the dramatic drop in interest rates on short-term Treasury obligations in late 2008. People want immediate access to their money during times of uncertainty and trouble. Data from restricted stock transactions suggest that relatively minor changes in the VIX can lead to increased discounts for lack of marketability. For the fall of 2008, given a VIX of over 50 percent, the discount for lack of marketability for the average private company's minority interest likely increased by 65 percent, to 100 percent. That means that, if an appropriate private company discount during normal times was 30 percent, then the appropriate discount to reflect the Great Recession in the fall of 2008, was probably 50 to 60 percent.

Combined, the greater drop in overall values for small companies, the lack of merger-and-acquisition activity, and the greater discounts for lack of control and marketability, minority interests for most private equity likely dropped by over 75 percent between 2007 and the second half of 2008.

If your valuation date was between September 19, 2008 and June 22, 2009, new empirical data suggest you

significantly overvalued your private company equity interest. The data strongly suggests you amend your return and **file for a refund**. In *Keller v. United States*, 2009 U.S. Dist. LEXIS 73789 (S.D. Tex. 2009), the estate filed for a refund 14 months after the initial return and received a \$40 million refund. As the audit rate is now approaching 100%, asking for a refund will not increase your chance of audit. And, at the end of the day, you don't get what you don't ask for.

...

The USC Gould School of Law Tax Institute is the longest running of the Law School's many distinguished continuing legal education programs. The three-day 2010 Institute featured renowned practitioners and presentations recognized as some of the most sophisticated on offer anywhere. The 62nd USC Law School Institute on Major Tax Planning for 2010 will be available online on Lexis.com in August 2010 and is available in print from the LexisNexis bookstore.

Return to Text

n1 By March 9, 2009, the Dow had dropped a further 25 percent for a total decline over less than 15 months of 49.8 percent.

n2 www.gfdataresources.com

n3 Greenberg, Andrew T. "Private equity contraction: a coming reality." January 2010.
<http://www.gfdataresources.com/news/articles.html>

n4 "PitchBook Annual Private Equity Breakdown 2010." www.pitchbook.com

n5 Nathanson, Ari. "Purchase Price Multiples Hit All-time Low." *Buyouts*: November 30, 2009.
<http://www.gfdataresources.com/news/GFDR-Buyouts-Nov-30-09.pdf>

n6 *Supra* at 15

n7 The Chicago Board Options Exchange's Volatility Index (VIX) measures the implied volatility reflected in 30-day option prices on the Standard and Poor's 500 index

n8 Antognelli, Ferreira, McArdle, and Traub "Fear and Greed in Global Asset Allocation." *The Journal of Investing*. (Spring 2000), pp. 27-32.

n9 On October 24, 2008, intraday, the VIX hit 90.

n10 Including common stock and stock plus options

RELATED LINKS: For further discussion, see

■ LexisNexis Tax Advisor -- Federal Topical § 1J:11.06

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Economic Substance Codification and Multinational Cross-Border Transactions

2010 Emerging Issues 5132

How U.S. Multinationals Can Proactively Address the Codification of Economic Substance with Respect to Cross-Border Transactions

By Robert Jennings and Elizabeth Sweigart

June 21, 2010

SUMMARY: The media has ballyhooed the new tax on tanning salons, but U.S. multinationals need to focus on the codification of the Economic Substance Doctrine in the recently enacted Health Care and Education Reconciliation Act of 2010, P.L. 111-152 [H.R. 4872]. The Act has created an immediate issue for U.S. multinational enterprises with contemplated or pending transactions that in-house and external counsel must be prepared to address.

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ARTICLE: Summary

Public attention has been captivated by the more sensational tax aspects of the newly enacted health care legislation, Health Care and Education Reconciliation Act of 2010, P.L. 111-152 [H.R. 4872], but for U.S. multinational enterprises the codification of the Economic Substance Doctrine - previously an amorphous judicial construct - has created an immediate issue. The 2010 Reconciliation Act both defines the Economic Substance Doctrine as law and supplies statutory rules for applying it. Effective as of March 30, 2010, the law has made it imperative for U.S. multinationals with contemplated or pending transactions to act quickly to put in place a practical cross-border risk-management plan.

Judicial History of the Economic Substance Doctrine. In the United States, the Economic Substance Doctrine is rooted in judicial decisions going back nearly eight decades. In *Gregory v. Helvering*, 293 U.S. 465 (1935), the Supreme Court held that a transaction satisfying all of the statutory requirements for a reorganization was not given effect as the transaction was "not imbued with sufficient non-tax business purpose." Because the transaction was contrived for the purpose of avoiding U.S. Federal income tax, the Court concluded that the transaction was in effect a "sham." Other significant decisions followed, including *Lynch v. Comm'r*, 273 F.2d 867, 871 (2d Cir. 1959), and *Knetsch v. United States*, 364 U.S. 361 (1960). Each case served to further define the doctrine and ultimately to create a two-part test for economic substance. Generally a transaction is deemed to have economic substance if (1) there is a meaningful non-tax business purpose, and (2) the transaction results in a consequential and appreciable enhancement in the net economic position of the taxpayer (without regard to any tax-related benefits). Although many cases cite the two-part test, the word "and" has not been applied by every court. In *Rice's Toyota World v. Comm'r*, 752 F.2d 89 (4th Cir. 1985), the court employed the disjunctive "or."

A Formal Definition. Under new 26 USCS 7701(o)(1), when it is determined that the Economic Substance Doctrine is relevant, a transaction has economic substance only if:

- the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and
- the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

As defined by the 2010 Reconciliation Act, the doctrine is conjunctive: The transaction must both affect the taxpayer's economic position in a meaningful way and have substantial non-tax business purpose. Even though the language is largely identical to that presented in the judicial decisions in which the doctrine played a role, applying the doctrine itself remains highly subjective.

Relevant Transactions. The new law provides no guidance with respect to determining the relevance of economic substance to a particular transaction. Instead, it relies on the current subjective common law determination based on the overall consistency between a transaction's tax benefits and business results. The court retains significant latitude in determining whether the doctrine may be relevant and may combine, dissect or otherwise typify a transaction. Best practices dictate that management and counsel consider the doctrine relevant in the case of any transaction that may, in whole or in part, be construed to create a U.S. Federal income tax benefit.

Understanding the Profit Test. New 26 USC 7701(o)(2)(A) introduces the so-called Profit Test, which looks at the ratio of pre-tax profit to tax benefit that would be allowed if the transaction were respected. This test is intended to create an objective measure of economic impact with respect to all or part of a given transaction by comparing the present value of the reasonably expected pre-tax profit from the transaction to the present value of the net tax benefits that would be allowed if the transaction were respected. If the pre-tax profit is "substantial" compared to the net tax benefits, the transaction would be deemed to pass the Profit Test. This language is problematic. The term "substantial" is not defined and there is no precedent or other available indicator as to what ratio would suffice. Further, in applying the Profit Test, transaction fees and costs - including foreign taxes - are treated as expenses in determining pre-tax profits. [The IRS is to issue accompanying regulations that require that foreign taxes be treated as expenses in calculating pre-tax profits where appropriate.]

Documentation Alternatives. As with most planning exercises, the Profit Test relies on estimates and forecasts for a given transaction created prior to actually closing the deal. Best practices dictate that management and counsel assume that the IRS's position is that the taxpayer knew or should have reasonably anticipated the net economic benefit of a given transaction. Contemporaneous documentation and analysis are critical to supporting the application of the Profit Test. Specifically, management and counsel should consider an analysis that includes an independent review of estimates and forecasts. In addition, counsel and management should conduct (or have an independent expert conduct) an analysis of industry trends and macroeconomic factors to support key assumptions and the potential net economic benefit of the deal.

The Need to Be Contemporaneous. To be effective, any analyses and documentation must be developed and completed during the period between the time the transaction is contemplated and when it is executed. Trying to reconstruct the qualitative and quantitative reviews and studies post-transaction is knotty. Given the fatigue among management, counsel and outside advisors in the wake of a transaction, significant time may pass before the contemporaneous documentation of the non-tax business purpose of the transaction is addressed, or the exercise may not be completed at all. When a deal closes, the usual reaction is, "Next!" Many taxpayers have experienced the chaos and frustration attendant to recreating analyses and locating all relevant materials after-the-fact. Post-26 USC 7701(o)(2)(A), gone are the days of thinking, "There's never time to do it right but always time to do it over."

New Penalties. The 2010 Reconciliation Act amends 26 USC 6662(b)(6) to include a 20% accuracy-related penalty of the portion of the underpayment of tax by reason of a transaction lacking economic substance (within the meaning of 26 USC 7701(o)) or failing to meet the requirements of any similar rule of law. Previous rules apply regarding reportable and listed transactions - meaning that under the U.S. Treasury Regulations, information must be

included with a return or statement as the transaction has the potential for tax avoidance or evasion - *and* are compounded by a 40% accuracy-related penalty if the transaction is deemed to be a "nondisclosed economic substance transaction." If a taxpayer does not disclose a reportable transaction on a return, amended return or supplement to a return before the IRS contacts the taxpayer - or any other date specified by the IRS in regulations - and the IRS determines the underpayment is a result of the transaction lacking economic substance, the penalty on the underpayment will be 40%.

Essentially, the new 40% penalty hands the IRS a trump card with respect to any undisclosed transaction it deems does not have economic substance. The nebulous Profit Test does not provide any specific quantitative measure nor do any of the other provisions of the new rules. With this statutory change, taxpayers are disadvantaged.

In addition, a 20% penalty applies to excessive claims for a refund or credit that are based on a lack of economic substance.

The new penalties are effective for transactions entered into after March 30, 2010.

Elimination of the Reasonable Cause Exception. If a transaction is deemed to lack economic substance, no in-house or external analysis would be able to protect against accuracy-related penalties. Regardless of the due diligence, examination or effort made by the taxpayer to analyze and document the economic substance of a transaction, the accuracy-related penalties would not be mitigated.

Given the apparent no-win situation presented by the new rules, taxpayers and their advisors might erroneously conclude that contemporaneous documentation of economic substance does not create value for the taxpayer. Rather, the change to the penalty provisions makes documentation even more critical. Proving economic substance at the outset becomes more important under the new rules. Taxpayers must be prepared to address economic substance in advance in any transaction since there is no way to determine ahead of time whether the IRS or the court of last resort will discern the magic quantum of economic substance from the facts presented.

The Path Forward. Given the immediate implications of the new law - applicable for transactions entered into after March 30, 2010 - management and in-house and outside counsel must move quickly to ensure taxpayers are able to respond to the new regulatory environment.

- **Capture Transaction-Related Communications.** Remember that the most damning evidence against the taxpayer in the case of *Schering-Plough Corp. v. United States*, 651 F. Supp. 2d 219 (D.N.J. 2009), came directly from the taxpayer's own internal emails and memoranda. Best practices dictate that taxpayers put into place policies, systems and procedures to collect and catalog internal correspondence and communications, which are discoverable should a transaction result in litigation. All personnel involved in the planning, execution and reporting of a transaction must be instructed as to the discoverable nature of all of their correspondence, no matter how seemingly insignificant or informal. There are no casual e-conversations.

- **Analyze and Document Contemporaneously.** While taxpayers cannot prevent the IRS from using economic substance to challenge a transaction, they can take steps to close off the government's arguments through systematic and comprehensive analysis and documentation. As was noted by Judge Maurice B. Foley in *Veritas Software Corp. v. Comm'r*, 133 T.C. No. 14 (2009), "taxpayers are merely required to be compliant, not prescient." There is no way for a taxpayer to know how a given transaction will play out before the transaction closes. Thus, contemporaneous documentation of the analyses, both quantitative and qualitative, used in evaluating and effecting a transaction is a powerful tool for the taxpayer to counter a lack of economic substance argument by the IRS.

- **Report Proactively.** For those transactions that may not be specifically listed or recognized as explicitly reportable, counsel should work closely with the taxpayer to determine if disclosing the transaction is appropriate as a proactive measure. The 40% accuracy-related penalty applies to undisclosed transactions only. Further, counsel should work closely with the taxpayer and the taxpayer's external auditor to ensure that appropriate reporting of uncertain tax positions under Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (known as "FIN 48") reflects the rule changes with respect to a transaction whose economic substance may be

relevant. [The accounting profession experienced a major change on July 1, 2009, when FASB promulgated the FASB Accounting Standards Codification ("the FASB ASC"). The FASB ASC replaced all previously existing financial accounting standards (other than U.S. Securities and Exchange Commission pronouncements) to become the single source of authoritative nongovernmental U.S. generally accepted accounting principles ("GAAP"). Going forward FASB will issue updates to the FASB ASC rather than individual announcements (e.g., FAS 109). Future references to FIN 48 will be to FASB ASC 740-10.]

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RELATED LINKS: For further discussion, see

- 2-18 Rhoades & Langer, U.S. Int'l Tax'n & Tax Treaties § 18.03

For the Health Care and Education Reconciliation Act of 2010, see

- 111 P.L. 152

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IRS Ignoring Inconsistent Application of Farmland Fertility Deduction

2010 Emerging Issues 5108

IRS Ignoring Inconsistent Application of Farmland Fertility Deduction

By Dr. Neil Harl

June 11, 2010

SUMMARY: Farmers have raised the question of whether a deduction for premium fertility could be claimed on the purchase of farmland that had been heavily fertilized. Because there has been no IRS response since 1991, the IRS has allowed a regional advantage to develop, by ignoring the growing confusion around this deduction. A situation of unfairness has developed that is begging for IRS clarification to level the playing field.

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ARTICLE: For several years, some farmers have raised the question of whether a deduction for premium fertility could be claimed on the purchase of farmland that had been heavily fertilized. A Minnesota farmer claimed such a deduction but was turned down. A private letter ruling, *PLR 9211007*, December 3, 1991, was requested and the holding was not favorable. Nonetheless, the practice of claiming the deduction has been relatively widespread in about 20 counties in Southern Minnesota and Northern Iowa. However, the matter has been ignored by IRS on audit. Apparently, IRS does not want to litigate. As a consequence a situation has developed of unfairness that many practitioners find difficult to understand. The Service appears to be concerned that they might lose the case and then everyone would have that advantage.

Before enactment of a provision in 1960 allowing a current deduction for fertilizer, lime and other soil amendments, such expenditures were considered capital in nature if the effect lasted for more than one year, as was often the case. [See, e.g., *Sanford v. Comm'r*, 2 B.T.A. 181 (1925); *Swaney v. Comm'r*, 5 B.T.A. 990 (1927), acq., II-2 C.B. 7.] Certainly with fall-applied fertilizer (and about any application of lime), the material contributed to soil productivity over a period of years. The emphasis of IRS in the pre-1960 era was on amortization of soil amendments over some reasonable time period.

Even after 1960, the Internal Revenue Service persisted in its belief that the cost of fertilizer should be amortized. In a General Counsel's Memorandum issued in 1989, IRS took the position that the cost of fertilizer applied to an existing stand of timber could not be deducted immediately and had to be amortized. [GCM 39,791, June 9, 1989.] However, that GCM was withdrawn less than two years later "pending further consideration of the issue." [GCM 39,844, April 16, 1991. See *Rev. Rul. 2004-62, 2004-1 C.B. 1072* (fertilization of timber deductible business expense and did not have to be capitalized; post-establishment fertilization promotes healthy development and maximizes timber volume and is performed for the management, maintenance and protection of timber stand and is an ordinary and

necessary business expense).]

Scope of fertilizer deduction provision (I.R.C. § 180; 26 USCS § 180)

As noted, taxpayers have been able to deduct currently, by election, expenditures for fertilizer, lime and other soil amendments or soil conditioners despite the carryover in the soil of benefits to later years, rather than capitalizing the expenditures over the period soil fertility is affected. [I.R.C. § 180, 26 USCS 180.] Note, however, that the deduction is *by election*, a feature often overlooked. While the election is easily made, by simply deducting the amount on the appropriate schedule on the income tax return, see Treas. Reg. § 1.180-2, the statute specifies two conditions beyond the election that must be met.

Land used in farming. The cost of soil amendments, including commercial fertilizer, that are paid or incurred during the taxable year for ". . . purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize or condition land used in farming" may be deducted [I.R.C. § 180(a), 26 USCS 180(a).] The provision states that the term "land used in farming" means ". . . land used (before or simultaneously) with the expenditures described . . . by the taxpayer or his tenant for the production of crops, fruits, or other agricultural products or for the sustenance of livestock." [I.R.C. § 180(b), 26 USCS 180(b).] Note that deductions cannot be claimed for soil amendments on tracts of land not previously used in farming. The regulations under I.R.C. § 180 [Treas. Reg. § 1.180-1(a).] also direct taxpayers to the regulations under the soil and water conservation section [I.R.C. § 175, 26 USCS 175] for further guidance as to the meaning of "land used in farming." That regulation states -

"If the expenditures are made by the taxpayer in respect of land newly acquired from one who immediately prior to the acquisition was using it in farming, the taxpayer will be considered to be using the land in farming at the time that such expenditures are made, if the use which is made by the taxpayer of the land from the time of its acquisition by him is substantially a continuation of its use in farming, whether for the same farming use as that of the taxpayer's predecessor or for one of the other uses specified in paragraph (a)(1) of this section." [Treas. Reg. § 1.175-4.]

It is important to note, also, that deductions cannot be claimed for the purchase of fertilizer (and other such expenditures) acquired through vendor financing until the amounts are actually paid or funds are borrowed from a lender other than the vendor. [Treas. Reg. § 1.461-1(a)(1). See 1 Harl, Farm Income Tax Manual § 3.08[2][a] (2010 ed.), Matthew Bender/LexisNexis; 4 Harl, Agricultural Law § 28.04[1][a] (2009), Matthew Bender/LexisNexis.]

Taxpayer engaged in the business of farming. The statute makes it clear that a deduction can be claimed for soil amendments only if the taxpayer is ". . . engaged in the business of farming. . . ." [I.R.C. § 180(a), 26 USCS . 180(a)] See *PLR 8440003*, May 22, 1984 (activity of growing and selling sod considered to be "farming" for purposes of I.R.C. § 180(a), 26 USCS 180(a)). As with the definition of "land used in farming," the soil and water conservation regulations also apply in defining a taxpayer "engaged in the business of farming." Treas. Reg. §§ 180-1(b), 1.175-3.] To be engaged in the business of farming, a taxpayer must be engaged in a farming operation, be leasing under a crop share or livestock share lease or be materially participating in the operation or management of the farm in the case of a cash rent lease. [Treas. Reg. § 1.175-3.] In general, land rented under a cash rent lease is not considered to be used in the business of farming unless the taxpayer "participates to a material extent in the operation or management of the farm." [See Treas. Reg. § 1.175-3.] Ordinarily a cash rent landlord would not pay for fertilizer but on occasion might pay for lime application. [See 4 Harl, Agricultural Law § 28.04[1][a] (2009), Matthew Bender/LexisNexis; 1 Harl, Farm Income Tax Manual § 3.08[2][b] (2010 ed.), Matthew Bender/LexisNexis.]

Deducting "premium fertility" on purchase of farmland

In a 1991 private letter ruling, [*PLR. 9211007*, December 3, 1991.] a farmer from West Central Minnesota purchased a farm but arranged for the farmer's corporation (which was owned 64 percent by the farmer) to purchase the "residual fertilizer supply" in the acquired land. The farmer argued that that the prior owner of the farmland had applied fertilizer to the point that the farm had premium fertility, referred to as the "residual fertilizer supply." The corporation

(as the taxpayer in the ruling) claimed an amortization deduction over a seven-year period for the residual fertilizer supply. IRS denied the amortization deduction.

A major issue is whether the fertilizer deduction provision pre-empts amortization. It is clear from the 1991 letter ruling itself that the amortization of fertilizer costs is not pre-empted by I.R.C. § 180, 26 USCS § 180. As the ruling states --

"If a taxpayer does not make a section 180 election for farm fertilizer expenditures, they are not deductible under section 180 but they are chargeable to a capital account. This account is amortizable over the period of the fertilizer's effectiveness."

However, the same letter ruling makes it clear that three conditions must be met to amortize the premium fertility in the soil-

- The taxpayer must be the beneficial owner of the fertilizer in the soil (in the facts of the letter ruling, the landowners were the beneficial owners of any fertilizer on the land and the corporation could not amortize the costs related to the fertilizer),
- The taxpayer must establish the presence and extent of the fertilizer in question (in the ruling, the corporation "... did not measure nor was data provided to indicate, the level of soil fertility attributable to fertilizer applied to the land by the previous owner" so the corporation as the taxpayer failed to establish the extent of the "residual fertilizer" if any), and
- The taxpayer *must be exhausting the fertilizer in the soil* (in the facts of the ruling, the soil test results showed that the level of fertility in the majority of the parcels was not declining as required for deductibility). [Ltr. Rul. 9211007, December 3, 1991.] As to the latter point, as the ruling pointed out, "... the taxpayer has provided no evidence indicating the period over which the fertility attributable to the residual fertilizer supply will be exhausted, and if in fact what was claimed as the residual fertilizer was declining." [Id.

Although the 1991 private letter ruling is "substantial authority" against deductibility of the residual fertilizer supply unless the three conditions are met, no further authority has emerged in the nearly 20 years since the ruling was published even though the practice of claiming a deduction has grown in some areas of the country.

Example: Farmer purchases 320 acres of farmland (assume no improvements) for \$6,000 per acre, i.e., a total cost of \$1,920,000. (Land is not depreciable). The farmer allocates \$400 per acre to "premium fertility" and deducts that amount (\$128,000) from ordinary income, leaving an income tax basis on the land of \$1,792,000. The value of the deduction of \$128,000 varies with the taxpayer's tax bracket but assuming the 35 percent tax bracket (plus state income tax assumed of five percent) the \$128,000 deduction would result in a sizeable benefit of \$51,200.

Conclusion

In the interests of fairness and equity, further guidance is needed as to the guidelines for deductibility, if any deductibility is to be allowed, particularly the evidence needed in the form of soil tests on the acquired land as well as on "benchmark" land in the area involved. It is widely known that soil fertility levels may vary significantly in the same area, because of the history of application of commercial fertilizer, the application of manure from livestock, and differences in fertility levels associated with different soil types in the natural or original state. Moreover, differences in soil fertility may exist because of the presence in times long past of the location of building sites where the presence of livestock on a concentrated basis. Human activity may also have produced a difference in fertility over time, usually in the direction of raising the fertility level. Presumably, those differences are reflected in the value of the land tracts. The question is whether and to what extent an amortization deduction should be permitted. Certainly, guidelines should be published establishing rules governing soil sampling on a "grid" basis to avoid oversampling on the higher soil fertility areas of the acquired land and undersampling of such areas on the benchmark tract or tracts.

RELATED LINKS: For further information, see

- LexisNexis Tax Advisor -- Federal Topical § 1E:10.05

For further information, see

- 1-3 Farm Income Tax Manual § 3.08

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Dr. Harl has published widely including 28 books; more than 400 professional articles and bulletins; and more than 850 articles in farm and financial publications. He is author of the 15-volume treatise, *Agricultural Law* and the single volume *Agricultural Law Manual* and *Farm Income Tax Manual*; senior author of two Tax Management Portfolios--*The Family-Owned Business Deduction* and *Reporting Farm Income* and co-author of *Taxation of Cooperatives* and co-author of *Principles of Agricultural Law*.

He has received more than 30 major awards including the USDA Superior Service Award in 1987; the President's Award from the Iowa State Bar Association in 1991; Charles A. Black Award from the Council for Agricultural Science and Technology in 1997, for effectiveness in communicating with the public; the Distinguished Service to Agriculture award from the Chicago Farmers Club in 1999, the *Wallaces Farmer* Iowa Master Farmer Award for Exceptional Service to Agriculture in 2000; the Speaker of the Year Award by the National Society of Accountants in 2000; the Presidential Service Award from Iowa State University in 2002; and the Service to American and World Agriculture Award from the National Association of County Agricultural Agents in 2006.

Dr. Harl has served on six federal advisory bodies -- a Farm Tax Reform Task Force for the U.S. Department of the Treasury in 1967; the Commissioner's Advisory Group (Commissioner of Internal Revenue) in 1979-80; the USDA Farm Structure Task Force in 1980; the Office of Technology Assessment, Technical Advisory Committee, by Congressional Appointment, 1987-1995 (chair in 1993-94); the USDA Advisory Committee on Agricultural Biotechnology, 2000-2002; and the Commission on Federal Payment Limitations in Agriculture, 2002-2003.

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Continue Business to Protect Gains Triggered in Chapter 12 Bankruptcy from Tax

2010 Emerging Issues 5103

Continue Business to Protect Gains Triggered in Chapter 12 Bankruptcy from Tax

By Dr. Neil Harl

June 9, 2010

SUMMARY: Absent definitive decisions in the applicable Circuit, bankruptcy chapter 12 debtors should consider pursuing a strategy of partial liquidation, paying available proceeds to secured lenders, and then utilizing the bankruptcy to deal with the taxes that typically accompany liquidation. But they should continue to conduct their business to avoid jeopardizing their qualification for favorable tax treatment.

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ARTICLE: The income tax treatment of gains triggered in Chapter 12 bankruptcy has been a serious problem (and shortcoming) since enactment of the provision in 1986. *The Bankruptcy Tax Act of 1980* did not extend the same treatment to Chapter 12 filers that had been available to filers under Chapter 7 and Chapter 11. The BAPCPA of 2005 included a provision to address the problem but several ambiguities resulted from the way the provision was redrafted. Accordingly, litigation has occurred. After Bankruptcy Court decisions in five states and several District Court decisions, the Eighth Circuit Court came down on all issues in favor of the debtors in September of 2009. The Ninth and Tenth Circuits have cases pending.

Background

Chapter 12 bankruptcy was enacted as a temporary measure in 1986, at the height of the 1980s farm debt crisis. It developed into a vitally important inducement to creditors to engage in debt restructuring with heavily indebted farmers and ranchers. The provision was extended ten times and was made permanent in the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*. [Pub. L. No. 109-8, § 1003, *119 Stat. 23 (2005)*.] That same Act also provided the framework for obtaining relief from income tax liabilities resulting from asset liquidation to achieve plan feasibility, which had been a serious shortcoming of the original enactment in 1986. [See *11 U.S.C. Sec. 1222(a)(2)(A)*.]

The Bankruptcy Tax Act of 1980

The uncertainties and ambiguities of income tax treatment of income tax liabilities in bankruptcy were first addressed in the *Bankruptcy Tax Act of 1980*. [Pub. L. No. 96-589, § 3(a)(1), *96 Stat. 589 (1980)*, enacting I.R.C. Section 1398, *26 USCS 1398*.] That legislation provided for a new tax entity for individual Chapter 7 and 11 filers, [IRC Section 1398(a), (e) *26 USCS 1398(a), (e)*.] which meant that the new tax entity had responsibility for gross

income of the debtor after bankruptcy filing (and perhaps before filing to the extent of the debtor's "first short year"). [I.R.C. Section 1398(e)(1) 26 USCS 1398(e)(1).]

The debtor was relieved of liability for gross income from the debtor's former property as of the date of bankruptcy filing until termination of the bankruptcy process [IRC Section 1398(e)(2) 26 USCS 1398(e)(2)]. Moreover, the 1980 Act specified that an election could be made by debtors with assets [IRC Section 1398(d)(2)(C) 26 USCS 1398(d)(2)(C)] to close the debtor's tax year as of the day before the date of bankruptcy filing [IRC Section 1398(d)(2)(A) 26 USCS 1398(d)(2)(A)] which triggered a provision that caused the debtor's tax attributes (including the income tax basis, holding period and character of assets) to pass into the bankruptcy estate as of the beginning of the debtor's taxable year in which the bankruptcy case commenced. [IRC Section 1398(g) 26 USCS 1398(g).] If the election to close the debtor's tax year was *not* made, the debtor's tax attributes passed into the new tax entity as of the date of bankruptcy filing. [IRC Section 1398(g) 26 USCS 1398(g).]

Thus, a debtor with two short years could avoid tax liability on assets sold or exchanged during the first short year, leading up to the bankruptcy filing, and could avoid tax on income triggered during the bankruptcy process because the new entity bared the tax liability during those periods.

The family farmer facing bankruptcy was not provided the same options, however. When Chapter 12 Bankruptcy was enacted in 1986, the decision was made *not* to grant Chapter 12 filers a new tax entity in the same manner as Chapter 7 and 11 individual filers. [See Ltr. Rul. 8928012, April 7, 1989 (conveyance by Chapter 12 bankruptcy debtor triggered gain as to difference between the fair market value of the property and the income tax basis; no separate tax entity provided)]. Therefore, income tax liability incurred in a Chapter 12 Bankruptcy has been the responsibility of the debtor. [*In re Lindsey*, 92-2 U.S.T.C. para 50,400 (Bankr. W.D. Okla. 1992) (trustee acted in capacity of standing trustee, not as trustee of separate liquidating trust).] Without an amendment to the *Bankruptcy Tax Act of 1980*, the existing provision governing separate entity status barred all separate entities except for those involving individuals filing under Chapters 7 and 11. [IRC Section 1399 26 USCS 1399]

All of this seemingly overrode earlier law recognizing separate entity status before the 1980 amendment. [*Bergman v. Comm'r*, T.C. Memo. 1985-256 (individual's bankruptcy estate was separate taxable entity); *Rev. Rul. 78-134*, 1978-1 C.B. 197 (separate entity for individual bankrupt); *Rev. Rul. 72-387*, 1972-2 C.B. 632 (same).] Before enactment of the *Bankruptcy Tax Act of 1980*, the estate of a bankrupt partnership was considered to be a separate tax entity. [*Rev. Rul. 68-48*, 1968-1 C.B. 301.] That outcome was barred by the 1980 legislation. [IRC Section 1399 26 USCS 1399.]

Experience with Chapter 12 bankruptcy soon confirmed that farm and ranch debtors often did not have sufficient funds to pay their taxes, even in deferred payments. [See, e.g., *In re Specht*, No. 96-21022 (Bankr. N.D. Iowa 1997).] Taxes were a priority claim that had to be paid in full, although taxes could be paid on a deferred payment basis extending up to six years from the date the tax was incurred. [11 U.S.C. § 507(a).]

BAPCPA of 2005

The *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* [Pub. L. No. 109-8, § 1003, 119 Stat. 23 (2005), (BAPCPA)] included a provision allowing a Chapter 12 debtor to treat claims arising out of "claims owed to a governmental unit" such as tax on the gain or recapture income, as a result of "sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation" to be treated as an unsecured claim that is not entitled to priority under Section 507(a) of the Bankruptcy Code, provided the debtor receives a discharge. [11 U.S.C. § 1222(a)(2), added by the BAPCPA.] By treating government claims (including taxes) as unsecured claims, the amounts would be in line for discharge.

The 2005 Act produced several ambiguities or unclear meanings:

1. Did the passage "used in the debtor's farming operation" limit the scope of the provision to capital assets or

Section 1231 trade or business assets, or did the language embrace ordinary income-producing property such as sales of grain or slaughter livestock?

2. In allocating tax claims between those attributable to the sale or taxable exchange of farm assets eligible for the special tax treatment and those taxes entitled to priority status, which are not eligible for possible discharge and must be paid in full in order to get the Chapter 12 plan confirmed, is the calculation to be on a marginal basis or a *pro rata* basis?

3. Does the newly enacted procedure apply to pre-petition transfers, post-petition transfers and transfers occurring post-confirmation but before the entry of Chapter 12 discharge in terms of eligibility for the BAPCPA provision? Note that the statute did not specify when the property could be disposed of to be eligible for unsecured claim status.

4. Is it appropriate to use a Chapter 12 liquidation analysis, which adds the portion of tax treatment as an unsecured claim to the traditional unsecured claims in determining whether the best-interest-of-creditors test is met rather than the Chapter 7 liquidation analysis which requires that the tax claims be treated as a priority claim to be paid in full?

5. Will the governmental claims treated as secured claims be discharged when the Chapter 12 discharge is entered?

6. If the debtor has a loss carryforward going into the Chapter 12 bankruptcy and sells farm assets, will the loss carryforward be utilized when the farm assets are sold, or will the loss carryforward be available to offset other income of the farm debtor when the tax claims are treated as unsecured claims?

7. If the farm debtor is a pass-through entity, such as a limited liability company (LLC), and the individuals owing the pass-through entity have guaranteed the entity's debt, can the individual debtors qualify to be Chapter 12 debtors if all of the farming is carried out through the entity?

8. If the individuals owning a pass-through farm entity qualify to file Chapter 12 bankruptcy, will they qualify to receive the favorable benefits of the priority stripping provisions of Chapter 12?

As might be expected, the IRS's reading of the BAPCPA was diametrically in opposition to the debtors' interpretations of the language as to several of the key issues above.

Bankruptcy Court Interpretations

The first Bankruptcy Court interpretation of the BAPCPA tax provisions came in *In re Knudsen*, [356 B.R. 480 (Bankr. N.D. Iowa 2006).] involving a hog and grain farmer from Northern Iowa who had encountered low prices for his hogs, disease problems in his swine herd and a personal injury. The Bankruptcy Court trial was held in July of 2006, but the decision was not released until November 20, 2006. The court held that the language, "farm asset used in the debtor's operation" limited the scope of the provision to assets used in the trade or business which are eligible for capital gain treatment as to gains (but ordinary losses for net losses) [IRC Section 1231 26 USCS 1231] and, presumably, for capital assets. [IRC Section 1221 26 USCS 1221.] In the court's view, the statute was not sufficiently broad to include assets held for sale such as slaughter hogs or grain.

The Bankruptcy Court also held that the calculation of tax claims allocated between those attributable to the sale of farm assets eligible for the special tax treatment allowing possible discharge, and those entitled to priority status and not eligible for discharge and which must be paid in full in order to get the Chapter 12 plan confirmed, must be carried out using the *pro rata* method, not the marginal approach. The court agreed with the debtors that the character of taxes eligible for the special tax treatment was changed from "priority" status to "unsecured" status such that, upon discharge, the unpaid portion of the taxes would be discharged along with interest and penalties.

The relief provision in the 2005 enactment was held to apply to post-petition taxes and allowed the taxes to be treated as an administrative expense. Thus, the post-petition taxes on the sale of farm assets eligible for the special

treatment should be treated as an unsecured claim, not as a priority claim and would thus be dischargeable without payment in full if the amounts are provided for in the bankruptcy plan *and the debtor receives a Chapter 12 discharge*.

Finally, the Iowa Bankruptcy Court held that it is appropriate to use a Chapter 12 liquidation analysis, which adds the portion of tax treated as an unsecured claim to the traditional unsecured claims in determining whether the best-interest-of-creditors test is met rather than the Chapter 7 liquidation analysis which requires that the tax claims be treated as a priority claim to be paid in full. Thus, from the debtor's perspective, the Bankruptcy Court decision represented no more than "half a loaf."

Some additional decisions:

A 2007 Bankruptcy Court decision in Arizona, *In re Hall*, [376 B.R. 741 (Bankr. D. Ariz. 2007).] held that post-petition sales of assets used in the debtor's farming operation did not qualify for the special treatment allowing eligible tax claims to be treated as unsecured claims rather than as priority claims.

The Nebraska Bankruptcy Court, in *In re Schilke*, [379 B.R. 899 (Bankr. D. Neb. 2007).] followed *In re Knudsen*, [above], in dealing with the assertion that there was no bankruptcy estate, held that the bankruptcy estate had sufficient existence to support treatment of gains from the post-petition sale of estate property (a farm) as a claim against the estate and not solely against the debtor outside of bankruptcy.

In a 2009 case, *In the Matter of Rickert*, [2009 Bankr. LEXIS 17 (Bankr. D. Neb. 2009)] the Chapter 12 debtor sold breeding livestock and farm equipment pre-petition and incurred federal income tax which was a post-petition tax liability. The court, following *In re Schilke*, held that the taxes were eligible for treatment as unsecured, non-priority claims. [11 U.S.C. § 122(a)(2)(A).] In another 2009 Nebraska case, *In re Uhrenholdt*, [2009 Bankr. LEXIS 144 (Bankr. D. Neb. 2009).] the court held that the proceeds of a corn sale to the debtor's corporation for continued use in the farming operation (cattle feeding) was eligible for treatment as an unsecured tax debt. [11 U.S.C. § 1222(a)(2)(A).]

A 2008 decision by the Bankruptcy Court in Kansas [*In re Dawes*, 382 B.R. 509 (Bankr. D. Kan. 2008)] also followed *In re Knudsen*, holding that the phrase "incurred by the estate" was ambiguous but, looking at the legislative history, determined that the phrase had reference to when tax liability was incurred, not the entity having liability for the tax. In interpreting the phrase "incurred by the estate" the *Dawes* court engaged in an exhaustive analysis of the legislative history of 11 U.S.C. Sec. 503(b)(1)(B)(i).

In a 2009 decision by the Colorado Bankruptcy Court, *In re Ficken*, [2009 Bankr. LEXIS 144 (Bankr. D. Colo. 2009)] the post-petition sales of calves, breeding cows and bulls were held to produce an unsecured tax debt eligible for discharge rather than a priority tax debt which would not be eligible for discharge. [11 U.S.C. § 1222(a)(2)(A).] The court approved the marginal tax allocation procedure.

District Court Decisions

In a well-reasoned and persuasive opinion, the U.S. District Court for the Northern District of Iowa, in the appeal from the Bankruptcy Court in *In re Knudsen*, 356 B.R. 480 (Bankr. N.D. Iowa 2006)] , ordered the Bankruptcy Court to confirm the plan. [*In re Knudsen*, 389 B.R. 643 (N.D. Iowa 2008)]. The judge held that the sale of slaughter hogs qualified as assets used in the debtor's farming operation, finding that the "debtor's farming operation" was the debtor's farming operation under the reorganization plan and specifically rejected the narrow interpretation that "used in the debtor's farming operation" limited the scope of the provision to those assets covered by assets used in the trade or business [IRC Section 1231] and capital assets. [IRC Section 1221 26 USCS 1211]. The court upheld the Bankruptcy Court's conclusion that the 2005 enactment [11 U.S.C. § 1222(a)(2)(A)] applied to post-petition transfers utilizing the rationale of *In re Dawes* [382 B.R. 509 (Bankr. D. Kan. 2008).] and, even though a separate estate is not created, the taxes could be treated as administrative expenses, [See 11 U.S.C. § 501(b)(1)(B).] which meant the taxes could be handled as an unsecured claim eligible for discharge. The District Court also adopted the marginal methodology as opposed to pro rating the taxes as had been done by the Bankruptcy Court.

In August 2008, the United States District Court for the District of Arizona reversed the Bankruptcy Court in *In re Hall* [393 B.R. 857 (D. Ariz. 2008)]. That case is on appeal to the Ninth Circuit Court of Appeal on the post-petition applicability issue.

On September 9, 2008, the *Schilke* case was affirmed by the United States District Court for the District of Nebraska. [*In re Schilke*, 2008 U.S. Dist. LEXIS 68176 (D. Neb. 2008)].

Court of Appeals

In the first of two Court of Appeals decisions, on September 16, 2009, the Eighth Circuit Court of Appeal affirmed the district court decisions in *In re Knudsen* (the Iowa case) and *In re Schilke* (the first of three Nebraska cases to be decided). [*Knudsen v. Internal Revenue Service*, 581 F.3d 696 (8th Cir. 2009).] The decision favored the debtors on four important issues :

1. Congress waived sovereign immunity in the enactment of 11 U.S.C. Sec. 1222(a)(2)(A);
2. a Chapter 12 debtor may treat post-petition taxes imposed on the debtor's income earned during the Chapter 12 proceeding as an administrative expense;
3. pre-petition and post-petition sales of slaughter hogs (and other ordinary income property) are eligible for discharge under the special treatment provided by the 2005 Act; [11 U.S.C. § 1222(a)(2)(A)] and
4. the "marginal" method of allocation is the correct way to allocate the taxes between the priority and non-priority claims under Chapter 12.

On the latter point, as to the "marginal" or "pro rata" approaches, the Eighth Circuit found the language in the statute to be ambiguous and invoked a long-standing rule of construction that ambiguous provisions should be construed in favor of the debtor.] That meant the marginal approach could be used by the taxpayer as opposed to the pro rata approach favored by the IRS. In *Knudsen*, the difference in approaches to the calculation methodologies exceeded \$40,000.

On May 7, 2010, the Bankruptcy Appellate Panel for the Tenth Circuit Court of Appeal affirmed the District Court of Colorado in the *Ficken* case. [*In re Ficken*, 2010 Bankr. LEXIS 1325.

What Lies Ahead

The Eighth Circuit decision in *Knudsen* settles the issues in that Circuit. The Tenth Circuit decision in *Ficken* likely settles the issues in that Circuit, unless appealed to the full Circuit inasmuch as it is a Bankruptcy Appellate Panel decision.

The case on appeal to the Ninth Circuit (*Hall*) will address the post-petition applicability issue.

Strategies for Debtors

Until final decisions holding otherwise are reached in the circuit of the debtor's residence, where the farm or ranch operation is overburdened with debt and is not cash-flowing, the debtor could pursue a strategy of partially liquidating, paying available proceeds to the secured lender, and then utilizing Chapter 12 to deal with the taxes that typically accompany liquidation.

However, it seems prudent to continue to conduct a farming or ranching operation when Chapter 12 is filed. Failure to do so could jeopardize qualification for the favorable tax treatment afforded by the 2005 Act [11 U.S.C. § 1222(a)(2)(A)] and could possibly subject the farmer or rancher to liability for all of the taxes.

RELATED LINKS: For further information, see

- 15-TX1 Collier on Bankruptcy Taxation P TX1.08

For further information, see

- LexisNexis Tax Advisor -- Federal Topical § 1L:1.03

For further information, see

- 13-120 Agricultural Law § 120.08

For further information, see

- 5-39 Agricultural Law § 39.04

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He has received more than 30 major awards including the USDA Superior Service Award in 1987; the President's Award from the Iowa State Bar Association in 1991; Charles A. Black Award from the Council for Agricultural Science and Technology in 1997, for effectiveness in communicating with the public; the Distinguished Service to Agriculture award from the Chicago Farmers Club in 1999, the *Wallaces Farmer* Iowa Master Farmer Award for Exceptional Service to Agriculture in 2000; the Speaker of the Year Award by the National Society of Accountants in 2000; the Presidential Service Award from Iowa State University in 2002; and the Service to American and World Agriculture Award from the National Association of County Agricultural Agents in 2006.

Dr. Harl has served on six federal advisory bodies -- a Farm Tax Reform Task Force for the U.S. Department of the Treasury in 1967; the Commissioner's Advisory Group (Commissioner of Internal Revenue) in 1979-80; the USDA Farm Structure Task Force in 1980; the Office of Technology Assessment, Technical Advisory Committee, by Congressional Appointment, 1987-1995 (chair in 1993-94); the USDA Advisory Committee on Agricultural Biotechnology, 2000-2002; and the Commission on Federal Payment Limitations in Agriculture, 2002-2003.

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Application of the Passive Activity Loss Rules to LLC Members

2010 Emerging Issues 5096

Application of the Passive Activity Loss Rules to LLC Members

By Neil Harl

June 4, 2010

SUMMARY: The IRS has acknowledged that additional guidance is called for in the treatment of LLCs and LLPs for passive activity loss purposes. In light of the widespread popularity of such entities, particularly LLCs, such guidance could not come too soon. This guidance will be particularly pertinent to those who have experienced wide swings in farm and ranch income in recent years.

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ARTICLE: In *Rev. Rul. 88-76, 1988-2 C.B. 360*, the IRS announced that limited liability companies (LLCs) and limited liability partnerships (LLPs) would be treated as partnerships for tax purposes by focusing on the basic characteristics from Treas. Reg. § 301.7701-2(a)(1) which specify that an entity is characterized as a corporation if it has: (1) associates; (2) an objective to carry on business and divide the gains; (3) continuity of life; (4) centralization of management; (5) liability for corporate debts limited to corporate property; and (6) free transferability of interests. The Wyoming LLC that was the subject of the ruling was considered to have associates and an objective to carry on business and divide the gains, but lacked the other corporate characteristics. Accordingly, the entity, which was organized as a limited liability company under Wyoming law, was classified as a partnership for federal tax purposes.

Because of the limited liability feature, the IRS maintained that LLCs should be treated the same as limited partnerships. In 1996, the IRS adopted a proposal to simplify entity classification regulations to allow taxpayers to treat domestic unincorporated business organizations as partnerships or as associations on an elective basis. [*61 Fed. Reg. 66,584, December 18, 1996. See Notice 95-14, 1995-1 C.B. 297.*] However, reliance on the earlier classification regulations continued because the temporary regulations issued for passive activity loss purposes, also issued in 1988 [Temp. Treas. Reg. § 1.469-5T(e)], did not refer to (apply to??) limited liability companies or limited liability partnerships but instead referred (applied to???) to limited partners in a limited partnership. [Id.] In general, a partnership interest is treated as a limited partnership interest *if so designated in the organizational documents or the liability of the holder is limited to a fixed, determinable amount under state law such as the amount contributed to the entity.* [Temp. Treas. Reg. § 1.469-5T(e)(3).] That meant that an LLC or LLP would be treated as a limited partnership for passive activity loss purposes.

The courts' view of the IRS position

In an unusual array of cases which have sharply criticized the IRS position on the handling of passive activity losses for LLCs and LLPs, the courts have been in general agreement that the IRS position as stated in the temporary regulations [Temp. Treas. Reg. § 1.469-5T(e).] is not defensible. The first case to reach that conclusion, *Gregg v. United States*, [186 F. Supp. 2d 1123 (D. Or. 2000)] in 2000 agreed that the regulations dealing with the limited partnership test looked only to the feature of limited liability under state law which was inappropriate when applied to an LLC and its members. [See Temp. Treas. Reg. § 1.469-5T(e)(3)(i)(B).] The court noted that LLC members are permitted to engage in active management of the business without losing their limited liability which can occur with a limited partnership. [See Uniform Limited Partnership Act, § 7 (if control is exercised over management decisions, a limited partner may become liable as a general partner).] Thus, the court held that, in the absence of a regulation stating that LLC members were to be treated as limited partners in a limited partnership, it was *inappropriate* for IRS to treat LLC members as limited partners. Accordingly, an LLC member could show material participation under any of the seven tests under the regulations rather than the higher standard set forth for limited partners. [See Harl, "Are Members of LLCs 'Limited Partners'?" 19 Agric. L. Dig. 109 (2008).]

The 2009 case of *Garnett v. Commissioner* [132 T.C. No. 19 (2009), 2009 U.S. Tax Ct. LEXIS] involved taxpayers who owned seven limited liability partnerships and two limited liability companies in Iowa, all engaged in farming and agribusiness operations. The LLP agreements provided that each partner would actively participate in the control, management and direction of the LLP's business. [Id.] The LLC operating agreements provided that business was to be conducted by a manager. [Id.] The Tax Court cited to *Gregg v. United States* [186 F. Supp. 2d 1123 (D. Or. 2000).] and focused on the application of the "general partner" exception and believed that the LLP and LLC members had the right to participate in management, as do general partners, which justified that exception inasmuch as state law did not preclude the members from actively participating in the management and operations of the LLPs and LLCs. Accordingly, the members were entitled to apply *all seven of the tests for material participation and were not limited to the three prescribed for limited partners*. [Temp. Treas. Reg. § 1.469-5T(e)(2).]

The late July 2009 decision of the United States Court of Federal Claims, *Thompson v. United States*, [2009-2 U.S.T.C. para. 50,500 (Fed. Cl. 2009), acq. in result only, AOD 2010 FED para. 46,300.] cited approvingly to both *Garnett* and *Gregg v. United States* [186 F. Supp. 2d 1123 (D. Or. 2000).] but went beyond those decisions in stating that the temporary regulation [Temp. Treas. Reg. § 1.469-5T(e)(3).] was ". . . simply inapplicable to membership interests in an LLC." [Thompson v. United States, 2009-2 U.S.T.C. para. 50,500 (Fed. Cl. 2009), acq. in result only, AOD 2010 FED para. 46,300.] That suggests that the current version of the regulations does not limit the losses in question. [See Harl, "The Tax Court and the U.S. Court of Federal Claims Agree: Members of LLCs and LLPs Are Not to be Treated as Limited Partners," 20 Agric. L. Dig. 2009).]

The Tax Court, in a Tax Court Summary Opinion, in October of 2009 [Hegarty v. Comm'r, T.C. Summary Opinion 2009-153 (involved charter-fishing business which was not deemed to be a passive activity).] held that LLC losses were not limited as determined in *Garnett*. [In a Tax Court case decided in 2010, the Tax Court again held that LLCs are not necessarily governed by limited partnership passive activity rules. [Newell v. Comm'r, T.C. Memo. 2010-23 (managing member of LLC materially participated under Temp. Treas. Reg. § 1.469-5T(a)(4).]

At New York University's 68th Annual Institute on Federal Taxation in New York on October 21, 2009, Curtis Wilson, IRS Associate Chief Counsel for Passthroughs and Special Industries, was quoted as stating that the issues in *Garnett* and *Thompson* ". . . [are] legitimate and . . . IRS intends eventually to respond with guidance." [CCH, Federal Tax Day, October 22, 2009).]

It is important to keep in mind that IRC § 469(c)(1) (26 USCS § 469(c)(1)) specifies that an activity is considered a passive activity if it involves the conduct of a trade or business and the taxpayer does not materially participate in the activity or a rental activity. [See *Dean v. Internal Revenue Service*, 09-1 U.S.T.C. para 50,185 (9th Cir. 2009) (passive loss limitations applied to carryback of limited partnership losses; limited partner failed to prove material participation). See also *Carlstedt v. Comm'r*, T.C. Memo. 1997-331 (taxpayer deemed to be materially participating in company activities so income could not be used to offset passive losses of a related partnership); *Cunningham v. Comm'r*, T.C.

Memo. 2009-194 (losses from horse breeding and raising activity disallowed as passive; failed to establish material participation). See generally 4 Harl, Agricultural Law § 30.08 (2009), Matthew Bender/LexisNexis; 2 Harl, Farm Income Tax Manual § 4.08 (2010 ed.), Matthew Bender/LexisNexis.] Moreover, a taxpayer is treated as materially participating only if the person ". . . is involved in the operations of the activity on a basis which is regular, continuous, and substantial." [I.R.C. § 469(h)(1) (26 USCS § 469(h)(1)). See *Chapin v. Comm'r, T.C. Memo. 1996-56* (taxpayers' involvement in renting beach-front condominium did not constitute material participation; rental agent handled all rental arrangements); *Cunningham v. Comm'r, T.C. Memo. 2009-194* (losses from horse activity disallowed under § 469 from partnership in which there was no participation).]

Treatment of limited partnerships for passive activity loss purposes

Under Temp. Treas. Reg. § 1.469-5T(2), losses attributable to limited partnerships are treated as arising from a passive activity unless the limited partner:

- Participates more than 500 hours in the activity, [Temp. Treas. Reg. § 1.469-5T(a)(1).]
- Materially participated in five or more of the 10 preceding years, [Temp. Treas. Reg. § 1.469-5T(a)(5).] or
- The activity is a personal service activity in which the limited partner had materially participated for any three preceding years. [Temp. Treas. Reg. § 1.469-5T(a)(6).]

The regulations go on to state that a general partner who holds a limited partnership interest is not necessarily treated as a limited partner. [Temp. Treas. Reg. § 1.469-5T(e)(3)(ii).]

Treatment of other taxpayers treated under the passive activity loss rules.

By contrast, taxpayers other than limited partners in a limited partnership are allowed to meet the material participation test under *seven* tests, not just the three tests open to limited partners in a limited partnership. Those tests include the following-

- A taxpayer is treated as materially participating if the individual participates in the activity for more than 500 hours during the year (this is the first of the limited partnership tests). [Temp. Treas. Reg. § 1.469-5T(a)(1). See *Dean v. IRS, 2009-1 U.S.T.C. para. 50,185 (9th Cir. 2008)*, aff'g, *2007-2 U.S.T.C. para. 50,845 (W.D. Wash. 2007)* (taxpayer failed to provide sufficient evidence of number of hours worked in business); *Lapid v. Comm'r, T.C. Memo. 2004-222* (time spent on investment activities did not count for purposes of 500-hour test).]
- The second test is for situations requiring fewer than 500 hours of involvement - or less than 500 hours by any one individual-during the year. [Temp. Treas. Reg. § 1.469-5T(a)(2).] If a taxpayer's participation in the activity constitutes "substantially all of the participation" in the activity by all individuals during the year, it is considered material participation.
- Under the third test, a taxpayer is considered to be materially participating if the individual puts more than 100 hours per year into the activity and the participation is not less than that of any other person. [Temp. Treas. Reg. § 1.469-5T(a)(3). See *Serenbetz v. Comm'r, 1996-510* (participation by owners in condominium partnership less than on-site employees).]
- The fourth test introduces the term -- "significant participation." A taxpayer is treated as materially participating in significant participation activities if the individual's aggregate participation in significant participation activities for the year exceeds 500 hours. [Temp. Treas. Reg. § 1.469-5T(a)(4). See *Speer v. Comm'r, T.C. Memo. 1996-323* (taxpayer failed to meet burden of proof that test met; ballpark "guesstimate" unacceptable).] A "significant participation activity" is a trade or business activity in which the individual participates for more than 100 hours during the taxable year. [Temp. Treas. Reg. § 1.469-5T(c)(1).]
- Under the fifth test, which is one of the tests for limited partnerships, a taxpayer is treated as materially participating if the individual materially participated in the activity for more than five of the ten taxable years immediately preceding the taxable year in question. [Temp. Treas. Reg. § 1.469-5T(a)(5).]
- The sixth test is for those involved in personal service activities (and it is the third test available to limited partners in a limited partnership). A taxpayer is deemed to be materially participating in a personal service activity if the taxpayer materially participated for any three taxable years preceding the taxable year in question. [Temp. Treas. Reg. §

1.469-5T(a)(6).] Personal service activities are those involving the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting or any other trade or business in which capital is not a material income-producing factor. [Temp. Treas. Reg. § 1.469-5T(d).]

■ The seventh and final test specifies that a taxpayer may be treated as materially participating in an activity based on all of the facts and circumstances. [Temp. Treas. Reg. § 1.469-5T(a)(7).] The regulations do not specify what facts and circumstances are to be considered but the regulations do point out three factors to keep in mind - (1) the fact that an individual is materially participating for purposes of social security [I.R.C. § 1402(a)(1) (26 USCS § 1402(a)(1)).] or special use valuation of land for federal estate tax purposes [See I.R.C. § 2032A(e)(6) (26 USCS § 2032A(e)(6)).] is not taken into account for purposes of the passive loss rules; [Temp. Treas. Reg. § 1.469-5T(b)(2)(i).] (2) an individual who does not participate in an activity for more than 100 hours cannot meet the facts and circumstances test; [Temp. Treas. Reg. § 1.469-5T(b)(2)(iii). See *Goshorn v. Comm'r, T.C. Memo. 1993-578* (taxpayer unable to meet facts and circumstances test in boat charter business; marina where boat kept spent more time in management than taxpayer and not clear that owner met 100 hour test since time actually constituted investment activity).] and (3) an individual's participation in management of an activity is not taken into account in applying the facts and circumstances test if a paid manager participates in the activity and no individual performs services in connection with the management of the activity that exceeds (by hours) the amount of service performed by the individual. [Temp. Treas. Reg. § 1.469-5T(b)(2)(ii).]

In determining whether a taxpayer materially participates (or actively participates), [I.R.C. § 469(i) (26 USCS § 469(i))] the participation of the taxpayer's spouse is taken into account whether or not they file a joint income tax return. [I.R.C. § 469(h)(5) (26 USCS § 469(h)(5)); See Temp. Treas. Reg. § 1.469-5T(f)(3).]

The statute refers to material participation by the taxpayer but does not specifically bar imputation of the services of an agent or specifically embrace I.R.C. § 1402(a)(1) (26 USCS § 1402(a)(1)).] which does bar imputation of the activities of an agent to a principal. [I.R.C. § 469(c)(1)(B) (26 USCS § 469(c)(1)(B)).] The legislative history states that activities of an agent are not attributed to the taxpayer and the taxpayer must personally perform sufficient services to establish material participation. [S. Rep. 99-313, 99th Cong., 2d Sess. 735 (1986).]

Other issues

Grouping involving an LLC. Certain activities defined under the "at risk" rules cannot be grouped together if the interests in those activities are owned by a limited partner or "limited entrepreneur." [I.R.C. § 464(e)(2) (26 USCS § 464(e)(2)).] The term "limited entrepreneur" is defined to include - (1) those with an interest in an activity other than as a limited partner, and (2) those who do not actively participate in the management of the enterprise. [Id.]

An example in the regulations indicates that a member of an LLC is treated as a limited entrepreneur if the LLC member does not actively participate in management (the implication is that an LLC member who is actively participating in management is *not* a limited entrepreneur). [Treas. Reg. § 1.469-4(d)(3)(ii).]

Active management test. A taxpayer may deduct annually up to \$25,000 of passive activity losses and the deduction equivalent of passive activity credits attributable to rental real estate activities in which the taxpayer *actively* participates. [I.R.C. § 469(i) (26 USCS § 469(i)).] The statute states that "[e]xcept as otherwise provided in regulations, no interest as a limited partner in a limited partnership shall be treated as an interest with respect to which the taxpayer actively participates. [I.R.C. § 469(i)(6)(C) (26 USCS § 469(i)(6)(C)).] If LLC members are characterized as limited partners, they would not be eligible for the deduction. However, if characterized on the basis of participation in management, an opposite conclusion would be reached. [See, e.g., *Garnett v. Comm'r, 132 T.C. No. 19 (2009)*.]

RELATED LINKS: For a further discussion on the tax issues surrounding the classification of an entity, see

■ LexisNexis Tax Advisor -- Federal Topical § 2D:2.01

For a discussion on the application of the passive activity rules to partnerships, see

■ LexisNexis Tax Advisor -- Federal Topical § 2D:6.13

For a further discussion on the application of the passive activity rules to limited partners, see

■ LexisNexis Tax Advisor -- Federal Topical § 1D:26.06.

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FRE 502: The Lawyer-Saving Provision for Inadvertent Waivers of Privileges

2010 Emerging Issues 5093

FRE 502: The Lawyer-Saving Provision for Inadvertent Waivers of Privileges

By Ann Murphy

June 3, 2010

SUMMARY: In 2006, the Supreme Court approved proposed amendments to the Federal Rules of Civil Procedure referred to as the "E-discovery Amendments." These rules eventually led the way to new Federal Rule of Evidence 502, which allows parties to claim a privilege after a protected document is produced. This rule in no way affects the substantive law on both the attorney-client and work product privilege, and had no bearing on the *Textron* case.

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ARTICLE: On September 19, 2008 then-President George Bush signed into law new Federal Rule of Evidence 502 "Attorney-Client Privilege and Work Product; Limitations on Waiver." One could imagine a huge sigh of relief coming from lawyers across the country. Prior to this rule, if a lawyer inadvertently included a privileged document within a discovery request response, he or she may have been held to have waived the attorney-client and/or work product privilege for the entire subject matter covered by that document. A costly error indeed!

Background:

Rule 501 of the Federal Rules of Evidence sets forth the general rules of privilege. The rule is simple. The rules of privilege are "governed by the principles of the common law as they may be interpreted by the courts of the United States in the light of reason and experience." The common law on the attorney-client privilege dates back to the 1500s. Interestingly, it originated as "an honor among gentlemen," under the theory that a gentleman would never reveal the secrets of a client. John Henry Wigmore, *A Treatise on the System of Evidence in Trials at Common Law*, Volume IV, published by Little, Brown, and Company, 1905, §2286, at 3187; and Paul R. Rice, *Attorney-Client Privilege in the United States*, Second Ed., at 6. Only later did the purpose emerge that it is to foster full and frank disclosure between a client and a lawyer. *Annesley v. Earl of Anglesea*, 17 How. St. Tr. 1229 (1743). Dean John Henry Wigmore stated the basis behind the attorney-client privilege as the following:

In order to promote freedom of consultation of legal advisers by clients, the apprehension of compelled disclosure by the legal advisers must be removed; hence the law must prohibit such disclosure except on the client's consent.

8 Wigmore, Evidence § 2291 (McNaughton rev. 1961). The "formulation" of the privilege appears in the often cited case *U.S. v. United Shoe Machinery Corp.*, 89 F. Supp. 357 (D. Mass. 1950). In *United Shoe*, Judge Wyzanski

proposed the following:

The privilege applies only if

- (1) The asserted holder of the privilege is or sought to become a client;
- (2) The person to whom the communication was made
 - (a) Is a member of the bar of a court, or his subordinate and
 - (b) In connection with this communication is acting as a lawyer;
- (3) The communication relates to a fact of which the attorney was informed
 - (a) By his client
 - (b) Without the presence of strangers
 - (c) For the purpose of securing primarily either
 - (i) An opinion on law or
 - (ii) Legal services or
 - (iii) Assistance in some legal proceeding, and not
 - (d) For the purpose of committing a crime or tort; and
- (4) The privilege has been
 - (a) Claimed and
 - (b) Not waived by the client.

89 F. Supp. 357, 358-359.

It is important to note in the area of taxation that much of the material furnished to an attorney for the preparation of a tax return is not privileged because it is "given for transmittal by the attorney to others-for example, for inclusion in the tax return." *Colton v. U.S.*, 306 F. 2d 633, 638 (2nd Cir. 1962). Additionally, business or other advice (investment advice) "gives rise to no privilege whatever." *Colton*, at 638.

The work product privilege is actually not a rule of privilege at all - it is a rule of immunity from the discovery rules under the Federal Rules of Civil Procedure (Rule 26(b)(3) n1). This rule has its origin in the Supreme Court case *Hickman v. Taylor*, 329 U.S. 495 (1947). In *Hickman*, the Supreme Court stated the following:

Proper preparation of a client's case demands that he assemble information, sift what he considers to be the relevant from the irrelevant facts, prepare his legal theories and plan his strategy without undue and needless interference. That is the historical and the necessary way in which lawyers act within the framework of our system of jurisprudence to promote justice and to protect their clients' interests...Were such materials open to opposing counsel on mere demand, much of what is now put down in writing would remain unwritten.

Hickman, at 511.

The work product privilege is a protection for the lawyer - for all of the lawyer's hard work and efforts. It is not an

absolute protection and is far less protective than is the attorney-client privilege. The Court stated the following:

We do not mean to say that all written materials obtained or prepared by an adversary's counsel with an eye toward litigation are necessarily free from discovery in all cases. Where relevant and non-privileged facts remain hidden in an attorney's file and where production of those facts is essential to the preparation of one's case, discovery may properly be had. Such written statements and documents might, under certain circumstances, be admissible in evidence or give clues as to the existence or location of relevant facts. Or they might be useful for purposes of impeachment or corroboration. And production might be justified where the witnesses are no longer available or can be reached only with difficulty. Were production of written statements and documents to be precluded under such circumstances, the liberal ideals of the deposition-discovery portions of the Federal Rules of Civil Procedure would be stripped of much of their meaning.

Hickman, at 511-512.

The work product doctrine only applies when an attorney prepares the documents in anticipation of litigation. *Hickman*, at 497. "It is not enough to trigger work product protection that the *subject matter* of a document relates to a subject that might conceivably be litigated. Rather, as the Supreme Court explained, "the literal language of Rule 26(b)(3) protects materials *prepared for* any litigation or trial as long as they were prepared by or for a party to the subsequent litigation.'" *U.S. v. Textron, Inc.*, 577 F. 3d 21 (1st Cir. 2009), cert. den. No. 09-750, May 24, 2010, quoting *Federal Trade Commission v. Grolier Inc.*, 462 U.S. 19, 25, 103 S. Ct. 2209, 76 L. Ed. 2d 387 (1983).

The Challenges of E-discovery Lead the Way to Rule 502

On April 12, 2006, the Supreme Court approved proposed amendments to the Federal Rules of Civil Procedure referred to as the "E-discovery Amendments." The rules that were changed were 16, 26, 33, 34, 37, and 45. The rule that led the way to new Federal Rule of Evidence 502 was 26(b)(5)(B). This allowed parties to claim a privilege **after** a protected document was produced. The text of new FRCP 26(b)(5)(B) is as follows:

(B) Information Produced. If information produced in discovery is subject to a claim of privilege or of protection as trial preparation material, the party making the claim may notify any party that received the information of the claim and the basis for it. After being notified, a party must promptly return, sequester, or destroy the specified information and any copies it has; must not use or disclose the information until the claim is resolved; must take reasonable steps to retrieve the information if the party disclosed it before being notified; and may promptly present the information to the court under seal for a determination of the claim. The producing party must preserve the information until the claim is resolved.

The reason for the rule changes is the sheer volume of electronically stored information. "When the complexities of the legal landscape are added to the logistical difficulties of performing effective privilege reviews on tens of thousands or perhaps millions of page-equivalents of information within the tight timeframes of typical pretrial discovery, it should come as no surprise that efforts are being made on several fronts to develop uniform laws for privilege and privilege waiver." Carl G. Roberts, *The Attorney-Client Privilege and the Amended Federal Discovery Rules*, Law Practice Today, ABA Law Practice Management Section, December 2006, available at: <http://www.abanet.org/lpm/lpt/articles/mgt12062.shtml>. The volume of discovery and dollar amounts involved is staggering. "A company of 100,000 employees may store an average of 1.5 billion emails annually." Damian Vargas, *Electronic Discovery: 2006 Amendments to the Federal Rules of Civil Procedure*, 34 Rutgers Computer & Tech. L. J. 396 (2008). In *Coleman (Parent) Holdings, Inc. v. Morgan Stanley*, Fla. Cir. Ct. Mar. 23, 2005, the plaintiff was awarded over \$1 billion in damages when Morgan Stanley failed to discover 2,330 backup tapes, despite the fact that backup tapes "numbered in the thousands and were located in warehouses across the country." Vargas, *Id.* In *Rowe Entertainment v. William Morris Agency, Inc.*, 205 F.R.D. 421 (S.D.N.Y. 2002), William Morris objected to Rowe's request for backup tapes, contenting that "the total cost of cataloging, restoring, and processing all backup tapes would reach \$9,750,000. Vargas, *Id.* New Rule of Civil Procedure 26(b)(5)(B) became effective on December 1, 2006.

Rule 502

A change to the rules of evidence regarding inadvertent waiver of the attorney-client and work product privileges was taking shape at the very same time as the change to the civil procedure rules. On January 23, 2006, House Judiciary Committee Chairman James Sensenbrenner, Jr. wrote a letter to the Director of the Administrative Office of the U.S. Courts and urged him to go forward with a new rule on inadvertent disclosure of the attorney-client and work product privileges. See Federal Rule of Evidence 502 Timeline, available at: <http://federalevidence.com/node/288>.

In December 2007, Senators Leahy, Specter, and Graham proposed a bill with the exact language of Rule 502. Public Law 110-322, 122 Stat. 3537, based upon S. 2450, 110th Congress, 2nd Session, and Report No. 110-264. The bill passed unanimously in both the House and Senate, with no added amendments. It was signed into law by President Bush, effective September 19, 2008.

The text of Rule 502 is all follows:

Rule 502 Attorney-Client Privilege and Work Product; Limitations on Waiver

The following provisions apply, in the circumstances set out, to disclosure of a communication or information covered by the attorney-client privilege or work-product protection.

a) Disclosure Made in a Federal Proceeding or to a Federal Office or Agency; Scope of a Waiver- When the disclosure is made in a Federal proceeding or to a Federal office or agency and waives the attorney-client privilege or work-product protection, the waiver extends to an undisclosed communication or information in a Federal or State proceeding only if:

- a. the waiver is intentional;
- b. the disclosed and undisclosed communications or information concern the same subject matter; and
- c. they ought in fairness to be considered together.

b) Inadvertent Disclosure- When made in a Federal proceeding or to a Federal office or agency, the disclosure does not operate as a waiver in a Federal or State proceeding if:

- a. the disclosure is inadvertent;
- b. the holder of the privilege or protection took reasonable steps to prevent disclosure; and
- c. the holder promptly took reasonable steps to rectify the error, including (if applicable) following Federal Rule of Civil Procedure 26(b)(5)(B).

c) Disclosure Made in a State Proceeding- When the disclosure is made in a State proceeding and is not the subject of a State-court order concerning waiver, the disclosure does not operate as a waiver in a Federal proceeding if the disclosure:

- a. would not be a waiver under this rule if it had been made in a Federal proceeding; or
- b. is not a waiver under the law of the State where the disclosure occurred.

d) Controlling Effect of a Court Order- A Federal court may order that the privilege or protection is not waived by disclosure connected with the litigation pending before the court--in which event the disclosure is also not a waiver in any other Federal or State proceeding.

e) **Controlling Effect of a Party Agreement-** An agreement on the effect of disclosure in a Federal proceeding is binding only on the parties to the agreement, unless it is incorporated into a court order.

f) **Controlling Effect of This Rule-** Notwithstanding Rules 101 and 1101, this rule applies to State proceedings and to Federal court-annexed and Federal court-mandated arbitration proceedings, in the circumstances set out in the rule. And notwithstanding Rule 501, this rule applies even if State law provides the rule of decision.

g) **Definitions-** In this rule:

a. "attorney-client privilege" means the protection that applicable law provides for confidential attorney-client communications; and

b. "work-product protection" means the protection that applicable law provides for tangible material (or its intangible equivalent) prepared in anticipation of litigation or for trial."

The Advisory Committee on the Federal Rules of Evidence cites to *Hopson v. City of Baltimore*, 232 F.R.D. 228 (D. Md. 2005) to provide some history on inadvertent waiver. The District Court for the District Court of Maryland stated the following, "electronic discovery may encompass millions of documents and to insist upon record-by-record pre-production privilege review on pain of subject matter waiver, would impose upon parties costs of production that bear no proportionality to what is at stake in the litigation." *Hopson, Id.* In *Hopson*, the District Court reviewed other court decisions and found there had developed three approaches to inadvertent waiver, and stated the following:

A few courts [found] that a disclosure must be intentional to be a waiver (the "lenient approach"). Most courts [found] a waiver only if the disclosing party acted carelessly in disclosing the communication or information and failed to request its return in a timely manner (the "middle of the road approach"). And a few courts [held] that any inadvertent disclosure of a communication or information protected under the attorney-client privilege or as a work product constitute[d] a waiver without regard to the protections taken to avoid such a disclosure (the "strict approach").

Hopson, as cited in the Advisory Committee Notes. Names of the three approaches are reflected in *Gray v. Bicknell*, 86 F. 3d 1472 (8th Cir. 1996). New Rule 502 takes the "middle of the road" approach.

By the first section, Congress clarified that if a waiver is intentional (for example in a tax shelter case, if a taxpayer asserts that he or she relied on advice of counsel), then the waiver will extend to the disclosed and undisclosed material concerning the same subject matter if the material ought in fairness be considered together. Rule 502(a). The main section to Rule 502 is (b). As is evident, if an inadvertent disclosure is made in a Federal proceeding or to a Federal office or agency (e.g. the IRS) then there is no general subject matter waiver if the party took reasonable steps both to avoid disclosure and to rectify the error.

One of the issues during the discussions of proposed Rule 502 was the effect of cross disclosure - for example if a disclosure is made in a State proceeding, the effect on a Federal proceeding; and conversely if a disclosure is made in a Federal proceeding, the effect on a State proceeding. These cross disclosures raised the "principles of federalism and comity." See Advisory Committee Notes, subdivision (c). The Committee decided that "the proper solution for the federal court is to apply the law that is most protective of privilege and work product."

Subdivision (e) of the new rule clarifies that if parties enter into an agreement to limit the effect of a waiver, that agreement binds only the parties to the agreement. It does not affect non-parties unless the agreement is made part of a court order. Subdivision (f) provides that "the protections against waiver provided by Rule 502 must be applicable when protected communications or information disclosed in federal proceedings are subsequently offered in state proceedings" See Advisory Committee Notes, subdivision (f).

One important note is that the Committee and Congress stressed that this rule in no way affects the substantive law on both the attorney-client and work product privileges. The *Textron* case (including the recent Supreme Court denial of

certiorari) has been the subject of much commentary lately. Rule 502 would not change the result in *Textron* in any way. The First Circuit in *Textron* cited to the District Court *Textron* opinion and reported that the District Court had earlier determined that *Textron* waived the privilege by furnishing the tax accrual workpapers to their outside accountant, Ernst & Young. See *U.S. v. Textron*, 507 F. Supp. 2d 138, 152 (D.R.I. 2007). This was a waiver due to a disclosure to a third party. Evidence Rule 502 would not even be applicable, because first, the disclosure to Ernst & Young was not inadvertent and second, the disclosure was made to its outside auditor, not to a Federal office or agency, or to an adversary in a Federal proceeding. The work product privilege was inapplicable because the First Circuit found the documents were not prepared in anticipation of litigation. The substantive law of privilege is unchanged. This evidence rule is really procedural in nature.

An interesting article on the actual effect of Rule 502 is Robert D. Owen and Melissa H. Cozart, *FRE 502: One Year Later*, New York Law Journal, October 13, 2009. Owen and Cozart cite to recent cases and conclude that Rule 502 has only been of limited help with litigation costs and the time devoted to discovery matters. They cite to a Fulbright & Jaworski 2009 Litigation Trends Survey, in which "89 percent of respondents said enactment of the amended Rule had not resulted in any costs savings for their company." *Id.* Perhaps it is too soon to tell the effect Rule 502 has had. It must be concluded that Rule 502 is a step in the right direction in our new age of e-discovery.

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n1 The text of FRCP 26(b)(3) is as follows:

(3) Trial Preparation: Materials.

(A) Documents and Tangible Things. Ordinarily, a party may not discover documents and tangible things that are prepared in anticipation of litigation or for trial by or for another party or its representative (including the other party's attorney, consultant, surety, indemnitor, insurer, or agent). But, subject to Rule 26(b)(4), those materials may be discovered if:

(i) they are otherwise discoverable under Rule 26(b)(1); and

(ii) the party shows that it has substantial need for the materials to prepare its case and cannot, without undue hardship, obtain their substantial equivalent by other means.

RELATED LINKS: For further information, see

■ LexisNexis Tax Advisor -- Federal Topical § 5B:11.01

and

■ 1-11 Tax Controversies: Audits, Investigations, Trials § 11.01

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Tax Challenges Emerging in H.R. 4213 Carried Interest Provisions

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Tax Challenges Emerging in H.R. 4213 Carried Interest Provisions

By Ivan Mitev and Matthew Kaden

May 26, 2010

SUMMARY: If enacted, H.R. 4213 (The American Jobs and Closing Tax Loopholes Act of 2010), managers in private equity, venture capital, real estate, and hedge funds will be in a significantly deteriorated tax posture as compared to the status quo. H.R. 4213 is a compromise in some respects, managers will likely be exposed to effective tax rates of over 30 percent (more than double the current rate), stiff potential penalties and anti-abuse measures.

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ARTICLE: The long-running movement to change the tax treatment of private equity, venture capital, real estate, and hedge fund managers' compensation, also known as "carried interests," took a major step forward on Thursday, May 20, 2010, when House and Senate committees agreed on an "extenders" bill that would be offset, in part, by the closure of what bill sponsors have termed the carried interest "loophole." A vote on the bill in both houses is expected soon. The emergence of an agreed-on version of the carried interest provision has created a sense that carried interest legislation may be imminent. However, it remains to be seen whether the bill can garner the required support in the Senate without an exception for managers of venture capital firms. Some Senators have emphatically advocated for such an exception.

Section 412 of the bill (H.R. 4213, the "American Jobs and Closing Tax Loopholes Act of 2010") would add Section 710 to Subchapter K of the Code. The scope of Section 710 (hereinafter the "**New Provision**") is not as broad as some previous variations of the "carried interest," which would have affected all partnership profits interests granted for services. Additionally, the New Provision taxes at ordinary income rates only a percentage of the income attributable to a manager's compensatory interest, which appears to be the hallmark of this new compromise bill. Despite the concessions made by House democrats, the New Provision, if enacted, is a game changer for private equity, venture capital, real estate and, to a lesser extent, hedge fund managers. (Many hedge fund managers will not be significantly affected by these changes, as many hedge funds engage primarily in short-term trading strategies that generate ordinary income).

Background

Since the early 1990s, the tax treatment of partnership profits interests granted for services has been relatively well settled. The service provider is generally not taxed on receipt of the interest (treatment that is codified in Section 411 of the new extenders bill) and the partnership's tax items of income, gain, deduction, and loss flow through to the service

provider as earned by the partnership. Since partnerships that hold investment assets generate predominantly long term capital gains taxed at a 15 percent rate, this treatment has led to investment fund managers structuring a large portion of their incentive compensation as profits interest, which is ultimately subject to a 15 percent tax. This profits interest has historically been referred to as "carried interest."

Commentators and academics have debated for years whether it was appropriate to tax at capital gains rates what many have argued is essentially compensation income, which is currently taxed at a 35 percent rate. However, no legislative efforts were made to change this treatment until 2007.

Previous Proposals

Two legislative attempts were made in 2007 to change the tax treatment of carried interest. Both attempts, one prepared by Representative Sander Levin (D-Mich.) and a second made by Rep. Charles Rangel (D-NY), passed the House but did not progress further. The New Provision, with some significant modifications, discussed below, is largely based on these 2007 proposals.

In early April of 2009, Levin re-introduced a modified version of his 2007 proposal, with two notable features distinguishing it from the 2007 version. The 2009 proposal:

1. Provided that any income attributable to an applicable carried interest would be taken into account in determining an individual's "net earnings from self-employment," which would be subject to the 2.9 percent Medicare hospital insurance tax.
2. Struck down the "performance of services" clause from the 2007 proposals, and provided that the "carried interest" will be taxed as ordinary income, instead of ordinary income from the performance of services. This change was intended to clarify that foreign and/or tax-exempt investors in investment management entities would not be subject to "effectively connected income" (ECI) or "unrelated business taxable income" (UBTI).

Levin's 2009 bill did not make any headway in the Senate as introduced or when it was later attached to the 2009 extenders bill.

Also in 2009, the Obama administration released its own proposal to tax carried interest. The administration's proposal, which applied to all partnership interests granted in exchange for services, was far broader in scope than any of the previous proposals, which only applied to interests granted in exchange for investment services.

Section 710: The New Provision

What is New?

Prior to the May 20th compromise, the most recent version of the "carried interest" legislation (which was essentially Representative Levin's 2009 proposal) was attached to the House Engrossed Tax Extenders Act of 2009 (H.R. 4213), passed by the House on December 9, 2009. The New Provision contains some major (and minor) modifications to that version, including but not limited to:

- An exception for the disposition of an interest in a publicly traded partnership (PTP) by an individual;
- An election with respect to certain exchanges of interest held by managers; and
- A special rule for individuals that limits ordinary income to a portion of 50 percent or 75 percent of the "carried interest."

A discussion of the more significant provisions follows.

Only Investment Service Interest Are Subject to the New Provision

The New Provision is not as broad as some of the prior carried interest proposals, which tried to capture all interest issued in exchange for services. However, the New Provision squarely captures almost any interest, in any entity, issued in exchange for investment management services. The New Provision applies to two types of interests: (i) true carried interests in investment partnerships ("**Investment Service Partnership Interests**" or "**ISPIs**"); and (ii) "Disqualified Interests" (i.e. interest in entities other than partnerships).

An ISPI is a carried interest in an investment partnership that holds "specified assets," which include securities, real estate held for rental or investment (except working farms owned exclusively by members of the same family), interests in partnerships, or commodities or options or derivative contracts with respect to any of the foregoing. To be subject to the New Provision, a partner must provide services in respect of these "specified assets." The range of services includes:

- (1) Advising as to the investing in, purchasing or selling a specified asset;
- (2) Managing, acquiring or disposing a specified asset;
- (3) Arranging financing with respect to acquiring specified assets; and
- (4) Any support activities related to the above.

If the New Provision is enacted, for planning purposes, it will be very important to clearly delineate what the purposes and functions of the entity are, and what kind of services a partner, may or may not provide.

Disqualified Interest on the other hand has an anti-abuse flavor. The notion of a Disqualified Interest derives from a provision in the Rangel proposal that was drafted in response to concerns that service providers would be able to avoid the reach of Section 710 by simply structuring their compensation as something other than a partnership profits interest, be it corporate stock, an option or a derivative. A Disqualified Interest is defined sweepingly as an interest in any entity, including a foreign corporation, and including convertible debt, options, or any other derivative instrument with respect to such entity. Notably, interests in domestic corporations or foreign corporations subject to a comprehensive income tax are excluded from the definition of Disqualified Interest. The New Provision also contains a broad grant of authority to draft anti-abuse rules.

Exception for Invested Capital

The purpose of the New Provision is to tax at ordinary rates only that portion of a service provider's interest that is compensatory. Accordingly, the New Provision, generally, does not apply with respect to income derived from capital contributed by the manager. The New Provision implements this concept by introducing the term "Qualified Capital Interest." A Qualified Capital Interest is a portion of partnership capital equal to the sum of: (i) money or the fair market value of any property contributed to the partnership by the service provider; (ii) the gross income taken into account by the service provider under Section 83 with respect to the interest; and (iii) net income taken into account by the service provider under Section 702 with respect to the interest. The New Provision excludes any contribution by a service provider that is funded by a loan written or guaranteed by another partner, the partnership, or any related parties thereto.

The New Provision sets forth a fairly strict test that governs whether allocations to a Qualified Capital Interest will be governed by Section 702(b) (i.e. the manager's income will retain its character if the test is satisfied) or by Section 710 (i.e. the manager's income will be taxed at ordinary rates if the test is not satisfied). The test essentially requires that the allocations to the Qualified Capital Interest are made in the same manner as allocations to the partners other than the service provider. The New Provision does carve out several exceptions to this test and also contains a grant of regulatory authority to implement other exceptions to the allocations test.

Only a Portion of Manager's Income is Subject to Ordinary Income Rates

In what seems to be the clearest manifestation of a compromise between the Senate and the House, and a departure from the previous proposals, the New Provision subjects only a percentage ("**Applicable Percentage**") of income derived by individuals from the performance of investment management services to ordinary income tax rates. For taxable years beginning on or after January 1, 2013, that percentage is 75 percent; for taxable years ending after the date of enactment, but before January 2013, the percentage is 50 percent. This Applicable Percentage applies to the various classes of income that fall under the New Provision (i.e. operating income, distributions, and dispositions of the carried interest).

Apart from the Applicable Percentage portion, the remainder of the net income attributable to an ISPI or Disqualified Interest retains its character (i.e. generally capital gains). Similar rules apply to distributions of property and disposition of the manager's interest. The Applicable Percentage of gains recognized by an individual from the disposition of an ISPI are generally treated as ordinary income, notwithstanding any nonrecognition provision of the Code, which is a provision first proposed by Representative Levin in 2009. Conversely, the non-Applicable Percentage portion would continue to be taxed at capital gains rates.

While the Applicable Percentage rule will be welcomed by many, questions regarding the application of the disposition rules remain unanswered. Practitioners and taxpayers are concerned about the specific events that might trigger the disposition rules, and whether there will be any carve outs for some common business transactions, such as dispositions of a partnership interest in connection with an IPO where the managers do not receive any cash. While questions still remain, in an earnest attempt to provide some clarity, tax writers have introduced several new rules that elucidate the disposition rules. Under the New Provision, exchanges of ISPI for another partnership interest in nonrecognition Section 721-type transactions, including deemed liquidations under Section 708, would not be subject to tax if the service provider makes an election to treat the received interest as an ISPI and meets certain reporting requirements.

In addition, the New Provision provides for a carve out for dispositions of publicly traded partnership (PTP) interest if the selling partner has never provided management services in respect of the investment assets of the PTP. This appears to be a response to a concern by practitioners that public investors who have invested in publicly traded investment managers such as Blackstone and Fortress would be subject to the "carried interest" rules without ever providing any management services.

Losses Limited to Post-Enactment Profits

As with prior bills, all losses with respect to an ISPI are treated as ordinary losses. Unfortunately, as with prior bills, the New Provision continues to ignore concerns raised by practitioners that the recognition of losses is unfairly postponed until the time a manager has generated some *post-enactment ordinary income*. Thus, for example, if an investment manager had built up a capital account of \$10 million with pre-enactment income and suffered a \$1 million loss in the first post-enactment year, the manager would not be able to deduct any part of that loss. Any such losses are carried forward indefinitely.

ISPI Net Income is Subject to Self-Employment Tax

The New Provision includes Representative Levin's 2009 modification to his initial carried interest proposal, which includes income attributable to an ISPI in an individual's "net earnings from self-employment," which would be subject to the 2.9 percent Medicare hospital insurance tax.

Foreign and Tax-Exempt Investors Spared

The New Provision adopts the change first made in Representative Levin's 2009 proposal to clarify that income from an ISPI should not be considered as derived from the performance of services, thus avoiding exposure to ECI for foreign investors in the management partnership and exposure to UBTI for tax-exempt investors in the management partnership.

Publicly Traded Investment Fund Managers

Under current law, a PTP is generally treated as a corporation for federal income tax purposes unless it meets the so-called 90/10 test: A PTP is not treated as a corporation for federal income tax purposes if at least 90 percent of its gross income for each taxable year consists of "qualifying income." In this context, "qualifying income" is generally passive investment income.

This means that publicly traded investment managers would be taxed as corporations. The change would not apply, however, to any existing publicly traded partnership for ten years after the date of enactment.

An Onerous 40 Percent Penalty

It seems no revenue raiser is complete these days without a harsh new penalty, and the New Provision is no different. It imposes a 40 percent penalty on underpayments attributable to the application of the Disqualified Interest rules or the anti-abuse regulations authorized by the New Provision. Importantly, there is no reasonable cause defense to this penalty. In order to avoid this penalty, the taxpayer must:

- Adequately disclose the relevant facts pertaining to the taxpayer's treatment of the income;
- Demonstrate that there is, or was, substantial authority for such treatment; and
- Show that the taxpayer reasonably believed that such treatment was more likely than not the proper treatment.

Conclusion

The enactment of the New Provision, perhaps with slight modifications, is viewed by many as imminent. The effects of the provision are yet to be seen, but if enacted, managers in private equity, venture capital, real estate, and hedge funds would be in a significantly deteriorated tax posture as compared to the status quo. While the provision is indeed a compromise in some respects, its thrust and its bite are nonetheless the same as initially envisioned by its proponents. If adopted, managers will likely be exposed to effective rates of over 30 percent, more than double the effective rate to which they are currently subject.

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The authors would like to thank Keith Blum of Boies, Schiller and Flexner, LLP for his comments and suggestions.

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"Disguised Sales" in Partnership Transactions: Precepts and Recent Cases

2010 Emerging Issues 5058

"Disguised Sales" in Partnership Transactions: Precepts and Recent Cases

By Jerold Friedland Esq.

May 24, 2010

SUMMARY: Partners who contribute property to a partnership and receive a related distribution from the partnership may be treated as if the property was conveyed to the partnership in a "disguised sale." Identifying "disguised sale" transactions is not a formulaic exercise, although there are objective signposts. Recent case law complements a host of factors bearing on determining what kinds of partnership/partner transactions qualify as disguised sales.

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ARTICLE: A partner who contributes property to a partnership and receives a related distribution of cash or other property may be treated as if he or she sold the property to the partnership under 26 USCS § 707 (a)(2). n1 Congress enacted that section in 1984 out of concern that property transfers between partners and partnerships were being structured as nontaxable contributions and distributions to "disguise" transactions that were, in substance, taxable sales. n2 Although regulations existing in 1984 authorize the Service to recharacterize a purported contribution as a sale if that is the substance of the transaction, n3 Congress believed that the courts had not applied those regulations properly. n4 A number of decisions allowed nontaxable property transfers between partners and partnerships in situations that Congress considered to be economically indistinguishable from a sale. n5

The economic effect of a property contribution followed by a cash distribution to the contributing partner is similar to that of a sale; in both cases the partnership owns the property and the partner receives cash equal to its value. n6

The tax consequences of these transactions, however, are quite different. A partner who sells property to a partnership recognizes gain or loss as if the transaction were with an unrelated party. In contrast, a partner is not taxable on a contribution of property to a partnership, and he is taxable on a distribution from a partnership only to the extent that the amount of cash he receives exceeds the basis in his partnership interest. n7

Tests Determine When a Disguised Sale Occurs.

A contribution and distribution are considered a disguised sale if the facts and circumstances show that:

1. The partnership would not have transferred money or other property to the partner but for the partner's transfer of property to the partnership; and

2. If the transfers do not occur simultaneously, the transfer the partnership makes to the partner is not dependent on the entrepreneurial risks of partnership operations. n8 The determination is based on the facts and circumstances existing on the date of the earliest transfer. n9

A contribution and distribution made within two years of each other (without regard to the order of the transfers) are presumed to be a sale. n10 Transfers more than two years apart are presumed not to be a sale. n11 These presumptions are rebuttable only by facts and circumstances that "clearly" establish the contrary.

Disguised sale signposts.

Many factors are conducive to identifying a disguised sale. For example:

- At the time the property contribution takes place, the timing and amount of the subsequent contribution can be determined with reasonable certainty.
- The contributor has a legally enforceable right to the subsequent transfer.
- The contributor's right to receive the distribution is secured in any manner. This factor is applied by taking into account the time period of the security arrangement.
- A person has a legal obligation to make contributions to the partnership to permit the partnership to make a contribution.
- A person has loaned or agreed to lend the partnership the money or other consideration required to enable the partnership to make the distribution. This is taken into account when a lender's obligation to make the loan is subject to contingencies related to the success of partnership operations.
- The partnership has borrowed or is obligated to borrow the funds needed to make the distribution. This is applied by taking into account the likelihood that the partnership will be able borrow the funds, considering whether anyone has agreed to guarantee or assume personal liability for the debt.
- The partnership holds money or liquid assets beyond the reasonable needs of its business. Any income that will be earned from these assets also is taken into account.
- Partnership distributions, allocations, or control of partnership operations are designed to cause an exchange of the burdens and benefits of ownership of property.
- The distribution to the contributing partner is disproportionately large in relationship to his general and continuing interest in partnership profits.
- The contributing partner is not obligated to return or repay the amount distributed to him by the partnership. This is also considered if the partner has a repayment obligation that is likely to become due at such a distant point in the future that the obligation's present value is small in relation to the amount of the distribution.

However, identifying a disguised sale is not a formulaic exercise. Recent cases illustrate the diverse and complex factual situations in which the Service may raise the disguised sale issue. n12

■ ***Virginia Historic Tax Credit Fund L.P. v Commissioner.*** n13 This case involved individuals that formed partnerships to acquire interests in other entities engaged in projects eligible for Virginia's historic rehabilitation tax credit. Investors that contributed capital for limited partnership interests were allocated shares of the state tax credits.

The Service asserted that, in substance, the investors were not truly partners and that the allocation of state tax credits to them were sales for federal tax purposes. Alternatively, the government maintained that the transactions between the investors and the partnerships were disguised sales under 26 USCS § 707.

The Tax Court disagreed, holding that the investors were partners for federal tax purposes, and that their contributions to the partnerships were not disguised sales under 26 USCS § 707. The court concluded from the partnership documents and the conduct and testimony of the parties that the investors and organizers had joined as

partners in good faith. The evidence established that the parties intended to and did form a partnership.

The court noted that the nature of the state credit program required a partnership structure and the investors assumed a risk that the projects would not succeed or not qualify for the state credit. The court also determined that the partnerships purpose of pooling capital to invest in other entities and to earn state tax credits was a valid business purpose. Reduction of state taxes may be a valid business purpose. Since the investors and organizers joined in good faith with a valid business purpose they were, in substance, partners in the venture.

The Tax Court rejected the view that the allocation of credits to the investors was a disguised sale under 26 USCS § 707(a)(2)(B). A disguised sale does not occur under that section if a subsequent transfer is subject to the entrepreneurial risks of partnership operations. The investors were not guaranteed that the venture would generate sufficient credits to allocate the promised amounts to the investors.

■ ***In re G-I Holdings, Inc.***, n14 GAF formed a partnership with Rhone-Poulenc S.A. (RP) by transferring business assets to the partnership in exchange for a limited partnership interest, and used the partnership interest as collateral for a nonrecourse loan that RP was obligated to repay. The Service maintained that the transfer of GAF's assets to the limited partnership was not a capital contribution, but rather a disguised sale of property under 26 USCS Section 707(a).

In determining that the transaction was a disguised sale, the court noted that:

- At the time of the asset transfer, GAF received the proceeds of the loan and RP was fully responsible for repayment.
- GAF received the loan proceeds free and clear.
- RP was fully liable for the loan and the partnership agreement contained provisions that ensured its ability to pay.
- The transfers, when viewed together, were properly characterized as a sale of assets because:
- The payment to GAF was not subject to an appreciable risk as to amount.
- GAF's partner status was transitory.
- GAF received the proceeds close in time to the transfer of the assets to the partnership.
- Facts and circumstances showed that GAF became a partner primarily to obtain tax benefits that would not have accrued if it transferred the assets as a non-partner.

Although the court reviewed the factors set forth in the regulations, these rules were issued after the transaction occurred and therefore were not specifically applicable. However these factors showed that:

- The context of the transaction suggested that the parties intended a sale.
- The contribution and loan transactions were planned and structured together.
- The asset transfer was designed to reduce taxation in an exchange of assets for cash.
- The contribution and loan transactions were integrated.
- The contribution and loan transactions occurred on the same date.
- GAF ceded operational control of its assets.
- The loan was in substance a payment.

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n1 See e.g., *IRS CCA 200704028* and *IRS CCA 200704030* (investors in transaction not considered partners and transaction recast under principles of substance-over-form-doctrine, under partnership anti-abuse rule and as disguised sale of partnership property under **26 USCS § 707(a)(2)(B)**).

n2 See HR Rep No 432 (Pt 2), 98th Cong, 2d Sess 1218 (1984); S Rep No 169 (Vol I), 98th Cong, 2d Sess 224-25 (1984).

n3 26 C.F.R. 1.721-1(a); *TD 6175* (May 23, 1956). The regulations state that the transfer is a sale if the partner who transfers the property receives money or other consideration (including a promissory obligation) as a result of the transaction. If the contributing partner receives a distribution of money or other property from the partnership within a short time before or after the contribution, the transaction may be treated as a sale to the partnership. 26 C.F.R. 1.731-1(c)(3). If property contributed by one partner is distributed to another partner, the transaction may be treated as a sale or exchange between the partners.

n4 HR Rep No 432 (Pt 2) at 1218; S Rep No 169 (Vol I) at 225.

n5 HR Rep No 432 (Pt 2) at 1218; S Rep No 169 (Vol I) at 225. Committee reports indicate that Congress specifically disagreed with the holdings in *Otey v Commr*, 70 TC 312 (1978), *affd per curiam*, 634 F2d 1046 (6th Cir 1980); *Communications Satellite Corp v US*, 625 F2d 997, 223 Ct Cl 253 (1980); and *Jupiter Corp v US*, 2 Cl Ct 58 (1983).

n6 A contribution of property to a partnership always involves a partial disposition of the property, because the partner gives up his complete interest in the contributed property, in exchange for a partial interest in all the partnership's assets. Although the partner has diversified his interests, the exchange is nontaxable under **26 USCS § 721** because the partner continues to bear a significant risk of loss with respect to the contributed property. However, if the partner receives cash equal to the value of the contributed property, the transaction closely resembles a sale, and the partner no longer bears any risk if the property later declines in value.

n7 **26 USCS §§ 721, 731.**

n8 26 C.F.R. 1.707-3(b)(1).

n9 26 C.F.R. 1.707-3(b)(2).

n10 26 C.F.R. 1.707 -3(c)(1). A taxpayer who does not report a transaction falling under the two-year presumption as a sale must disclose this fact to the Service on Form 8275 or on a statement attached to his return.

n11 26 C.F.R. 1.707 -3(d).

n12 See generally, Lipton, Golub, McDonald, A Tale of Two Cases: *G-I Holdings* and *Virginia Historic Tax Credit Fund*-Can They Both Be Right?, 112 JTAX 154 (March 2010).

n13 T.C. Memo 2009-295.

n14 2009 U.S. Dist. LEXIS 115850 (DC NJ, 2009).

RELATED LINKS: For more information about disguised sales, see

- LexisNexis Tax Advisor -- Federal Topical § 2D:7.04

For more information about taxation principles related to pass through entities, see

- Tax Planning for Partners, Partnerships, and LLCs

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Defenses to Penalties Attributable to Partnership Items

2010 Emerging Issues 5062

Defenses to Penalties Attributable to Partnership Items

By Jerold Friedland Esq.

May 24, 2010

SUMMARY: It is important to distinguish partnership-level defenses that can be asserted in partnership proceedings, from partner-level defenses that can be raised only in refund litigation following payment. Recent decisions by the Tax Court and Fifth Circuit have provided some guidance.

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ARTICLE: The partnership-level procedure rules refer to three kinds of tax items-partnership items, nonpartnership items and affected items.

Partnership items. Each partner must report partnership items consistently with the partnership or must notify the Service of the inconsistency, and all controversies about the treatment of the item must be determined in a partnership-level proceeding.

Nonpartnership items. Nonpartnership items are excluded from the partnership-level rules; the treatment accorded them is governed by the general procedural rules of the Code.

Affected items. Affected items are items affected by adjustments to the treatment of a partnership item. Although the treatment of an affected item is not determined at the partnership-level, the partnership-level statute of limitations for assessing tax for these items generally applies.

Partnership Items

The partnership-level procedure rules apply only in determining the proper treatment of partnership items. **IRC Section 6231(a)(3), 26 USCS 6231(a)(3)**, defines a partnership item as any item that must be taken into account for the partnership's taxable year that, according to the regulations, is [m]ore appropriately determined at the partnership level than at the partner level." The procedural rules for partnership items also apply to any penalty, addition to tax, or additional amount relating to an adjustment to a partnership item. **IRC Section 6221, 26 USCS 6221**.

The regulations [Treas. Reg. 301.6231(a)(3)-(1)(a)] describe the following partnership items:

(1) The partnership total and each partner's share of each of the following partnership items-

- (a) income, gain, loss, deduction, or credit;
- (b) nondeductible expenditures (e.g., charitable contributions and foreign taxes);
- (c) tax preference items for any partner under **IRC Section 57, 26 USCS 57**;
- (d) tax-exempt income;
- (e) partnership liabilities-including determinations about the amount of the liability, whether they are recourse or nonrecourse, and changes in them from the preceding taxable year; and
- (f) other amounts determinable at the partnership level regarding partnership assets, investments, transactions, and operations needed to compute the partnership's or partners' investment tax credit or recapture, oil well and gas well depletion, or ordinary income or loss attributable to partnership unrealized receivables and inventory under **IRC Section 751, 26 USCS 751**.

(2) Guaranteed payments under **IRC Section 707(c), 26 USCS 707**.

(3) Adjustments to the basis of partnership assets under an IRC Section 754, 26 USCS 754 election. These adjustments include any determinations required before the partnership-level basis adjustments can be made (e.g., establishing a transferee partner's basis in his partnership interest). If no **IRC Section 754, 26 USCS 754** election is in effect, the factors used to determine a transferee partner's basis for his partnership interest (e.g., the amount the partner paid for his interest), ordinarily are not partnership items.

(4) Any item relating to-

(a) contributions to the partnership-

(i) the character of amounts the partnership receives from a partner (i.e., whether it is a loan, a capital contribution, or the repayment of loan),

(ii) the amount of money contributed by a partner,

(iii) the applicability of investment company rules of **IRC Section 721(b), 26 USC 721(b)** to a contribution, and

(iv) the partnership's basis for contributed property, including preliminary determinations, such as the contributing partner's basis in the property;

(b) distributions from the partnership-

(i) the character of amounts transferred to a partner (i.e., whether it is a distribution, a loan, or the repayment of a loan),

(ii) the amount of money distributed to a partner,

(iii) the partnership's basis in property it distributes to a partner, and

(iv) the character of distributed partnership property (i.e., whether it is inventory or a capital asset); or

(c) transactions between the partnership and a partner who is not acting in a partner capacity-

(i) the amount the partnership transfers to a partner in a nonpartner capacity,

(ii) the character of the transferred amount (i.e., whether it is a loan, a principal payment, or an interest payment),

and

(iii) each partner's percentage interest in partnership capital and profits.

Contributions to the partnership, distributions from the partnership, and transactions between the partnership and a partner who is not acting in a partner capacity are partnership items to the extent that their proper treatment can be ascertained from determinations the partnership must make to keep its books and records or to provide information to its partners regarding an amount, the character of an amount, or a partner's percentage interest in the partnership. If the partnership is required to determine an amount, the amount is a partnership item, regardless of whether the partnership fulfills its responsibility (i.e., the partnership may fail to keep the required books and records).

The regulations illustrate partnership items as transactions whose treatment can be ascertained from determinations the partnership must make to keep its books and records or to furnish information to its partners.

(5) All accounting practices, and the legal and factual background that determines the amount, timing, and character of partnership income, credit, gain, loss, deduction, and other items. This category includes the partnership's method of accounting, tax year, and inventory method. Also included are determinations of whether the partnership made a particular election; whether partnership property is a capital asset, **IRC Section 1231, 26 USCS 1231** property, or inventory; whether an item is currently deductible or must be capitalized; whether the partnership engaged in an activity to make a profit under the hobby-loss rules of **IRC Section 183, 26 USCS 183**; and whether the partnership qualifies for the research and development credit under **IRC Section 30, 26 USCS 30**.

Practice Tip:

Revenue Ruling 2006-11, 2006-12 IRB 635, states that the tax treatment of an item on a consolidated return filed by an affiliated group is not a partnership item (nor an affected item) where the item concerned the parent corporation's payment to a partnership in which the parent is not a partner. This was true even though another member of the consolidated group is a partner in the partnership.

The ruling concerns a deduction for a payment made by the common parent of an affiliated group of corporations to a partnership in which a subsidiary of the parent is a partner. The payment was made to the partnership in the ordinary course of the parent corporation's business and not as an agent for the affiliated group. The partnership treated the payment as income for services it provided. The Service disallowed the deduction on the consolidated return, maintaining that the payment is actually a loan from the parent to the partnership.

The Service concluded that the deduction was not partnership item because the parent is not deemed a partner of the partnership for purposes of the partnership rules of Subchapter K. Thus, the manner in which the partnership characterizes the receipt of the payment is a separate item from, and does not affect the parent's characterization. Accordingly, the parent corporation's deduction for its payment to the partnership is not subject to the TEFRA partnership procedures.

Partnership penalty defenses. The procedural rules for partnership items also apply to any penalty, addition to tax, or additional amount relating to an adjustment to a partnership item. See **IRC Section 6221, 26 USCS 6221**. Accordingly, all partnership-level penalty defenses must be resolved during the partnership proceeding. However, a partner may raise any individual defenses regarding a penalty in a refund action following the partnership-level determination. For this purpose, partner-level defenses are limited to those that are personal to the partner or are dependent upon the partner's separate return, and cannot be determined at the partnership level.

The tax treatment of partnership items, including penalties, is determined through administrative and judicial proceedings at the partnership level. The regulations provide that partnership-level defenses to penalties attributable to partnership items must be raised in the partnership-level proceedings. If a penalty is imposed in a judicial proceeding, it is assessed and collected immediately after the litigation is final.

Under the regulations, a partner wishing to assert a partner-level defense to a penalty must pay the penalty and then initiate a separate refund action. Partner-level defenses are those that are personal to the partner or are dependent upon the partner's separate return and cannot be determined at the partnership level. Such defenses include assertions that the threshold amount for the underpayment of tax penalty under IRC Section 6662, 26 USCS 6662, has not been met or that taxpayer had a reasonable cause and acted in good faith with respect to an underpayment under IRC Section 6664(c) 26 USCS 6664(c).

Although taxpayers have challenged the regulations barring partner-level defenses at partnership-level proceedings, recent cases have upheld the validity of these rules. See *New Millennium v. Commr*, 111 TC No. 18 (2008); *Klamath Strategic Investment Fund v. US*, 568 F.3d 537 (5th Cir 2009).

Accordingly, it is necessary to distinguish partnership-level defenses that can be asserted in partnership proceedings from partner-level defenses that can be raised only in refund litigation following payment. Recent decisions by the Tax Court and Fifth Circuit provide some guidance.

The fact that the regulations list reasonable cause and good faith as examples of partner-level defenses does not mean that these defenses may never be considered at the partnership level. Several courts have held that the reasonable cause and good faith defense may be considered in partnership-level proceedings if presented on behalf of the partnership. For example, the Tax Court allowed a partnership to assert, at a partnership-level proceeding, that the partner who prepared the partnership return relied on professional advice. See *Santa Monica Pictures, LLC v. Commr*, T.C. Memo 2005-104. See also *Stobie Creek Investments, LLC v. US*, 82 Fed.Cl. 636 (2008). The defense was allowed because the partner was acting on behalf of the partnership in preparing the partnership return.

A district court allowed a similar partner-level defense where a partner received individual tax advice after leaving the partnership. The court concluded that the economic substance of the transaction and its reporting were not personal to the partner, dependent on the partner's separate return or could not be determined at the partnership level. The court maintained that reasonable cause may be considered in the partnership-level proceeding if the actions are taken by the managing member or partner. The Fifth Circuit affirmed the district courts holding, *Klamath Strategic Inv. Fund v. United States*, 472 F. Supp. 2d 885 (ED Tex. 2007), aff'd, 568 F.3d 537 (5th Cir. 2009), thus barring imposition of an accuracy-related penalty.

The Tax Court also has suggested that reasonable cause is a partner-level defense only where each partner's defense is unique. *Tigers Eye Trading LLC v. Commr*, TC Memo. 2009-121.

Accordingly, the court could review, at the partnership level, whether the tax opinion the partners relied upon was "inherently unreliable" because issued by a promoter of the transaction. The court reasoned that this issue was not personal to any partner.

It is important to note that the Court of Federal Claims has not allowed a reasonable cause defense by a non-managing member of an LLC. *Stobie Creek Investments, LLC v. US*, 82 Fed.Cl. 636 (2008).

The Claims Court maintains that the regulations clearly do not permit reasonable cause defenses at partnership-level proceedings, concluding that the Fifth Circuit and Tax Court holdings are "in error." *Clearmeadow Invs., LLC v. US*, 87 Fed.Cl. 509 (2009).

A Texas District Court, taking notice of the conflicting opinions in the Claims Court and Fifth Circuit, was bound to follow the Fifth Circuit's decision granting jurisdiction to consider the reasonable cause and good faith defense at a partnership-level proceeding. *Southgate Master Fund, LLC v. US*, 651 F Supp 2d 596 (ND Tex 2009).

Most recently, the Seventh Circuit has disagreed with the Court of Claims, holding that a partnership may raise its own reasonable cause defense, allowing a court to consider the conduct of its managing partner on behalf of the partnership. *American Boat Company, LLC v. US*, 583 F 3d 471 (7th Cir, 2009).

Thus, a partnership may raise a defense based on facts and circumstances common to all partners and which does not rely on an individual partner's tax return or conduct. The panel concluded that a court may consider whether a partnership, acting through its general partner, had reasonable cause for its tax position.

The IRS Chief Counsel maintains that penalties related to partnership items are determined at the partnership level, except for partner-level defenses such as the reasonable cause and good faith of the partners. CCA 200947040. A partnership's reasonable cause is determined at the partnership level, based on the reasonable cause of a manager or general partner who engaged in partnership transactions in a representative capacity.

RELATED LINKS: For more information, see

- LexisNexis Tax Advisor -- Federal Topical § 2D:15.01

For more information, see

- 2-15 Tax Planning for Partners, Partnerships, and LLCs § 15.01

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The Tax Treatment of Health Coverage for Children up to Age 26

2010 Emerging Issues 5032

The Tax Treatment of Health Coverage for Children up to Age 26

By Jayne Zanglein

May 14, 2010

SUMMARY: The Patient Protection and Affordable Care Act and the Health Care and Education Reconciliation Act include provisions that require health plans to extend coverage to children of employees up to age 26, regardless of whether the child is a dependent or a full-time student.

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ARTICLE: The Patient Protection and Affordable Care Act (PPACA) includes new provisions that require health plans to extend coverage to children of employees up to age 26 regardless of whether the child is a dependent or a full-time student. According to the Department of Labor, "The goal of this new policy is to cover as many young adults under the age of 26 as possible with the least burden. Plans and issuers that offer dependent coverage must offer coverage to enrollees' adult children until age 26, even if the young adult no longer lives with his or her parents, is not a dependent on a parent's tax return, or is no longer a student." DOL Fact Sheet on Young Adults and the Affordable Care Act: Protecting Young Adults and Eliminating Burdens on Families and Businesses, at <http://www.dol.gov/ebsa/newsroom/fsdependentcoverage.html>.

About 20% of the nation's uninsured are between ages 18 and 26. *Id.*

Notice 2010-38 (2010 IRB LEXIS 258)

On April 27, 2010, pursuant to the PPACA, the IRS issued *Notice 2010-38* to provide guidance on the tax treatment of coverage to children under age 27 (as of the end of the taxable year). Section 1001 of the PPACA requires health care plans that provide dependent coverage to children to extend such coverage to any employee's child until the child reaches age 26. The IRS has noted that there is some confusion as to the age-26 or 27-and explained that although plans must cover children up to age 26, "employers may exclude from the employee's income the value of any employer-provided health coverage for an employee's child for the entire taxable year the child turns 26 if the coverage continues until the end of the taxable year." Section 54.9815-2714T (Preamble) (see 26 CFR 54.9815-2714T).

IRC Section 105(b) (26 USCS 105) allows an employee to exclude from gross income employer-provided reimbursements made to the employee, either directly or indirectly, for medical care of the employee's dependent. The Health Care and Education Reconciliation Act of 2010, Section 1004(d), extended this exclusion to reimbursements

made on behalf of a child who has not reached age 27 by the end of the employee's taxable year. In other words, this means that "if a child turns 26 in March, but stays on the plan past December 31st (the end of most people's taxable year), the health benefits up to December 31st can be excluded for tax purposes." Regulation § 54.9815-2714T (Preamble) (26 CFR 54.9815-2714T). The employer may assume that the employee's taxable year is the calendar year and the employer may rely on the employee's representation as to the child's age.

Practice Tip:

IRC Section 152(f)(1) (26 USCS 152(f)(1)) defines a child as a son, daughter, step-son, step-daughter, adopted child, or eligible foster child. The exclusion from gross income also applies to children who are no longer dependents. It does not apply to grandchildren. Regulation Section 54.9815-2714T, at (c). (26 CFR 54.9815-2714T)

IRC Section 106 (26 USCS 106) allows an employee to exclude from gross income coverage provided by an employer-provided health plan. Proposed Treas. Reg. Section 1.106-1 provides that the exclusion applies to employer-provided coverage for the employee, spouse, and dependents, without regard to whether the children are dependents. The IRS plans to amend Regulation Section 1.106 (26 CFR 1.106) to provide that coverage for a child under age 27 is excludable from the employee's gross income, effective March 30, 2010. This will allow for parallel tax treatment under IRC Sections 105 and 106 (26 USCS 105 and 26 USCS 106)

Examples:

The PPACA allows an employee to exclude from gross income, health care coverage and reimbursements provided to a child under the age of 27, even if the child is not a dependent or is not a full-time student. The IRS provides the following example:

Employer X provides health care coverage for its employees and their spouses and dependents and for any employee's child (as defined in IRC Section 152(f)(1)) who has not attained age 26. For the 2010 taxable year, Employer X provides coverage to Employee A and to A's son, C. C will attain age 26 on November 15, 2010. During the 2010 taxable year, C is not a full-time student. C has never worked for Employer X. C is not a dependent of A because prior to the close of the 2010 taxable year C had attained age 19 (and was also not a student who had not attained age 24).

C is a child of A within the meaning of IRC Section 152(f)(1). Accordingly, and because C will not attain age 27 during the 2010 taxable year, the health care coverage and reimbursements provided to him under the terms of Employer X's plan are excludable from A's gross income under IRC Sections 106 and 105(b) for the period on and after March 30, 2010 through November 15, 2010 (when C attains age 26 and loses coverage under the terms of the plan).

Notice 2010-38, Example 1.

Another example illustrates that the exclusion is available to the employee, even if the child makes enough income to be self-sufficient:

Employer Y provides health care coverage for its employees and their spouses and dependents and for any employee's child (as defined in IRC Section 152(f)(1)) who has not attained age 27 as of the end of the taxable year. For the 2010 taxable year, Employer Y provides health care coverage to Employee E and to E's son, G. G will not attain age 27 until after the end of the 2010 taxable year. During the 2010 taxable year, G earns \$50,000 per year, and does not live with E. G has never worked for Employer Y. G is not eligible for health care coverage from his own employer. G is not a dependent of E because G does not live with E and E does not provide more than one half of his support.

G is a child of E within the meaning of § 26 USCS 152(f)(1). Accordingly, and because G will not attain age 27 during the 2010 taxable year, the health care coverage and reimbursements for G under Employer Y's plan are excludable from E's gross income under IRC Sections 106 and 105(b) for the period on and after March 30, 2010

through the end of the 2010 taxable year.

Notice 2010-38, Example 2.

The same result would occur even if the child's employer offers health care coverage and the child declines coverage or if the child is married. If the employee pays for coverage for the child's spouse, however, the fair market value of the spouse's coverage will be included in the employee's gross income. *Notice 2010-38, Example 3.*

The IRS also provides an example of the exclusion of income relating to health care coverage provided to a child who was previously excluded from the plan:

Employer Z provides health care coverage for its employees and their spouses and dependents. Effective May 1, 2010, Employer Z amends the health plan to provide coverage for any employee's child (as defined in IRC Section 152(f)(1)) who has not attained age 26. Employer Z provides coverage to Employee F and to F's son, K, for the 2010 taxable year. K will attain age 22 in 2010. During the 2010 taxable year, F provides more than one half of K's support. K lives with F and graduates from college on May 15, 2010 and thereafter is not a student. K has never worked for Employer Z. Prior to K's graduation from college, K is a dependent of F. Following graduation from college, K is no longer a dependent of F.

For the 2010 taxable year, the health care coverage and reimbursements provided to K under the terms of Employer Z's plan are excludible from F's gross income under IRC Sections 106 and 105(b). For the period through May 15, 2010, the reimbursements and coverage are excludible because K was a dependent of F. For the period on and after March 30, 2010, the coverage is excludible because K is a child of F within the meaning of IRC Section 152(f)(1) and because K will not attain age 27 during the 2010 taxable year. (Thus, for the period from March 30 through May 15, 2010, there are two bases for the exclusion.)

The revised tax provisions also apply to reimbursements from health flexible spending accounts and health reimbursement accounts. The IRS has clarified that a change-in-status event under IRC Section 125 will include changes to the number of an employee's dependents. Although Regulation Section 1.125-4(c) (26 CFR 1.125-4(c)) does not currently allow for election changes for children under 27 who are not dependents, the IRS plans to amend the regulation retroactively to include a change in status event affecting children not yet 27, "including becoming newly eligible for coverage or eligible for coverage beyond the date on which the child otherwise would have lost coverage." *Notice 2010-38.* Finally, health care coverage and reimbursements for children under age 27 are not considered wages for FICA or FUTA purposes. *Notice 2010-38.*

Interim Final Rules Issued May 7, 2010

The IRS, DOL, and the Department of Health and Human Services (HHS), issued Interim Final Rules for Group Health Plans and Health Insurance Issuers Relating to Dependent Coverage of Children to Age 26 under the PPACA on May 7, 2010.

In its interim regulation, Section 54.9815-2714T(a)(2) (26 CFR 54.9815-2714T(a)(2)), the IRS clarifies that for a calendar plan year, a child need only be covered until the day before the child turns 26. The IRS also clarifies that a plan cannot define dependent "other than in terms of a relationship between a child and the participant. Thus, for example, a plan or issuer may not deny or restrict coverage for a child who has not attained age 26 based on the presence or absence of the child's financial dependency (upon the participant or any other person), residency with the participant or with any other person, student status, employment, or any combination of those factors." The terms of the plan cannot vary based on age except for children over age 26. For example, a plan cannot charge higher premiums for children over age 18. A plan cannot limit children over age 18 to a HMO plan. *Id.* at (e), Example 3. A plan can continue to charge different premium rates for tiers such as "employee only", "employee plus spouse", "employee plus one child", or "employee plus two children", as such tiered rates apply regardless of the child's age.

The IRS provides transitional rules for children whose coverage ended prior to age 26. The plan must offer the child a written notice of the opportunity to enroll in the plan no later than the first day of the first plan year beginning on or after September 23, 2010. Coverage must begin no later than the first day of the first plan year beginning on or after September 30, 2010. The child must be "offered all the benefit packages available to similarly situated individuals who did not lose coverage by reason of cessation of dependent status."

According to the DOL, "Plans and issuers must give children who qualify an opportunity to enroll that continues for at least 30 days regardless of whether the plan or coverage offers an open enrollment period. This enrollment opportunity and a written notice must be provided not later than the first day of the first plan or policy year beginning on or after September 23, 2010. The new policy does not otherwise change the enrollment period or start of the plan or policy year." *DOL Fact Sheet*. The IRS provides the following example with respect to the enrollment opportunity notice:

Employer Y maintains a group health plan with a calendar year plan year. The plan has a single benefit package. For the 2010 plan year, the plan allows children of employees to be covered under the plan until age 19, or until age 23 for children who are full-time students. Individual B, an employee of Y, and Individual C, B's child and a full-time student, were enrolled in Y's group health plan at the beginning of the 2010 plan year. On June 10, 2010, C turns 23 years old and loses dependent coverage under Y's plan. On or before January 1, 2011, Y's group health plan gives B written notice that individuals who lost coverage by reason of ceasing to be a dependent before attainment of age 26 are eligible to enroll in the plan, and that individuals may request enrollment for such children through February 14, 2011 with enrollment effective retroactively to January 1, 2011. ...

In this example, the plan has provided an enrollment opportunity to C that lasts at least 30 days.

Practice Tip:

If the child is on COBRA coverage, the plan must provide the child with an opportunity to enroll in the plan other than as a COBRA qualified beneficiary.

To avoid a gap in coverage for recent college graduates, HHS has called on health insurance companies to comply with the law before the effective date. To date, more than 60 health insurers have agreed, including Blue Cross, WellPoint, Cigna, Aetna, and Humana. *DOL Fact Sheet*.

RELATED LINKS: For more information, see
 ■ LexisNexis Tax Advisor -- Federal Topical § 1A:10.02

For more information, see
 ■ 1-14 FEDERAL TAX GUIDEBOOK § 14.04

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Recent State Court Decisions Highlight Pitfalls in Classifying Business Income

2010 Emerging Issues 5028

Recent State Court Decisions Highlight Pitfalls in Classifying Business Income

By Cindy Hangartner

May 11, 2010

SUMMARY: A series of high profile state tax cases illustrate the pitfalls in determining whether income from isolated corporate transactions is properly classified as business or non-business income. These cases fail to provide tax practitioners with any reasonable guidance on the proper classification. The randomness created by these, and other equally perplexing court decisions, creates many potential pitfalls for the unwary.

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ARTICLE: The Due Process Clause and the Commerce Clause of the United States Constitution limit a state's ability to tax the multistate income of a nondomiciliary corporation by requiring "a minimal connection between the interstate activities and the taxing State." *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 772 (1992). In addition, there must be "a rational relation between the income attributed to the taxing State and the intrastate value of the corporate business." *Allied-Signal* at 772. States may not tax a nondomiciliary corporation's income if that income is derived from "unrelated business activity" that constitutes a "discrete business enterprise." *Allied-Signal* at 773. To determine when a State may tax a portion of the nondomiciliary corporation's income, the Supreme Court has developed the unitary business principle, inquiring whether the three factors - functional integration, centralization of management, and economies of scale - are present between the corporations. *Allied-Signal* at 781. Another relevant unitary business principle inquiry focuses on the objective characteristics of the asset's use and the relationship between the taxpayer and the taxpayer's activities within the taxing state, or, whether the asset serves an investment function or an operational function. *Allied Signal* at 785. However, whether the asset serves an "operational function" is not itself a ground for apportionment unless courts first find that the corporations are unitary. *MeadWestvaco Corporation v. Illinois Department of Revenue*, 553 U.S. 16 (2008).

In 1957, the National Conference of Commissioners on Uniform State Laws, recognizing the differing formulae states were using to tax income of multistate businesses and the inequitable results, adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA"). UDITPA defines "business income," which is apportionable in states where the entity conducts its business, as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." "Non-business income" is all income other than business income and is allocated to situs. Based on the two phrases within the business income definition, courts have generally determined whether income is apportionable business

income based on the so-called "transactional test" and "functional test." As noted in *Allied Signal*, the definitions of "business income" and "non-business income" may be, in the abstract, compatible with the Supreme Court's unitary business principle. *Allied Signal*, at 786. However, states' interpretations vary greatly when applying these definitions, especially when the capital gain or loss is attributable to the sale of a business. A series of high profile state corporate income tax cases illustrate the pitfalls present when determining whether income from isolated corporate transactions is properly classified as business or non-business income.

Illinois

Pursuant to Illinois' previous definition of "business income" and Illinois case law, a selling taxpayer's gain resulting from an IRC § 338(h)(10) election is designated as "non-business income" as a matter of law.

Illinois recognizes an IRC § 338(h)(10) election and treats "old target" and "new target" as two separate corporations for all purposes of the Illinois Income Tax Act. 86 Ill. Adm. Code 100.9750(b)(2)(B)(2010). Prior to July 30, 2004, Illinois defined "business income" as including both a transactional test and a functional test where the functional test applied to "income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." *Nicor, Inc. v. Illinois Department of Revenue*, No. 05 L 01306 (Cir. Ct. of Cook County, IL, 4/19/2007) citing 35 ILCS 5/1501(a)(1)(2002). In the *Nicor* case, Nicor, Inc. ("Nicor") had its principal place of business in Illinois and was the parent corporation of a group of affiliates engaged in exploring for and producing natural gas and oil. One affiliate, Nicor Oil and Gas Corporation ("NOGC") was a Delaware corporation that was domiciled in Colorado. NOGC owned all of the stock of Nicor Exploration and Production Company ("the Target"), which was also domiciled in Colorado and did not own property or conduct any business in Illinois. In 1993, NOGC sold all of its issued and outstanding stock in the Target to a South Carolina corporation. Jointly, NOGC and the South Carolina corporation made an IRC § 338(h)(10) election. Nicor then filed the combined Illinois corporate income and replacement tax return and reported the gain from the transaction as non-business income not allocable to Illinois. The Illinois Department of Revenue ("Department") audited Nicor and recharacterized the gain as apportionable business income in Illinois.

At the circuit court level, the parties stipulated that if Nicor's gain was non-business income, then none of the gain should be allocated to Illinois, but if the court determined that the gain was business income, then the gain would be apportionable in Illinois. The parties also agreed that the "functional test" within Illinois' definition of business income was determinative. The Cook County Circuit Court found that Nicor's gain was non-business income, primarily relying on *American States Insurance Company v. Hamer*, 352 Ill. App. 3d 521 (Ill. App. 2004), which also involved the sale of a subsidiary pursuant to an IRC § 338(h)(10) election. The *American States* court described the functional test as the keeping of corporate property and whether the property sold is an integral part of the taxpayer's trade or business. *American States* at 527. Previously, the Illinois Supreme Court, interpreting the functional test, had determined that the sale of pipeline was business income where the sale did not result in a liquidation or cessation of the business and the proceeds from the sale were invested back into the business rather than distributed to shareholders. *Texaco-Cities Service Pipeline Co. v. McGaw*, 182 Ill. 2d 262 (1998). Distinguishing *American States*' sale of a subsidiary pursuant to an IRC § 338(h)(10) election, the *American States* court found that the Department could not rely on *Texaco-Cities* and claim *American States* continued its business and, at the same time, recognize the § 338(h)(10) fiction whereby "old target" is liquidated and "new target" is deemed an unrelated entity. Therefore, the *American States* court held that *American States*' gain was properly treated as non-business income.

The *Nicor* circuit court, after reviewing *American States* and similar Illinois Appellate Court decisions, surmised that each of the cases had three distinguishing factors: the elements of liquidation, cessation of business operations, and distribution of proceeds to the shareholders. When these three factors have been met, Illinois courts have consistently characterized the proceeds as non-business income. Citing *American States*, the circuit court determined that applying the "liquidation exception" of the functional test to a § 338(h)(10) election results in a complete liquidation for both federal and Illinois income tax purposes. The fiction established by the § 338(h)(10) election contains all elements of

the exception and, therefore, the circuit court held that Nicor's gain was non-business income not allocable to Illinois.

The Illinois Appellate Court affirmed the circuit court decision. *Nicor Corporation v. The Illinois Department of Revenue*, No. 1-07-1359; 1-07-1591 (Ill. App., 12/05/2008). After reviewing the facts and applicable law, the appellate court determined that summary judgment in favor of Nicor was proper because Nicor was unable to recognize either a gain or loss on the sale of the Target's stock due to the § 338(h)(10) election and could only report the proceeds of the transaction as non-business income in Illinois. Similar to the circuit court, the appellate court stated that the Target's sale must be treated as a complete liquidation and cessation of business. In a footnote to the case, the appellate court went on to indicate that, had the Department not conceded a valid § 338(h)(10) election, the Department's argument regarding what Nicor did with the proceeds from the sale had merit. Given that the parties stipulated to a valid § 338(h)(10) election, the appellate court confirmed the *American States* decision and its holding that transactions pursuant to a § 338(h)(10) election result in non-business income as a matter of law. However, the appellate court noted that the Illinois legislature's amended definition of "business income" completely changes the analysis of transactions pursuant to a § 338(h)(10) election and the *Nicor* case will have no relevance for transactions occurring on or after July 30, 2004. *Nicor Corporation v. The Illinois Department of Revenue*, No. 1-07-1359; 1-07-1591 (Ill. App., 12/05/2008) (footnote 5).

Illinois' current definition of "business income" changes how corporations interpret the gain received from the sale of "old target" pursuant to a § 338(h)(10) election.

Effective July 30, 2004, the Illinois General Assembly amended the "business income" definition to include all income that is treated as apportionable income under the United States Constitution. 35 ILCS 5/1501(a)(1)(2010). As a result, the "functional test" utilized with the previous definition of "business income" no longer has relevance for § 338(h)(10) transactions occurring on or after July 30, 2004. *Nicor Corporation v. The Illinois Department of Revenue*, No. 1-07-1359; 1-07-1591 (Ill. App., 12/05/2008) (footnote 5). Although the United States Supreme Court has not decided any tax apportionment cases specifically involving a § 338(h)(10) election, other tax apportionment cases, such as *Allied Signal*, are instructive when considering whether the gain received on a stock sale pursuant to a § 338(h)(10) election should be characterized as business or non-business income.

Alabama

Alabama Supreme Court declares that sale of assets used in taxpayer's business was allocable non-business income.

In *Kimberly-Clark Corp. v. Department of Revenue*, Alabama Supreme Court, No. 1070925 (February 26, 2010), the Alabama Supreme Court held that the taxpayer's gain from the sale of a mill and timberland, both of which were located in Alabama, was an extraordinary transaction rather than a transaction in the ordinary course of the taxpayer's business, and therefore, the gain was not subject to apportionment.

In 1962, Kimberly-Clark Corp. ("Kimberly"), a company domiciled in Texas and primarily engaged in manufacturing and selling consumer paper and paper-related products, acquired the "Coosa properties," consisting of an Alabama pulp/paper mill and related timberlands. In 1996, the Coosa properties were transferred to KimberlyClark Worldwide ("KCW"), an entity formed by Kimberly to hold title to and manage Kimberly's domestic and foreign timberlands. In 1998, the Coosa properties were sold to an unrelated party for approximately \$600 million, with \$350 million going to KCW for the timberland, and \$250 million going to Kimberly for the mill. Kimberly and KCW characterized the gain from the sale as "business income" on their Alabama income tax returns.

The Alabama Department of Revenue ("ADOR") audited the taxpayer and proposed to tax the gain as non-business income which was solely allocable to Alabama. Upon appeal, the administrative law judge agreed with the taxpayer and reversed the decision of the ADOR. The trial court overruled the decision of the administrative law judge and upheld the tax assessment issued by the ADOR. After the Alabama Court of Civil Appeals reversed the trial court's decision, the case was appealed to the Alabama Supreme Court.

The ADOR argued that the holding of the appeals court conflicted with its prior decision in *Ex parte Uniroyal Tire Co.*, 779 So.2d 227 (Ala. 2000). In *Uniroyal*, the Alabama Court of Appeals defined the "transactional test" and the "functional test" and explained the differences between the two tests. The Court described the functional test deriving from the business income definition as the phrase "and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations ... Under the functional test, all gain from the disposition of a capital asset is considered business income if the asset disposed of was 'used by the taxpayer in its regular trade or business operations...' As noted by the Court, the transactional test derives from the first phrase in the business income definition and includes "earnings arising from transactions and activity in the regular course of the taxpayer's trade or business." Ultimately, the *Uniroyal* Court reasoned that "[t]he functional test may seem reasonable as a matter of tax policy, but it is hard to extract it from the language of the statute," and thus concluded that Alabama's statute embodies only the transactional test for determining what constitutes "business income."

In reviewing the court of appeals decision in favor of Kimberly and KCW, the Alabama Supreme Court declared that the Court of Civil Appeals put too much emphasis on the number of transactions other than the sale of the Coosa properties that occurred during and around the audit years, and too little emphasis on "the nature of the particular transaction giving rise to the income." (Citing *Uniroyal*, 779 So. 2d at 230.) It is difficult, the Supreme Court said, to conceive how the sale of properties that had been operated by the company as part of its business for 34 years and were sold because of a new corporate strategy could be said to be in the "regular course of business" for Kimberly. The Supreme Court stated that to label the gain from the sale of the properties as "business income," it would have to look past the undisputed facts that the sale of the properties was the companies' largest during the audit years, and ignore the reason for the sale, which was to drastically reduce internal pulp production in order to focus on other business lines. The sale of the properties was, the Supreme Court said, an extraordinary transaction, rather than a transaction conducted in the regular course of business. Accordingly, the Supreme Court held that the income from the sale of the properties cannot be categorized as business income under the state statute. The judgment of the court of appeals was reversed, and the case was remanded for the reinstatement of the trial court's order upholding the ADOR's final assessments.

Oregon

Oregon Tax Court explains that consistency in state corporate income tax characterization of a gain is a desirable policy but is not the law.

In *Oracle Corporation v. Dep't. of Revenue, State of Oregon*, Or. T.C., No. TC-MD 070762C (Feb. 11, 2010), the taxpayer, Oracle Corporation ("Oracle") realized gains from the sale of stock and other corporate assets. Such gains were reported in California and Oregon, both of which are Multistate Tax Compact ("MTC") states that have adopted the Uniform Division of Income for Tax Purposes Act ("UDITPA") "business income" definition. The overall purpose of MTC and UDITPA is to create uniformity in state taxation. When filing its return in California, Oracle's state of domicile, such gains were reported as business income while the same gains were reported as non-business income in Oregon. The result of such treatment was to allocate gains away from taxation in the case of Oregon and limit the amount of gains subject to California tax through apportionment.

The Oregon Department of Revenue ("ODOR") sought the creation of an equitable doctrine requiring uniformity in tax reporting positions among UDITPA states. In addition, Oregon acknowledged this would be "a decision of first impression in the UDITPA states." However, the court wisely declined the opportunity to fashion such a doctrine and, in rejecting ODOR's arguments, stated: "The court agrees that UDITPA is premised on a goal of uniformity, and that the Oregon Supreme Court has sanctioned consideration of uniformity in the cases cited by Defendant . . . However, aspirational goals and "consideration" of such goals represent matters of policy, not law."

The court concluded that the question of whether an item of income is business or non-business must be governed by Oregon law, not by some judicially declared doctrine that may pervert the law in a given situation. Further, the court noted that ruling for Oregon would require the court to become an expert in all of the other states' laws, compromise the

notion of state's rights, and reject the analysis of law as applied to the facts of a particular case. Given these hurdles, along with the decision to place the interpretation of Oregon's laws over setting new doctrines established through aspirational goals, the court rejected Oregon's arguments and ruled in favor of taxpayer.

Georgia

Georgia Supreme Court forces Georgia Department of Revenue to accept consequences of § 338(h)(10) election made by S Corporation.

The gain following an IRC § 338(h)(10) election was not subject to Georgia corporate income tax because the election was not recognized for Georgia income tax purposes. The Georgia Supreme Court ruled that, under Georgia's statute, Georgia recognizes only elections made by a taxpayer, and not elections made on behalf of the taxpayer. [*Trawick Construction Company, Inc. v. Georgia Department of Revenue*, 690 SE2d 601, 3/1/2010]

Trawick Construction Company, Inc. ("Trawick") was an S corporation doing business in Georgia, among other states, and had its principal place of business in Florida. For Georgia income tax purposes Trawick was treated as a C Corporation because Georgia's statute only recognizes S corporation elections if all stockholders are residents of the state or, if nonresidents, have consented to be subject to Georgia tax on their portion of the corporate income. As such, because Trawick's shareholders were nonresidents and had not consented to be subject to Georgia income tax, the S corporation was not recognized for Georgia income tax purposes.

Trawick's shareholders, together with Quanta Services, Inc., jointly made a § 338(h)(10) election resulting in Trawick's reporting of more than \$35 million of federal taxable income (§ 338(h)(10) gain plus income prior to the deemed asset sale) for the year of the transaction. Trawick took the position that the § 338(h)(10) gain, or approximately \$29 million of that amount, represented non-business income and allocated it to Florida. The Georgia Department of Revenue ("GDOR") argued that the income was apportionable business income and assessed additional tax. Trawick appealed the assessment to the Office of State Administrative Hearings. Trawick argued that the income was allocable non-business income and that Georgia was precluded from taxing the gain because the election was not recognized in Georgia. The Administrative Law Judge ("ALJ") held in favor of Trawick, but the Commissioner of GDOR exercised his right to refuse and did not acquiesce to the ALJ's decision. On appeal, the superior court agreed with the decision of the ALJ and concluded that the election was not recognized, and further concluded that any associated income was non-business income, which was properly allocated to Florida.

The Georgia Court of Appeals reversed the decision of the trial court, holding that the election was recognized for purposes of determining Georgia taxable income. The appellate court decided that the income was subject to apportionment as it was connected with Trawick's unitary business conducted in Georgia. Trawick appealed to the Georgia Supreme Court, arguing that the federal § 338(h)(10) election was inapplicable to the determination of Georgia corporate income tax because the applicable Georgia statute recognizes elections "made by corporate taxpayers under the Internal Revenue Code" except elections involving consolidated return corporations and Subchapter S elections. Trawick argued that because the federal § 338(h)(10) election cannot be "made by" a target company, but rather is "made for" the target company by its shareholders, the election is not recognized under Georgia law.

Ga. Code Ann. § 48-7-21(b)(7) provides that federal elections made by corporate taxpayers are recognized for purposes of computing Georgia taxable income. The Georgia Supreme Court, based on the literal meaning and structure of the statute, explained that because the statute contains the words "by corporate taxpayers," in order for the federal election to be applicable in the determination of Georgia corporate income tax, Trawick, as the Georgia taxpayer, would have had to be "the actual maker of the election or have possessed the authority to direct that the election be made." Contrary to the Court of Appeals assertion that "Trawick joined in making the election as a matter of fact," the Court explained that Trawick, as the target, did not make, nor could have made, the federal § 338(h)(10) election because such

elections can only be made by the seller and the buyer. Despite its contention that the IRC provides for numerous elections that can be made on behalf of a taxpayer, the GDOR failed to identify any elections, except for § 338(h)(10) elections, which are generally legally required to be made by entities other than the taxpayer.

Further, the Court explained that even if the construction of the statute is debatable, such construction is not contradictory or absurd and does not result in ill effects, as the GDOR contends. As the Court noted, it is not unreasonable for Georgia to forego the § 338(h)(10) election made by an S Corporation, when the State had consistently refused to recognize the taxpayer's original S corporation election. In refusing to recognize the original election, the State had benefited for years as Trawick consistently paid taxes on its entire net income. Therefore, because the legislature did not specifically define the phrase "by corporate taxpayers," the legislative background did not contain any reason to justify a departure from the plain meaning, and the plain meaning did not result in ill effects, the Court held that the Georgia statute only recognizes elections made by the corporate taxpayer. Since Trawick did not make the § 338(h)(10) election, but rather the election was made on its behalf by the S Corporation shareholders and Quanta Services, the election was not recognized under Georgia's statute. As such the Court held, without providing additional analysis, that the gain from the § 338(h)(10) election, or deemed sale of assets, recognized by Trawick on its federal income tax return did not constitute taxable income for Georgia corporate income tax purposes.

Conclusion

When read together these cases fail to provide tax practitioners with any reasonable guidance on the issue of whether gain from a particular transaction constitutes business or non-business income. While the rights of the states to establish and enforce their own income tax laws is a vital power, the randomness created by these, and other equally perplexing court decisions, creates many potential pitfalls for the unwary.

Practitioners need to take a more holistic approach to what otherwise appear to be narrow state tax law questions. For example, consideration should be given to the judicial forum in which potential litigation would be conducted. For example, do the issues presented in the case make the perceived familiarity and expertise of a tax court desirable, and, if so, is a tax court available or is the only available judicial forum a state court of general jurisdictions? Also, the appetite of the particular state department of revenue to aggressively assert contrary positions should be evaluated.

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n1 All references to "IRC" or "Code" are to the Internal Revenue Code of 1986, as amended.

n2 A discussion of the mechanics of the election under IRC § 338(h)(10) exceeds the scope of this article. For a more detailed discussion of the mechanics and impacts of the steps of a transaction involving an election under IRC § 338(h)(10), see **1-10 Tax Planning for Corporations and Shareholders § 10.03**

RELATED LINKS: See also

- [1-3 Bender's State Taxation: Principles and Practice § 3.07](#)

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Economic Substance and the Foreign Tax Credit Generator Regs

2010 Emerging Issues 4999

Rufus Rhoades on Economic Substance and the Foreign Tax Credit Generator Regulations

By Rufus Rhoades

April 29, 2010

SUMMARY: Rufus v. Rhoades, Esq., co-author of the treatise Rhoades & Langer, U.S. International Taxation and Tax Treaties, reviews the foreign tax credit generator regulations and new IRC Section 7701(o) codifying the "economic substance" doctrine.

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ARTICLE: In July 2008, Treasury issued Temp. Reg. Section 1.901-2T(e)(5)(iii) designed to shut down what has become known as the "foreign tax credit generator" transaction. In March 2010, Congress finally granted Treasury its wish and codified the "economic substance" doctrine. This Emerging Issues Analysis reviews those two items.

Foreign Tax Credit Generator Regulations

1. *Background.* Let's start with what a foreign tax credit generator is. Its purpose is to create for a U.S. taxpayer a foreign tax credit where none (or a smaller one) might otherwise be available. Under the plan, the FTC is increased without much change in the underlying structure.

Example. National Food Company ("the Parent"), a publicly held multinational, owns all of the shares of a French subsidiary, National Food SA ("SA"). In 2009, the Parent forms another foreign subsidiary ("SPV, SA"), also in France. National Food contributes \$1.5 billion to the capital of SPV which, in turn, loans that amount to SA in exchange for an 8 percent interest (a rate that we assume is arm's length) promissory note. National Food then sells the stock of SPV to Bank Paris, SA, a French bank that is unrelated to National Food, for \$1.5 billion, subject to the Parent's obligation to repurchase those shares in five years for \$1.5 billion (a "repo" agreement).

The repo agreement actually transfers ownership of the SPV stock to Bank Paris for French law purposes, but for U.S. purposes, the agreement is treated as a secured loan and the "sale" is disregarded. In 2010, SA pays SPV \$120 million in interest for which SPV pays France \$36 million in tax, and distributes the balance, \$84 million, to Bank Paris, as SPV's shareholder (at least it is the shareholder for French law purposes). Under French law, Bank Paris is not required to include the \$84 million in its income.

Under U.S. law, however, the stock of SPV is still owned by the Parent, so the \$84 million is treated as a dividend

to the Parent, carrying a \$36 million foreign tax credit with it.

Under those facts, National Food, in effect, borrowed \$1.5 billion from Bank Paris and paid the bank \$84 million in interest. That equates to an interest rate of 5.6 percent, when eight percent would be the normal arm's length rate. So, as a business purpose, National Food demonstrates that it was able to borrow funds from the bank at below market interest.

Treasury views that structure as inherently artificial and designed (or, as Treasury stated, "engineered") to generate foreign tax credits out of the whole cloth. Although the transaction might appear vulnerable to an attack based on the ever present "business purpose" or "economic substance" doctrine, Treasury chose not to attack the problem on that ground, even though *Compaq Computer Corp. v. Comm'r* [277 F.3d 778 (5th Cir 2001)], and *IES Industries, Inc. v. U.S.* [253 F.3d 350, 354 (8th Cir 2001)] both indicated that the economic substance doctrine is a viable doctrine in the foreign tax credit arena.

2. *The Temporary Regulations.* The folks at Treasury viewed that type of transaction as a threat to the fisc. Treasury views the transaction as artificial and the result has nothing to do with the basic purpose of the foreign tax credit, which is to alleviate double taxation on the same income. In Treasury's mind, the only question was how to shut the transaction down. The solution that Treasury chose was to expand the "voluntary" tax payment concept to fit the transaction, even though it might have tried to challenge on the economic substance doctrine. As you may recall, a payment to a foreign government that is voluntary is not an income tax. So, if the \$36 million of French tax that SPV paid in the foregoing example is treated as voluntary, then it would not be creditable.

Treasury labeled the transaction as a "structured passive investment arrangement" and stated that any transaction that fell within the scope of such an arrangement would strip the foreign tax of its foreign income tax character. The foreign tax would still be deductible; it just would not be creditable. A transaction that meets the following six conditions will be treated as a "structured passive investment arrangement" under Temp. Treas. Reg. § 1.901-2T(e)(5)(iii) (Jul 15, 2008):

1. *SPV.* The arrangement uses a "special purpose vehicle" ("SPV") (think "SPV" in the foregoing example).
2. *U.S. Party.* A U.S. party (think "National Food Company") is in a position to claim a foreign tax credit if the foreign payment the SPV makes is a foreign tax.
3. *Direct Investment.* That foreign payment is substantially greater than the amount of the foreign tax credits that the U.S. party would be expected to claim had the U.S. party directly owned the assets of the SPV.
4. *Foreign Tax Benefit.* The arrangement is expected to result in a material tax benefit in the foreign country for the counterparty.
5. *Unrelated Counterparty.* The arrangement involves a foreign person (a counterparty") who is a party subject to tax in the foreign jurisdiction and who owns an interest in the SPV (think "Bank Paris, SA").
6. *Inconsistent Treatment.* The U.S. and the foreign country treat some parts of the arrangement differently.

The facts in the example meet all six conditions, which are pretty narrow, so one wonders what Treasury's response will be to a fact pattern that does not fall within those six conditions.

While reading the temporary regulations, one might wonder if Treasury is not guilty of the same defect that the taxpayers who use the foreign tax credit generator device were - over-engineering. Why would it not be easier for both Treasury and taxpayers to have a regulation that simply adopts the "but for" test - that is, we look at a transaction and ask whether a reasonable businessman would have entered into the transaction but for the foreign tax credit benefit. If the answer is "no," then the taxpayer is denied the credit. [That statement is a variation on the "net" or "gross" argument.

See, *IES Industries, Inc. v. U.S. and Compaq Computer Corp. v. Comm'r* where the courts rejected the Government's litigation position that the business purpose doctrine analysis should be based on the transaction net of income tax.] As a regulation, rather than just a litigation position, that position would be difficult to refute.

Economic Substance Doctrine

1. *The Statute - Substance.* Historically, courts have struggled with what the "economic substance" doctrine is and when (or even if) it applies to a given fact pattern. Congress has now given all of us, courts included, some form of answer in IRC Section 7701(o), which was adopted as a part of the Reconciliation Act of 2010 (HR 4872).

As Congress struggled to craft that section, it also struggled with the concept. As written, the section only applies to transactions to which the doctrine is relevant. As the Joint Committee on Taxation stated [see 2010 TNT 55-23, Doc 2010-6147, Mar 21, 2010], the provision does not change present law standards in determining when to utilize the doctrine.

Once the court crosses the relevance bridge, the taxpayer must demonstrate that the transaction met two tests to avoid the conclusion that the transaction lacked economic substance: The transaction changed, in a meaningful way, the taxpayer's economic position (disregarding tax effects), and the taxpayer had a "substantial purpose" for entering into the transaction.[See IRC § 7701(o)(1).]

Transactions where profit is not a given - that is, the potential for profit is speculative -are subject to a special rule. Under that rule, a taxpayer's potential profit is to be taken into account only if the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected. Since the profit, by definition, is speculative, how a taxpayer is to make such a present worth calculation is unclear, to state the obvious.

2. *The Statute - Penalties.* A taxpayer who engages in a "noneconomic substance" transaction is looking at a penalty of 40 (!) percent on the underpayment attributable to the transaction *unless* the taxpayer discloses the relevant facts on its tax return. [See IRC § 6662(i).] The reasonable cause exception contained in IRC § 6664(c) is not to apply to a nondisclosed noneconomic substance penalty. [See IRC § 6664(c)(2).] So, even if the taxpayer were wholly reasonable in entering into the arrangement and in taking the position that the taxpayer took, the taxpayer may not use "reasonable" as a defense to a claim for penalties by the Service.

3. *Comment.* The section has the likelihood of creating havoc with a large number of transactions, not so much because they will not have economic substance but because the taxpayer and its advisors will not know whether the section applies to any particular transaction. It is all well and good for the Joint Committee to pontificate that the new law is not intended to alter the tax treatment of certain basic business transactions that, under long-standing judicial and administrative practice are respected, but, in reality, none of us knows what those basic transactions are.

What, for example, is the non-tax reason to create a foreign subsidiary? If challenged, can the taxpayer really argue that the economic substance doctrine is not relevant? How does one show relevance, since relevance, as beauty, is in the eye of the beholder? Once the Government is by that hurdle, the parent corporation will need to demonstrate that formation of the foreign subsidiary changes "in a meaningful way" the parent corporation's economic position (other than its income tax effects) *and* that the parent had a substantial purpose for creating the foreign subsidiary.

As with so many sections of the Code (think corporate inversions), Congress has created another rigmarole for taxpayers, with little, if any, corresponding benefit to Treasury (unless you view relieving Treasury lawyers of the task of demonstrating that a transaction did not have economic substance is a benefit).

Future of the Foreign Tax Credit Generator Regulations

The foreign tax credit generator transaction seems to fall squarely within the scope of IRC Section 7701(o). Taking

a look at the example that we set forth above, the likelihood is not high that National Food would be able to demonstrate that the economic substance doctrine is not relevant to any challenge by the Service. That would mean that National Food would need to demonstrate that (1) the transaction changed in a meaningful way National Food's economic position, and (2) National Food had a substantial purpose, apart from the federal income tax benefit of an unearned foreign tax credit, for entering into the transaction. The question would then be whether the lower interest rate would allow National Food to meet those two tests.

Note, however, that even before National Food reached that point in the audit process, National Food's auditors would be faced with the question of whether to describe the transaction in National Food's tax return and, if so, how should it be described?

New IRC Section 7701(o) may well have rendered the temporary regulations academic, in which case Treasury, in light of the limited scope of the regulations, should give some thought to withdrawing them.

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Foreign Account Tax Compliance: Problems and Complications

2010 Emerging Issues 4952

Shahzad A. Malik on Foreign Account Tax Compliance: Problems and Complications

By Shahzad Malik J.D. and LL.M.

April 8, 2010

SUMMARY: The Hiring Incentives to Restore Employment Act (H.R. 2847), Public Law 111-147, includes a version of the previously proposed Foreign Account Tax Compliance Act ("FATCA"). FATCA's purpose to combat offshore tax evasion through increased information reporting and tax withholding requirements is tempered by concerns about conflicts with tax treaties, onerous taxpayer burdens, administrative compliance, credit agreement problems, and other issues.

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ARTICLE: On March 18, 2010, President Obama signed into law H.R. 2847, the Hiring Incentives to Restore Employment Act, which includes a slightly modified version of the previously proposed Foreign Account Tax Compliance Act ("FATCA"). FATCA is intended to combat offshore tax evasion through increased information reporting and tax withholding requirements. FATCA is also intended to require foreign financial institutions ("FFI"s) to disclose significant information on their U.S.-based investors. FFIs are broadly defined to include private equity, venture capital funds, and hedge funds.

FATCA was introduced largely in response to high profile U.S. tax evaders, particularly at Union Bank of Switzerland (UBS), as well as in certain other foreign banks. In fact, in a news release introducing FATCA, Charles Rangel said, "I am confident that most banks will do the right thing and help to make bank secrecy a thing of the past."
n1

FATCA is similar to other legislation that has been enacted in direct response to high profile and egregious abuse. It is very broad, and could have significant and sometimes unintended and inappropriate impact on investors.

Many groups have raised concerns that FATCA might be a violation of U.S. obligations under existing tax treaties, or that it could raise the cost of capital in the United States by imposing onerous compliance burdens on FFIs investing in the United States. Moreover, it is not clear how certain aspects of FATCA could be complied with in a timely manner.

This article analyzes FATCA, setting forth certain potential problems, and offering suggestions of potential solutions to some unanswered questions. Generally, FATCA creates significant changes in five main areas: 1. FATCA

imposes a 30 percent withholding tax on withholdable payments made to FFIs and nonfinancial foreign entities that do not comply with the new information reporting obligations. For purposes of this analysis, "withholdable payments" includes dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income from U.S. sources, including gross proceeds from the sale of U.S.-based stocks and securities. 2. FATCA repeals the "foreign targeted obligation" exceptions to the sanctions imposed on bearer bonds (which include denying the portfolio interest exemption from withholding). Grandfathering of outstanding bearer bonds is very limited, which effectively precludes the sale of U.S. bearer bonds in the international capital markets. 3. Additional reporting requirements apply with respect to foreign financial assets, including equity investments in passive foreign investment companies. These reporting requirements would supplement existing foreign bank and financial account ("FBAR") reporting requirements, and are substantially similar to the currently elective qualified electing fund-reporting ("QEF") regime. 4. New reporting requirements and other rules apply to foreign trusts. 5. A new withholding tax will be imposed on dividend equivalent amounts received by foreign persons under financial contracts, including notional principal contracts and similar equity swaps. Analysis - Withholding Tax on Withholdable Payments to Foreign Financial Institutions (FFIs): This article focuses on the most significant of these changes: the 30 percent withholding tax on non-U.S. financial institutions that do not comply with the new information-reporting regime. The four other changes will be the subject of subsequent articles in this space.

This legislation applies to any payments made after December 31, 2012, subject to a grandfathering provision which exempts payments on, and the gross receipts from disposition of, obligations which are outstanding on March 18, 2010.

Unless certain information reporting requirements are satisfied, the proposed withholding regime requires a withholding agent to withhold a 30 percent tax on any withholdable payment made to a FFI. FATCA defines an FFI broadly to include any entity that: . Accepts deposits in the ordinary course of banking or similar business; . Is engaged in the business of holding financial assets for the account of others; and . Is engaged in the business of investing, reinvesting, or trading securities, partnership interests, commodities, or any interest in securities partnership interests, commodities (including futures, forwards, and options). Accordingly, the term "foreign financial institution" includes all investment vehicles such as hedge funds, private equity funds, venture capital funds, and securitization vehicles. FATCA also considers non-publicly traded debt or equity interest held in an FFI (i.e., stock or bonds issued by the bank itself) as a financial account that is subject to withholding and information reporting. Consequently, an FFI will be required to report information on U.S. persons that are either individuals or non-publicly held entities, and who either have financial accounts with the FFI or hold any non-publicly traded debt or equity interest of the FFI. These include U.S. shareholders of investment funds and holders of debt and equity issued by securitization vehicles.

Terms of Art Defined: For purposes of FATCA, a "**specified U.S. person**" is any U.S. person other than a corporation (the stock or shares of which is publicly traded), an affiliate of such a corporation, a bank, certain specified tax exempt organizations, a government entity or instrumentality thereof, state government or instrumentality thereof, a real estate investment trust, a regulated investment company, and certain specified trusts. It is noted that FATCA grants broad authority to the U.S. Treasury to exempt from withholding any class of investor it identifies as posing a "low risk of tax evasion."

"United States account" means any and all financial accounts held by one or more "specified U.S. persons" or a foreign entity with "substantial U.S. ownership." Deposit accounts are not treated as financial accounts for this purpose, but only if: (1) All account holders are natural persons; and (2) the aggregate valuable deposits, in whole or in part, held by such holder[s] do not exceed U.S. \$50,000.

"Substantial U.S. owner" means a specified U.S. person who holds a 10 percent or greater interest in a foreign entity, or, in the case of an investment entity, any ownership by such person. Therefore, an investment entity with even a single *de minimis* U.S. owner could cause an FFI to become subject to this reporting regime.

New IRC Provisions: FATCA creates a new chapter of the Internal Revenue Code, in that it will impose a 30

percent withholding tax either on a payment to an FFI of U.S. source income or on gross proceeds from the sale of its U.S. source dividends or interest. Accordingly, this withholding tax will apply to all withholdable payments made by account holders of the FFI (including on assets held for the institution's own account and not merely withholdable payments attributable to a U.S. person).

Information Reporting Agreements or 30 Percent Withholding: Dual withholding will not be required under either the provisions of FATCA or under current rules applicable to U.S. source payments. However, non-U.S. person account holders of the FFI who would otherwise be permitted to obtain tax treaty benefits with respect to a payment of U.S. source income will not be entitled to treaty benefits with respect to this new 30 percent withholding tax. This withholding tax will only be avoided if the FFI enters into an agreement (an "**information reporting agreement**") with the U.S. Treasury.

Information reporting agreements will require FFIs to:

- (1) Obtain information from the account holder to determine whether the account is a "United States account";
- (2) Comply with verifications and due diligence rules relating to the identification of United States accounts;
- (3) Report information annually on their United States accounts;
- (4) Comply with the requests from the United States government that the FFI provide information on such United States accounts;
- (5) Obtain waivers of local and foreign laws relating to privacy from the owner of such United States accounts; or
- (6) If waivers are not obtainable, to close such accounts. n2

The U.S. Treasury may still make a determination that the information reporting agreement requirements by a foreign financial institution have not been fully satisfied and that the FFI is therefore subject to the 30 percent withholding tax. It is unclear at this point whether the 30 percent withholding tax will apply merely because the FFI is not in technical compliance or whether some gross noncompliance is required. The Act does seem to address this issue by requiring that an FFI should withhold from payments to recalcitrant account holders (or to have withheld a corresponding amount from its applicable payment).

A "recalcitrant" account holder is an account holder that fails to comply with reasonable requests for information pursuant to IRS mandated verification and due diligence procedures. However, the Joint Committee Technical Explanation of the Tax Extenders Act (which contained the previously proposed version of FATCA) notes, that "it is anticipated that the Secretary may require, under the terms of the agreement, that the foreign financial institution achieve certain levels of reporting and make reasonable attempts to acquire the information necessary." It is not clear whether this premise is carried through in the enacted legislation and an FFI may not be able to enter into a withholding agreement, despite its best efforts or desires, if it has too many recalcitrant account holders.

Information Reporting Agreement - Impact Analysis: In effect, and as written, these rules seem to require that FFIs provide the IRS with account statements relating to a U.S. account. At the same time, these rules create an economic compulsion; that is, applying a 30 percent gross withholding tax upon any foreign financial institution with U.S. source investments if it does not enter into an information reporting agreement.

As an alternative, FFIs may elect to undertake information reporting as if they themselves were U.S. financial institutions and subject to certain modifications (i.e., reporting payments on IRS Form 1099). Under this election, an FFI would provide a report on each account holder that has been determined to be a specified U.S. person or a U.S. owned foreign entity (as though the holder of the account were a natural person and citizen of the United States). As a result, both U.S. and foreign source amounts, including gross proceeds, would be subject to reporting under this

election, regardless of whether those amounts are paid within the U.S.

Certain FFI's Deemed to Meet Reporting Requirements: The Act provides two procedures for FFIs to avoid having to enter into an IRS Agreement because the FFI does not have U.S. accounts.

1. Comply with IRS prescribed procedures with respect to other accounts of FFIs maintained at that FFI.
2. The FFI is a member of a class of institutions with respect to which the IRS has determined that the application of the agreement/withholding provisions is not necessary. Potential Problems and Uncertainties Regarding the Regime

Identifying "Specified U.S. Persons"

At this point, the provisions of FATCA are unclear as to how an FFI is to determine whether someone is a specified U.S. person. The Joint Committee Report on Taxation Technical Explanation (the "Joint Committee Report")ⁿ³ suggests that the FFI should generally rely on certified documents.

FATCA specifies that due diligence and verification rules will be detailed in future rules and regulations. The Joint Committee Report states that these anticipated rules and regulations would be based on the "know your customer" standards for identifying U.S. persons, including indirect account holders that are followed in the anti-money laundering context.ⁿ⁴

It is unclear how feasible it is to require FFIs to obtain tax certifications from its global client base of non-U.S. customers that are not investing in U.S. securities. Moreover, in cases where a payment passes through multiple financial intermediaries on its way to the beneficial owner, it is very difficult to fully determine each party's obligations or to identify the beneficial owner.

This is still very broad legislation and it may be very difficult for a global financial institution to obtain certifications from its global investor base that may not have invested in U.S. securities at all. It would seem unduly harsh to call these account holders "recalcitrant" for not wanting to report to the IRS when they have no U.S. nexus.

Should the FFI withhold on the non-complying investor?

Presumably, an FFI would withhold from its withholdable payments to any account holder that fails to provide the required identifying information. Agreements with such account holders may need to be revised to address this additional potential withholding.

FATCA does not require withholding on payments to noncomplying depositors or other creditors because such payments would not be U.S. sourced and would have no necessary relationship to withholdable payments received by the FFI. It is unclear when non-compliance by such depositors could result in a disqualification of the FFI from the information reporting agreement standards.

The Tax Extenders Act requires FFIs to withhold from payments to such holder's foreign accounts (or the financial institution may elect to have withheld a corresponding amount from its applicable payment.). Further analysis is needed regarding the scope of this withholding obligation and will be discussed in a subsequent piece.

Redundant reporting in fund-to-fund or tiered investment context

The compliance burden under the provisions of FATCA will be very difficult for fund-to-fund investments. Each FFI that owns an interest in another FFI will be required to enter into an agreement with the IRS. Otherwise withholdable payments to any FFI in the chain will be subject to withholding. This could result in multiple redundant levels of information reporting agreements and certifications for each stream of payments.

This system could prove impractical in many contexts where an FFI simply does not have information about the

next tier of information reporting. For example, note issuers who sell their notes to investors generally have no direct contact with the investor, and likely will not be able to provide the required identification information. This identification information likely will be available only to the broker-dealers. Requiring the issuing note holder to report this information would be redundant if the broker-dealers are supplying the same information.

As a practical and policy matter and to avoid redundant reporting, it would make sense to create an exception from withholding in the case of an FFI that itself has an information reporting agreement in place. The Tax Extenders Act may address this issue because, as discussed above, it permits an FFI to elect to let another FFI that has an information reporting agreement in place with the IRS, withhold on it. It may be possible for lower tier FFI's to comply by electing to let the higher tier U.S. withholding agent or other FFI withhold on its behalf. This is not clear under current legislation.

Refund procedure limited to amounts beneficially owned by foreign financial institutions

FATCA provides a refund procedure under which foreign financial institutions will be able to claim the benefit of any applicable income tax treaty benefits to the extent that the 30 percent withholding tax is applied to payments beneficially owned by that financial institution. However, there is no similar refund procedure available for non-U.S. persons who are clients of such financial institutions and subject to the withholding tax. It appears from the provisions of FATCA that such account holders could lose the benefits of such tax treaty.

As discussed below, this is likely a violation of the existing applicable tax treaties. It is noted that the Joint Committee specifically states that this procedure is consistent with existing applicable tax treaties without providing a specific answer as to how. It appears that one of the purposes of this provision is to coerce non-U.S. financial institutions to enter into an information reporting agreement by denying the investors in such institutions the benefit of treaties.

Potential Issues in Typical Credit Agreements

Credit agreements typically contain a gross-up provision. This requires the debtor to gross up for withholding taxes, the payment of which is required in respect of such amounts. Well-drafted and well-negotiated credit agreements typically contain an exception to the gross-up for withholding taxes as a result of the lender's failure to provide information that it is reasonably able to provide. It is not clear how such provisions would apply in situations where the FFI enters into an information reporting agreement to avoid the 30 percent withholding tax. Such an agreement would subject the FFI to onerous reporting burdens that it had not contemplated.

Typical provisions were drafted in contemplation of the FFI supplying a Form W-8BEN or comparable certification of reduced treaty-withholding rate and did not intend for the FFI to undertake onerous compliance burdens to avoid the withholding. Depending upon the precise wording of the language in a credit agreement, it may be possible to push the withholding tax or the compliance burden onto the FFI, or, alternatively, force the U.S. borrower to bear a 30 percent gross-up.

It is almost certain that the next generation of credit agreements will specifically address and contemplate this issue. At present, borrowers and lenders would be well advised to review and parse the relevant provisions of their respective existing credit agreements. Policy Issues with FATCA

Treaty Override Issues

FATCA imposes broad compliance obligations regarding worldwide investors of every FFI receiving any U.S. source payments. This is especially arduous in the case of private equity funds, hedge funds, and securitization vehicles, which, unlike traditionally financial institutions, do not have elaborate compliance systems and staff in place. This additional compliance burden could cause many of these institutions to elect not to invest in the United States or at least place the U.S. markets at a competitive disadvantage for capital to financial markets that do not require such additional

costly compliance burdens. As a result, the cost of capital in the United States could rise.

FATCA overrides the reduced rate of withholding in many U.S. tax treaties. The U.S. treaties in place now typically have various objective tests to determine whether a foreign person is a "qualified resident." FATCA adds new information reporting that is not presently written into the existing treaties. Where FATCA conflicts with existing treaties, FATCA will be the applicable U.S. law in view of enactment later than the respective treaties. As noted above, results of FATCA's provisions could be especially harsh where investors of an FFI are denied treaty benefits because the FFI has not entered into an information reporting agreement with the IRS. Treaty overrides may adversely affect future treaty negotiations and may result in reciprocal overrides by foreign governments. It would seem more appropriate to consult with treaty partners and not unilaterally enact such broad and sweeping legislation. It is noted that the Joint Committee Technical Explanation indicates that FATCA is "consistent" with existing U.S. obligations under existing income tax treaties, because it allows foreign entities subject to withholding under FATCA to apply for a refund of the tax withheld.

Unless the Joint Committee is suggesting that the FFI account holders may obtain treaty benefits where the FFI does not enter into an information exchange agreement, this statement appears incorrect. This interpretation is not evidenced by the language of FATCA itself.

Potential Issues with Synthetic Securities

It is noted that foreign (or dishonest U.S.) investors wishing to invest in the U.S. markets could seemingly do so through a derivative that was denominated in U.S. dollars but was foreign source income. This could occur, where, for example, a U.S. or foreign investor enters into a notional principal contract or other synthetic security with a foreign bank. The foreign bank could then hedge itself by investing in comparable underlying U.S. securities. It does not seem like the foreign bank would need to report information regarding the foreign (or U.S) investor because they are merely counterparties to a financial contract.

Although both FATCA and the Tax Extenders Act contain provisions that treat dividend equivalent equity swap amounts as "withholdable payments," these provisions would only seem to pick up swaps between a U.S. party and an FFI and not a swap between a FFI and a foreign person, merely because it is based upon U.S. economic indicators. There would appear to be no practical way to withhold on payments between two wholly foreign parties unless the provision is interpreted broadly enough to treat the "hedging investment" by the FFI in U.S. securities as a direct payment to the swap counterparty (subject to withholding) and not as a payment to an FFI (which can presumably discharge its obligations under either FATCA or the Tax Extenders Act by reporting that it has no U.S. holders). It may be appropriate to address this potential loophole with additional legislation, although it is debatable whether something that is merely indexed to U.S. economic indicators should be U.S.-sourced, under even the most ambitious definitions of U.S. tax enforcement.

Low Risk of Tax Evasion

Given the broad scope of FATCA, the U.S. Treasury might find it appropriate to narrow the categories of investors where there is a "low risk of tax evasion." While the issue requires further study and more rigorous analysis, potential categories may include investors from treaty partner countries with substantial rates of taxation that do not have bank secrecy legislation. Conclusion

While FATCA is aimed to address the laudable goal of increasing U.S. tax compliance, it may be too broad in its scope. FATCA could substantially increase the compliance cost of foreign financial institutions, including smaller private equity and hedge funds investing in the United States.

FATCA is likely a violation of existing U.S. tax treaty obligations and could impair future treaty negotiations, or even result in countervailing measures by foreign countries. More importantly, it could raise the cost of capital in the United States at a particularly delicate time for the economy. It is advisable to address these issues through more

rigorous analysis.

While the enacted version of FATCA narrowed some of the withholding provisions, it still imposes an onerous compliance burden on foreign financial institutions and raises the same issues regarding tax treaty violations. Fortunately, FATCA does not go into effect until December 31, 2012, giving the U.S. time to address these issues with treaty partners and for financial institutions to address the compliance issues. While FATCA is a step in the right direction, further analysis and modifications are needed to balance the goals of legitimate tax law enforcement with legitimate international investment.

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n1 United States Congress news release dated October 27, 2009.

n2 See Joint Committee on Taxation, *Technical Explanation of the "Foreign Account Tax Compliance Act of 2009"* (JCX-42-09), October 27, 2009. Explanation at p.17.

n3 Joint Committee Report at p.17.

n4 Joint Committee Report at p. 18.

RELATED LINKS: See Patricia Hughes Mills' commentary on the Hiring Incentives to Restore Employment Act:

■ [New Jobs Bill's Tax Provisions Favor Employers](#)

See relevant authority and insight on H.R. 2847:

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The UK's New Code of Tax Practice for the Banking Sector

2010 Emerging Issues 4947

Dialani on UK's New Code of Tax Practice for the Banking Sector: Will It Hamper Banking in the UK?

By Jyoti Dialani

April 7, 2010

SUMMARY: In 2009 the UK's HMRC proposed a new code of tax practice for banks operating in the country with a view to streamline tax planning activities resulting in tax savings to their customers but revenue losses for Treasury. We examine the Code, perceived as damaging to the UK as it brings a competitive disadvantage to domestic and foreign banks operating within the country, and whether its sanctions will encourage banks to adopt it voluntarily.

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ARTICLE: The UK's Tax Department, HM Revenue and Customs (HMRC), had proposed a new Code of Tax Practice (the Code) for the banking sector in the UK in June 2009. Following the announcement of the proposal to introduce the Code, HMRC published a consultation inviting responses by September 2009 on the new Code for banks, setting forth the new sets of rules and regulations for compliance by banks operating within the UK. The timing of this proposal by HMRC is significant in view of the enormous rescue package amounts awarded to salvage the loss-sustaining banks from bankruptcy which seemed a very strong possibility in the wake of the Lehman Brothers crash last year. The costs of rescuing these banks which were running into billions of pounds have been heavily borne by the taxpayers in the country. The banking industry has effectively been saved by the significant support from taxpayers.

This new Code for the banking industry is not mandatorily imposed on the banks but is voluntary, and those banks that wish to adopt the code have to accept and sign up for it and adopt it in their internal working systems. However, though announced as a voluntary initiative, those banks which do not adopt it in their working systems will be subjected to a higher degree of scrutiny from HMRC and the Financial Services Authority (FSA). HMRC is also in talks with the FSA to declare the senior officials and responsible persons in the banks who do not adopt the Code as not "fit and proper" persons. Besides the letter of the tax law, the Code directs banks to also observe the spirit of the law. Effectively, banks are subject to a web of rules that have never been imposed on any other industry or sector by practically making them responsible to determine the Parliament's intent and then to take steps to follow that rather than merely following the written law as enacted by the Parliament. In a nutshell, the banks are expected to refrain from designing or structuring transactions which lead to minimizing or reducing the tax liability. Further, all kinds of financial products or schemes which contribute towards minimizing their clients' tax liabilities must not be developed or promoted by the banks. The overall sentiment among the banking industry and tax professionals is that this new measure by HMRC will work to the detriment of the competitiveness of banks in the UK. Other industries and

professions will not be affected by this new Code, leaving the door very much open to tax planning and schemes to reduce tax liabilities. It is of relevance to note that banks operating outside the UK do not come within the purview of the new rules. As a natural consequence, the focus will shift to the banks outside the UK, thus reducing the competitiveness of the UK on the global map compared to the banks in other countries. The Code and rules and regulations introduced through it for banks are examined in detail below.

The Code of Tax Practice for the UK Banking Sector

HMRC in the UK had published the draft Code for the banking sector on June 29, 2009, following the announcement of that year's budget. The aim of this Code is to bring about a change in the entire perspectives and attitudes of the banks which is directed towards devising methods or structuring transactions in such a way that they minimize the tax liabilities and also advise their clients about reducing their tax burdens. The Code seeks to encourage the banks to operate in a manner that makes them responsible for ensuring that they do not encourage or advise their clients to enter into any deals which are aimed at tax avoidance. Effectively, it is almost placing the banks in a position of stepping into the shoes of the taxman as a part of discharging their official banking duties.

Will the Code transform banks into HMRC watchdogs?

The global financial crisis which was fuelled by the deficiencies in the banking policies and regulatory framework has triggered an anti-bankers sentiment largely in the UK and the United States. Banks are in a position where they have a unique advantage in terms of influencing their clients' financial and investment decisions based on their tax minimizing or avoidance schemes and transactions through their various complex financial products.

Banks are in an extremely vital position as far as the tax office is concerned because of the following reasons: (1) they can plan their own transactions in a manner that they can avoid or minimize their own tax liabilities; (2) they are also in a position where they can advise and influence their clients in the course of their official duties and discharge of financial services which are very crucial to the resulting overall tax liabilities, some of which can be used for tax avoidance, and many of the products or schemes sold to their clients can bring about huge benefits to them in terms of large tax savings; and (3) banks, having access to capital, can assist their clients in delivering plans or transactions which invariably lead to tax avoidance through schemes and plans designed and effected by third parties.

Essentially, the Code casts new and serious responsibilities on all banks operating in the UK participating in the scheme by accepting the Code, adopting and adhering to the new framework of rules and guidelines, and changing behavior patterns as far as any prospective or potential tax avoidance possibilities are concerned. This Code is not made applicable to any other industry and, in fact, the Code even goes a step further. In its initiative to increase transparencies in its working arrangement with banks, the Code also encourages them to hold discussions with HMRC prior to finalizing any transaction regarding the tax aspects and probable risks involved, as well as matters concerning any reports to professional organizations responsible for regulating the executive who is the signatory of the Code on behalf of the bank. Essentially, the Code seeks to raise the standards of working patterns of the banks so that they take an active part in helping the tax authorities eliminate the possibility of their clients taking advantage of loopholes in the tax laws in the course of their duties, and also to actively discourage or refrain them from implementing any tax avoidance strategies in their planning. It also imposes upon the banks as a part of their responsibilities to make reports to professional bodies governing the activities of any director of any bank who is a signatory to the Code for the bank.

Background

The Code is aimed at encouraging banks as well as large business enterprises to develop an open and transparent relationship with HMRC as it is the key to establishing long-term good governance as well as increasing accountability of top level executives of these business houses in relation to tax matters. This is a natural consequence of the post-recession cautionary approach to avoid a similar failure of regulatory mechanisms governing the banking and financial industry in general. The purpose of establishing clear and frank communication channels with HMRC is to

iron out any uncertainties faced by the banks adopting the Code through a method of one-on-one discussion with HMRC. However, there is no mention of the probability of situations where HMRC and the banks do not reach an agreement. In such situations, the absence of a mechanism similar to that of an "appeal" in the normal course of justice, poses serious questions as to the consequences of HMRC handing out solutions or suggestions that are unacceptable to the taxpayer in question. Also, although being publicized as a voluntary scheme, in essence, the banks in the UK really have very little say in exercising a so-called choice in not adopting the Code. The details and fine points of the Code are dealt with below.

Highlights of the Code

HMRC has laid down the following vital points as a part of the Code:

Scope and Applicability

The Code is applicable and can be adopted by all banks and other organizations engaged in banking activities operating within the UK.

Who should sign the Code?

The Code is required to be signed by a senior executive of the organization, preferably at a Director level. By adopting the Code, the bank or financial institution gives a commitment to apply the requirements and operations of the Code to all their transactions including those with their subsidiaries and group companies.

Which business sectors will be affected by the introduction of this Code?

The Code will directly affect all banking and similar businesses, their subsidiaries and their branches, operating in the UK.

Governance and compliance

The Code mandates upon the banks to adopt the requirements in an internal working policy which documents the taxation issues affected by their business transactions and also a streamlined governance process which brings out a comprehensive compliance policy. The banks are required to have a documented plan and strategy for compliance of tax issues. With clear and detailed policy guidelines, the Code is expected to turn the existing relations between HMRC and business enterprises to one that is more open, professional and transparent. A senior executive or a person who is at board level in the company will be held accountable for the governance and compliances arising out of the rules laid down in this Code.

Tax planning and tax avoidance

The Code leaves no ambiguity to declare that any action or behavior of the banks to take advantage of the tax laws with an ultimate intention of avoiding or mitigating tax liabilities by interpreting the legislations or provisions of the law which were not originally intended as such by the Tax Code will be declared as unacceptable patterns of behavior. It aims at providing assistance to boards and helping them determine the limits within which tax planning can be legitimately carried out. By this process, it aims at lending clearer insight to the accountable persons as to whether the nature of the transaction or activity is such that it leads to tax avoidance or reduces the tax liability to an extent which would never have been the Parliament's intent. Since tax planning in any commercial transaction is inevitable, it does form a crucial part of any business decision. Moreover, the banking industry plays with large amounts of money but with extremely low profit margins, leading to a very delicate line between profits or losses, and sometimes a small difference can result in huge profits or losses as well. However, although against tax planning, the Code does acknowledge that efficient and genuine tax planning in certain transactions is important and hence does not discard it as totally prohibitive or illegal. At the same time, the Code is clear in declaring that in the garb of tax planning any action

by the banks which is in essence a method of using loopholes in tax legislations and interpretations of the tax laws in a manner which is of advantage to itself or its customers and a disadvantage to the government in terms of loss of tax revenues, will not be considered acceptable behavior.

Scope of the Code

The Code outlines situations where the banks will be obliged to follow the guidelines:

- Transactions where the bank is involved in the role of a principal.
- Transactions where the bank is not the principal but is a facilitator of services or advice to its clients without being involved as a participator.
- Where the bank plays the role of an employer in its relationship with its employees.

Bank as principal

In transactions where the bank is the principal, the Code states that the tax results must be consistent with and must reflect the true economic picture. The tax liability in such situations must be directly proportionate to the profits arising out of such transactions.

Bank as facilitator

In transactions where the bank acts as a facilitator or acts as a service provider to its customers, the Code mandates upon the bank to adhere to certain standards and refrain from actively promoting strategies, which may result in any kind of avoidance or mitigation of tax, which is contrary to the Parliament's intent. The Code also provides that by adopting the Code, the banks undertake to not promote schemes to their clients which result in tax avoidance. In such situations, if banks are not actively promoting such schemes but merely facilitating them by rendering services to their customers, it would not be construed as a violation of the Code.

Bank as employer

The Code directs that the bank, in its role as an employer, follow the requirements of the policies imposed by the government for all employers and employees to pay the correct amount of tax as well as their employees' National Insurance contributions on the rewards of employment.

"Signposts" / Indicators of tax avoidance transactions

The Code has outlined the following features or "signposts" which can be considered to be indicative of transactions which are unacceptable due to the resulting avoidance of tax:

- Transactions characterized by little or no economic substance;
- Transactions resulting in little or no pre-tax profit which rely on anticipated tax reduction for significant post-tax profit;
- Transactions reflecting inconsistencies in substance between legal form or the accounting treatment and the economic substance; or between the tax treatment for different parties or entities; or between the tax treatment in different jurisdictions;
- Transactions involving contrived artificial, transitory, preordained or commercially unnecessary steps. This will include, for example, a combination or a package of options intended to generate a tax loss without any economic loss, and
- Transactions or arrangements where income, gains, expenditure or losses are not proportionate to the economic activity taking place or disproportionate to the actual value generated to the business in the country. This will typically include all such transactions of transfer of ownership of an income from a UK company into an associated offshore vehicle in a tax haven.

The UK Government has also acknowledged the presence of certain situations where the UK tax law may depart

from the underlying economics. In such situations, the Code mandates that the tax results must not be contrary to what was intended by the Parliament. However, in situations where the bank is unable to easily determine the Parliament's intent, the Code has provided for businesses to discuss their proposed transactions in advance with HMRC. However, the final decision on the transaction and how it will take place will rest with the bank concerned and the bank in turn must also have a full report ready to support its course of action.

Relationship between the Bank and HMRC

The Code also provides for methods to open up channels of communication between the Banks and HMRC in an effort to bring about transparency and form a constructive relationship based on mutual trust. In its effort to improve relations, the Code further clarifies that the banks must initiate a frank dialogue with HMRC, particularly in situations where it is crucial for them to understand the Parliament's intent.

Vital ingredients of the relationship between Banks and HMRC

To strengthen their relationship with HMRC, banks are encouraged to discuss their issues with the Client Relationship Manager at HMRC.

Certain crucial requirements which are distinctive in terms of the relationship between the banks and HMRC are:

- The business fully discloses issues that HMRC would want to know about and might want to discuss;
- Both the business and HMRC focus on significant issues, using resources where there is risk;
- Discussions often occur in real time;
- The tone of the relationship is positive and professional, and
- The business and HMRC work together to resolve any issues quickly.

Typically, this will encourage the development of mutual trust between the business and the Client Relationship Manager team.

Implementation and Enforcement

During the consultation period, HMRC had met with banks individually to discuss the Code. This dialogue process will continue until after the Code has been adopted, with the HMRC stating that it will use the Code as an integral part of its risk assessment and relationship management with each of the banks.

Currently, there are well established lines of communication, both at the sector level through regular discussions with the main banking organizations and at the individual bank level. Also, the introduction of the Customer Relationship Manager (CRM) in the HMRC has enabled strong relationships to be created. Although the open dialogue and clear communication channels have helped HMRC in its understanding of the banking business, the Code also acknowledges the fact that banks will have a better grip over their own business. In this perspective, the Code places responsibility for governance on the board (or other senior party) which will be ultimately responsible to form a view and make decisions accordingly, bearing in mind that they will be accountable for their decisions.

Annual risk review by the CRM

As per the Code for compliance purposes, the CRM for each bank must carry out an annual risk review. Through this review, the CRM aims to examine whether the bank has complied with the Code. During such examination, the CRM will raise issues with the bank that arose and whether they were resolved. Specifically, the CRM will test whether the bank had made any efforts to raise any significant uncertainties with HMRC at an appropriate time for the CRM to be satisfied that the bank is applying the required degrees of transparency and disclosure. The Code further declares that those banks not adopting the Code will be subject to a greater degree of scrutiny from HMRC. Regarding banks which are not compliant or with which HMRC has doubts regarding their compliance issues, HMRC will raise the issue with the board of the bank. In certain cases, where suitable, HMRC will raise its concerns with the senior non-executive. If

there is a deliberate failure of compliance and the officer of the bank is a signatory to the Code for adoption and is a member of a professional body, HMRC may also make a report to that body.

In situations where banks are found to be indulging in inappropriate or wrongful behavior and if such patterns of behavior continue, the government will consider further steps to reinforce the Code, such as (1) requiring banks to disclose in their accounts the extent to which they have complied with the Code, and /or (2) requiring an audit of a bank's compliance with the Code.

Conclusion

The banking industry in the UK has not taken kindly to the government's new approach to deal with the post-financial crisis criticism blamed largely on the banking sector. Professional and accounting bodies have also come down heavily in terms of criticizing the Code, warning that the proposals threaten to undermine the rule of law in taxation. In their response to invitations from HMRC to the consultation process before implementing the Code, the professional organizations have voiced serious concerns regarding the Code, which is described by many as "The Fiscal Magna Carta." In principle, there is a strong sentiment by banking and tax professionals that the Code has an overriding impact over the tax statutes in the UK. Besides opposing the very Code in its essence and intentions, the various tax experts are concerned about the ability of HMRC to police the Code. The main fears are that what is not taxed by the legislation or statute will nevertheless be taxed by the Code, and this possibility surely goes against the rule of law. It is also felt that the tax legislations and the Tax Code must be reconciled so that there are no inconsistencies in the governing laws and the intentions of the Parliament on tax need not be interpreted or left open to debate. If the tax statutes do not clearly reflect the Parliament's intent, the law ought to be amended to lend greater clarity. In modern times, tax systems are expected to be clear, certain and supported by well-drafted statutes. Also, since the Code is being publicized as being voluntary in nature, the fact that it also clearly states that those not adopting it would be subjected to a greater degree of scrutiny by HMRC destroys the very claim it makes. It is only fair that if HMRC has proclaimed the Code to be voluntary in nature, there must also be equal responsibilities cast on HMRC to actually implement the tax systems in accordance with the Parliament's intent rather than imposing harsh consequences on those who do not adopt the Code.

The concept of following the "*spirit of the law as against the letter of the law*" by deciphering and interpreting the Parliament's intent is the toughest part expected by this Code. The Parliament's intentions are being judged, debated and argued upon relentlessly in scores of litigations across courtrooms. The fact that HMRC expects the banks to approach their officers or representatives to seek guidance to understand the Parliament regarding their tax liabilities weighs more in favor of the Treasury and not the taxpayer banks. Further, the obligation cast on the banks to determine and ensure proper payment of tax and National Insurance contributions payments by their employees will significantly impact the payment and reward systems for their employees. The only visible benefit to those banks which adopt the Code and show a greater degree of compliance to it seems to be a lesser degree of scrutiny on these banks by HMRC.

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New Jobs Bill's Tax Provisions Favor Employers

2010 Emerging Issues 4909

Hiring Incentives to Restore Employment Act (H.R. 2847) Driving Employment Recovery

By Patricia Hughes Mills J.D. and LL.M.

March 17, 2010

SUMMARY: Hiring Incentives to Restore Employment Act ("HIRE" Act) tax provisions include a payroll tax holiday for employees hired in 2010, along with an employer tax credit if those employees are retained for a year. HIRE also increases business assets that may be expensed for 2010, expands the Build America bonds program, and imposes a 30 percent withholding tax on foreign financial institutions not in compliance with prescribed reporting requirements.

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ARTICLE: The Hiring Incentives to Restore Employment Act (referred to as the "HIRE" Act, or as the "Jobs Bill"), n1 contains several tax provisions. One set of provisions is designed to encourage employers to hire unemployed workers by creating a payroll tax holiday for employees hired in 2010, along with an employer tax credit if those employees are retained for a year. HIRE also increases the amount of business assets that may be expensed for 2010, expands the Build America bonds program, and imposes a 30 percent tax withholding requirement on broadly defined foreign financial institutions that are not in compliance with new reporting obligations about U.S.-based account holders.

Payroll Tax Forgiveness

The employer-paid Old-Age, Survivors, and Disability Insurance tax of 6.2 percent on wages (the "OASDI tax," part of the "FICA" or "Social Security" tax) is a significant cost to employers. The Jobs Bill provides relief from the employer share of the OASDI tax, and essentially exempts employers from paying the 6.2 percent Social Security tax on certain new employees from the date of enactment through 2010. n2 This payroll tax forgiveness is available for all non-governmental employers. n3 The provision applies to wages paid after the date of enactment n4 and ending on December 31, 2010. The key to this benefit is that the worker must be a "qualified individual," which is defined as an individual who:

(1) begins work for a qualified employer after February 3, 2010 and before January 1, 2011;

(2) certifies by signed affidavit (under penalties of perjury) that he or she was employed for a total of 40 hours or less during the 60-day period ending on the date such employment begins;

(3) is not being employed to replace another employee unless such employee separated from service voluntarily or for cause; and

(4) is not a party related to the employer. n5

This provision is elective, in that employers can choose to pay their share of the OASDI tax if they wish. Why would an employer not want to take advantage of this payroll tax forgiveness? If an employer takes advantage of the payroll tax forgiveness, then the employer is not entitled to receive the work opportunity tax credit (WOTC) on those wages for a one-year period beginning on the hiring date of that individual. The WOTC n6 is part of the general business credits available under *IRC* § 38, and is available for employers who hire members of certain groups, such as veterans, those receiving food stamps or other public assistance, and other targeted groups. The work opportunity credit is equal to 40 percent of the first \$6,000 of wages paid to employees who are members of the targeted groups. The WOTC provides a credit against income, but is subject to limitations, in combination with other business credits. Thus, employers need to determine which available tax benefit - the payroll tax forgiveness or the work opportunity credit - produces the most favorable result.

The net benefit to the employer of this payroll tax holiday will depend on the employer's tax bracket, since the payroll taxes are deductible business expenses. Thus, for an employee making less than the Social Security maximum wage base, n7 an employer in a 35 percent tax bracket will save a cost of approximately 4 percent of the employee's wages under this provision (6.2 percent x 35 percent).

Since the estimated cost of this provision is \$13 billion, in order not to impact the Social Security fund, the new law provides that the Federal Old-Age and Survivors Trust Fund and the Federal Disability Insurance Trust Fund will receive transfers from the General Fund of the United States Treasury equal to the reduction in payroll taxes as a result of this provision. n8

The Jobs Bill does not apply the payroll tax holiday for wages paid during the first calendar quarter of 2010. However, the amount of the OASDI that would have been reduced under the payroll tax holiday provision during the first calendar quarter shall be treated as a payment of OASDI tax for that employer's second calendar quarter. The HIRE Act permits a similar payroll tax holiday for railroad retirement purposes that parallels the OASDI holiday rules for other employers.

Tax Credit for Retaining Workers

Current law provides for several types of business tax credits. n9 Under the Jobs Bill, employers who hire workers eligible for the payroll tax forgiveness and retain them for a minimum period will be entitled to a general business credit, which is \$1,000 for each retained worker or 6.2 percent of wages paid to the retained worker during the prescribed 52-week period. n10 This applies to those workers who qualified for the payroll tax forgiveness described above if those workers:

- are employed during the taxable year;
- continue to be employed by that employer for at least 52 consecutive weeks; and
- do not have a substantial decline in compensation during the last half of that period. n11

This credit may not be carried back to taxable years prior to the date of enactment. n12 Thus, the credit will benefit the employer's 2011 return, since it applies only to workers hired in 2010, who must remain employed for 52 weeks.

Additional Expensing of Business Property

IRC § 179 allows certain taxpayers to elect to currently deduct (or "expense") the cost of qualifying property n13, rather than take depreciation deductions on the property over time. For 2009, the limit on the amount that could be expensed under *IRC § 179* was \$250,000. For 2010, however, as in effect prior to the enactment of HIRE, the amount that a taxpayer was allowed to currently expense was scheduled to be \$125,000. n14 That amount is further scheduled to be reduced to \$25,000 for 2011.

The Jobs Bill provision increases for one year the amount that may be expensed under *IRC § 179* to \$250,000, thus maintaining the 2009 levels. This provision is only for years beginning after 2009 and before 2011. The \$250,000 amount is reduced, but not below zero, by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$800,000. Thus, the Jobs Bill essentially continues the amount that was allowed to be expensed in 2009 through 2010. Note that *IRC § 179* applies to a business's tax year rather than the calendar year - that is, the new limits will apply to tax years beginning in 2010.

Making the Build America Bonds Available for Tax Credit Bonds

The American Recovery and Reinvestment Act of 2009 introduced the Build America Bonds, n15 authorized under *IRC § 54AA*, allowing state and local governments to borrow at lower costs. Build America Bonds are government bonds, the interest on which is subsidized by the federal government by means of a tax credit to the holder, or, in certain cases, by a direct payment to the issuer. Qualified Tax Credit Bonds, authorized under *IRC § 54A*, generally are not interest-bearing obligations, but rather provide the holder a tax credit, and include clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds, and qualified school construction bonds. n16

The HIRE Act expands the Build America Bond model by making it available to other qualified Tax Credit Bonds. The legislation will allow issuers of Tax Credit Bonds to treat bonds issued after the date of enactment as Build America Bonds, thus qualifying for direct subsidy. n17 The Bill also makes certain changes to the tax credit bond provisions.

Offset Provisions: Foreign Account Reporting, Payments to Foreign Financial Institutions and Foreign Entities

The HIRE Act imposes a 30 percent withholding tax on withholdable payments made to broadly defined foreign financial institutions and non-financial foreign entities that do not comply with new information reporting obligations about U.S. account holders. "Withholdable payments" includes dividends, rents, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodic gains, profits, and income from U.S. sources.

Provisions from the Foreign Account Tax Compliance Act (FATCA), conceived in 2009, are included in H.R. 2847 in order to help pay for \$13 billion in HIRE Act employment incentives.

FFIs subject to the 30 percent tax withholding requirement are broadly defined, and generally apply to payments after December 31, 2012. To avoid the withholding requirement, FFIs must identify U.S. account assets and ownership to the IRS. Foreign corporations must identify principals who own more than 10 percent of the enterprise.

Separately, other FATCA provisions -- with different effective dates -- also impose tax penalties on: understatements related to undisclosed foreign assets (40 percent); U.S. taxpayers who do not report on their annual returns offshore account assets that exceed \$50,000; and bearer bonds sold to offshore investors.

In addition, FATCA elements include, but are not limited to: failure-to-file penalties on certain foreign trust related information returns; a filing requirement for passive foreign investment company shareholders; a statute of limitations

period extension to six years for omissions that exceed \$5,000 and 25 percent of income earned from offshore assets; and an electronic withholding tax filing requirement.

What's Missing?

What's not included in the current Jobs Bill is an extension of many tax provisions which expired at the end of 2009, including, among others, the additional standard deduction for real property taxes, the state and local sales tax deduction, the deduction of environmental remediation costs and qualified leasehold improvements, and credits for biodiesel and renewable diesel fuel. However, on March 10, the Senate passed H.R. 4213, the "American Workers, State, and Business Relief Act," which reinstates and extends through 2010 a number of tax provisions that expired at the end of 2009. This bill will have to be reconciled with the version of H.R. 4213 passed by the House in December as the "Extenders Act of 2009."

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n1 SA 3310 to H.R. 2847.

n2 HIRE Act § 101. The employer remains responsible for the Medicare Hospital Insurance amount of 1.45 percent of covered wages.

n3 For these purposes, a qualified employer, eligible for the payroll tax relief, includes public higher educational institutions. *IRC § 3111(d)(2)(B)*, as amended by HIRE Act § 101(a).

n4 March 18, 2010.

n5 *IRC § 3111(d)(3)*, as amended by HIRE Act § 101(a).

n6 *IRC § 51*.

n7 For 2010, \$106,800.

n8 HIRE Act § 101(c).

n9 IRC § 38.

n10 HIRE Act § 102.

n11 The employee must receive wages during the second 26 weeks of that 52-week period that are at least 80 percent of the wages earned during the first 26 weeks. HIRE Act § 102(b).

n12 HIRE Act § 102(c). The general business credit of IRC § 38, of which this new credit will be a part, can generally be carried back one year, to the extent the credit exceeds the current year's tax liability. IRC § 39(a)(1).

n13 Qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. IRC § 179(d)(1).

n14 IRC § 179 generally allowed a deduction for up to \$125,000 for qualified property purchased in taxable years after 2006 and before 2011, with inflation adjustments, but this limitation was increased for 2008 and 2009 as part of the Economic Stimulus Act of 2008, P.L. 110-185 § 102(a), and the American Recovery and Reinvestment Act of 2009, P.L. § 111-5, § 1202(a)(1). Thus, for 2008 and 2009, the § 179 amount was \$250,000, but was scheduled to return back to the \$125,000 in 2010.

n15 IRC § 54AA, added by P.L. 111-5, § 1531(a).

n16 See IRC § 54A.

n17 HIRE Act § 301.

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Disclosure Requirements for "Groupings" Under the Passive Activity Rule

2010 Emerging Issues 4904

Consistency and Disclosure Requirements for "Groupings" Under the Passive Activity Rule: Revenue Procedure 2010-13

By Jerry Paulukonis

March 15, 2010

SUMMARY: Revenue Procedure 2010-13 changed requirements for disclosure for "grouping" activities for purposes of the passive loss rules. It also provides alternative relief for untimely filing of required disclosures. The Revenue Procedure requires taxpayers to report to the IRS their groupings and regroupings of activities, and the addition of specific activities within their existing groupings for purposes of IRC Section 469 and Reg. Section 1.469-4.

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ARTICLE: The cornerstone for the proper application of the passive activity rules is the determination of what constitutes an "activity." The determination of an activity is critical because virtually every passive activity rule is applied on an activity-by-activity basis: (1) material, active, and significant participation by a taxpayer is based upon the degree of involvement in the activity; (2) passive income or loss is measured with respect to the specific activity; (3) disposition of the activity may trigger suspended losses; (4) the passive activity limitations are applied separately with respect to each passive activity in which a taxpayer owns an interest.

Taxpayers may group multiple activities to constitute a single economic unit for the measurement of gain or loss for purposes of *IRC Section 469*. By doing so, activities within the single economic unit can be treated as a single activity under *IRC Section 469*. Taxpayers have significant leeway in making groupings, and may use any reasonable method of applying relevant facts and circumstances in grouping activities to do so.

A taxpayer who has grouped activities generally may not regroup them in later taxable years. In the event of a material change in relevant facts and circumstances, or if it is later determined that the original grouping was clearly inappropriate, the taxpayer not only may, but must, regroup the affected activities and comply with any disclosure requirement prescribed by the IRS. (The IRS, however, always has power to regroup activities in order to prevent tax avoidance.)

Revenue Procedure 2010-13 has changed requirements concerning disclosure for grouping activities, and provides alternative relief for untimely filing of the required disclosures. The Revenue Procedure requires taxpayers to report to the IRS their groupings and regroupings of activities, and the addition of specific activities within their existing groupings of activities for purposes of Section 469 and Reg. Section 1.469-4.

Taxpayers must report to the IRS their groupings and regroupings of activities and the addition of specific activities within their groupings. The required disclosures must be made with the return for the tax year in which the changes occur. n1 The disclosure requirements vary, depending on the type of change. Special rules apply for groupings by partnerships and S corporations. n2 Failure to make a proper disclosure may result in each trade or business activity or rental activity being treated as a separate activity for purposes of applying the passive activity loss and credit limitation rules. n3

Statement Required for New Groupings

If there is a new grouping of activities, the taxpayer must file a written statement with its original income tax return for the first taxable year in which two or more trade or business activities or rental activities are originally grouped as a single activity. The statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business activities or rental activities that are being grouped as a single activity. In addition, any statement reporting a new grouping of two or more trade or business activities or rental activities as a single activity must contain a declaration that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of *IRC Section 469*. n4

NOTE: No disclosure or statement needs to be filed if an activity within a particular grouping is disposed of. Although a prior notice indicated that disclosure might be required in this circumstance, *Revenue Procedure 2010-13* dropped the requirement. n5

Statement Required for Addition of New Activities to Existing Groupings

A taxpayer who adds a new trade or business activity or a rental activity to an existing grouping for a taxable year must file a written statement with the taxpayer's original income tax return for that taxable year. The statement must identify the names, addresses, and employer identification numbers, if applicable, for the new trade or business activity or rental activity that is being added to the existing grouping, as well as the names, addresses, and employer identification numbers, if applicable, for the activity or activities within the existing grouping. In addition, the statement reporting an addition to an existing grouping must contain a declaration that the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of *IRC Section 469*. n6

Statement Required for Regroupings

If it is determined that the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities. n7 If such a determination and regrouping is made, the taxpayer must file a written statement with the taxpayer's original income tax return for the taxable year in which the trade or business activities or rental activities are regrouped. The statement must identify the names, addresses, and employer identification numbers, if applicable, for the trade or business or rental activities that are being regrouped. If two or more activities are regrouped into a single activity, the statement reporting a regrouping must also contain a declaration that the regrouped activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of *IRC Section 469*. Furthermore, the statement reporting a regrouping must contain an explanation of why the taxpayer's original grouping was determined to be clearly inappropriate or the nature of the material change in the facts and circumstances that makes the original grouping clearly inappropriate. n8

Special Rules for Groupings by Partnerships and S Corporations

Partnerships and S corporations are not subject to the disclosure requirements mentioned above. Instead, they must comply with the disclosure instructions for grouping activities provided for on Form 1065, U.S. Return of Partnership Income and Form 1120S, U.S. Income Tax Return for an S Corporation, respectively. Generally, compliance with the applicable form requires disclosing the entity's groupings to the partner or shareholder by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the entity's annual Schedule K-1. A partner or shareholder who does any of the following, however, is required to make a separate disclosure of the groupings disclosed by the entity as described above: n9 (1) groups together any of the activities that the entity does not group together; (2) groups the entity's activities with activities conducted directly by the partner or shareholder; or (3) groups the entity's activities with activities conducted through other entities.

NOTE: A shareholder or partner may not treat activities grouped together by a C corporation, S corporation, or partnership as separate activities. n10

Disclosure With Respect to Pre-Existing Groupings

A taxpayer is not required to file a written statement reporting the grouping of the trade or business activities and rental activities that have been made for tax years beginning before January 25, 2010 (pre-existing groupings) until the taxpayer makes a change to the grouping as described above. n11

Effect of Failure to Report

If a taxpayer is engaged in two or more trade or business activities or rental activities and fails to report whether the activities have been grouped as a single activity in accordance with *Revenue Procedure 2010-13*, then each trade or business activity or rental activity will be treated as a separate activity for purposes of applying the passive activity loss and credit limitation rules. Notwithstanding the previous sentence, a timely disclosure will be deemed made by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer. If the failure to disclose is first discovered by the IRS, however, the taxpayer must also have reasonable cause for not making the required disclosures. n12

NOTE: Although the above "default" rule will generally result in unreported activities being treated as separate activities, the IRS may still regroup a taxpayer's activities to prevent tax avoidance. n13 Furthermore, because *Revenue Procedure 2010-13* provides alternative relief for untimely filing of the required disclosures, administrative extensions for relief for untimely disclosures are not available. n14

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n1 *Rev Proc 2010-13, 2010-4 IRB 329*, effective for tax years beginning on or after 1/25/10 [*Rev Proc 2010-13, 2010-4 IRB 329*, § 5].

n2 *Rev Proc 2010-13, 2010-4 IRB 329*, § 4.05.

n3 *Rev Proc 2010-13, 2010-4 IRB 329*, § 4.07.

n4 *Rev Proc 2010-13, 2010-4 IRB 329, § 4.02.*

n5 *Rev Proc 2010-13, 2010-4 IRB 329; see Notice 2008-64, 2008-31 IRB 268.*

n6 *Rev Proc 2010-13, 2010-4 IRB 329, § 4.03.*

n7 *Reg § 1.469-4(e)(2).*

n8 *Rev Proc 2010-13, 2010-4 IRB 329, § 4.04.*

n9 *Rev Proc 2010-13, 2010-4 IRB 329, § 4.05.*

n10 *Treas Reg § 1.469-4(d)(5)(i).*

n11 *Rev Proc 2010-13, 2010-4 IRB 329, § 4.06.*

n12 *Rev Proc 2010-13, 2010-4 IRB 329, § 4.07.*

n13 *Reg § 1.469-4(f).*

n14 *Rev Proc 2010-13, 2010-4 IRB 329, § 4.07; Treas Reg § 301.9100-1(d)(2).*

RELATED LINKS: For more information, see

■ LexisNexis Tax Advisor -- Federal Topical 1D:26.01

For more information, see

■ 1-4 FEDERAL TAX GUIDEBOOK 4.05

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Announcement 2010-9 Introduces New Tax Reporting Transparency Standards

2010 Emerging Issues 4903

Announcement 2010-9: A New IRS Approach to Transparency for Uncertain Tax Positions

By Shahzad Malik J.D. and LL.M.

March 9, 2010

SUMMARY: IRS *Announcement 2010-9* advances uncertain tax position reporting requirements under standards broader than Financial Accounting Standards Board Interpretation No. 48 (FIN 48) parameters. Affected taxpayers are concerned that the Schedule required with annual return filings could create a roadmap for audits and cause them to reveal otherwise privileged information about advice of counsel regarding the strength of a specific tax position.

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ARTICLE: On January 26, 2010, the Internal Revenue Service published *Announcement 2010-9* ("2010-9") which addresses the proposed reporting requirements with respect to uncertain tax positions of certain business taxpayers. According to 2010-9, the IRS is in the process of developing a schedule (the "Schedule"), which must be filed with the annual U.S. tax returns of such taxpayers, in which such taxpayers would disclose their uncertain tax positions. The Schedule is almost certainly broader than what is required by Financial Accounting Standards Board ("FASB") Interpretation No. 48 Accounting for Uncertainty in Income Taxes, an Interpretation of FASB Statement No. 109 ("FIN 48"). Under 2010-9 standards, disclosure is required for certain uncertain tax positions for which no reserve is required to be recorded because it is expected that the taxpayer will litigate the position or because the taxpayer has determined that the IRS has a general administrative practice not to examine the position. Taxpayers are understandably concerned that the Schedule could create a roadmap for audits and could require them to reveal otherwise privileged information about advice of counsel regarding the strength of a specific position.

This article will examine 2010-9 in its historical context, analyze its requirements, and address uncertainties.

Taxpayers Affected by 2010-9

2010-9 applies to "business taxpayers" (presumably including all corporations, and some LLCs and partnerships) with assets in excess of \$10 million that have taken at least one "uncertain tax position" of a type required be disclosed. This *includes* (but is not limited to) taxpayers who prepare financial statements. 2010-9 standards also apply to taxpayers that are included in the financial statements of a related entity that prepares financial statements if that taxpayer or related entity determines that it must have a U.S. federal income tax reserve under FIN 48 or other accounting standards relating to uncertain tax positions involving U.S. tax law.

It would appear, for example, that this would pick up a U.S. subsidiary (with \$10 million in assets) of a foreign parent corporation that is required to prepare financial statements under foreign generally accepted accounting principles and would be required to take a tax reserve for its U.S. tax position under such foreign accounting standard.

"Uncertain tax position"

2010-9 does not precisely define "uncertain tax position." It makes clear that an "uncertain tax position" *includes* disclosure of U.S. federal income tax positions that are included in a tax reserve that the taxpayer is required to establish for accounting purposes under FIN 48 or other generally accepted accounting standards. It is noted that there are potential differences in accounting standards between different international jurisdictions. For example, the parent company of a U.S. company could be subject to lesser or greater accounting standard scrutiny in its home country, resulting in inconsistency of disclosure. For example, the current United Kingdom ("UK") accounting standards only require disclosure of matters that have a main purpose of securing UK tax advantages (i.e., tax shelters). By contrast, Canada has tax disclosure requirements similar to FIN 48. It may be appropriate for the IRS to study different accounting standards in order to define the scope of disclosure more precisely. A survey of these differing accounting standards is beyond the scope of this article. This article, therefore, will limit its focus to the FIN 48 standard as applied to 2010-9.

FIN 48 imposes restrictions on corporate taxpayers' ability to recognize uncertain tax benefits and requires reserves and disclosure in financial statements for uncertain tax benefits. Under FIN 48, corporations are required to determine whether it is more likely than not that their tax position can be sustained under an IRS examination or by tax courts, based on the technical merits of the position. Tax positions that meet this threshold may be recognized in the corporation's financial statements. The value of the tax benefit is the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon ultimate resolution and settlement with the IRS. Tax positions that do not meet the 50 percent criterion may not be recognized as tax benefits (and interest and penalties must be accrued as a reserve on the financial statements).

Tax practitioners frequently have been called upon to give "more likely than not" opinions or opinions expressing greater levels of certainty on tax positions taken for purposes of assuaging auditor concerns in a FIN 48 context. Taxpayers receiving such opinions do not generally establish a reserve. 2010-9, however, goes further than FIN 48 by defining "uncertain tax positions" to *include* any position related to which the taxpayer has not established a tax reserve because the taxpayer has determined that it expects to litigate the position. 2010-9 does not make clear whether a taxpayer would be required to disclose such a position if the taxpayer has received a "should" or even a "will" opinion on such an issue from a tax advisor that the taxpayer will prevail in litigation. If so, it would appear that the 2010-9 standard could be significantly broader than FIN 48.

It is further noted that 2010-9 does state that it "includes" FIN 48 disclosures and litigated positions described above. Are there circumstances where 2010-9 could be interpreted as picking up additional disclosure? This would seem like an extremely unwarranted result, where a taxpayer has received a "will" opinion on a matter from a tax advisor or has otherwise reached that level of comfort on an issue, because such a standard implies that the taxpayer has reached a level of confidence that is beyond a reasonable doubt.

However, suppose that a taxpayer's level of comfort is at a "should" level, implying that the taxpayer is significantly more confident than a "more likely than not" standard requires, but that there is still some doubt of the position. In this instance, is it possible that 2010-9 could be interpreted as requiring disclosure of such a position?

IRS Chief Counsel William Wilkins, in recent comments to the District of Columbia Bar Taxation Section meetingⁿ¹ suggested that the new schedule would piggyback on accounting reserves and should not be interpreted much more broadly than that. While noting the additional categories of issues that (1) were not reserved against because the taxpayer intended to litigate or (2) that were not audited by the IRS as an administrative practice, he suggested that these categories were narrow and discrete. Hopefully, a future IRS Notice of Proposed Rulemaking will reflect the

Chief Counsel's fairly narrow interpretation of 2010-9

Information Disclosure Required

A taxpayer that is subject to the proposal would be required to file the Schedule with its tax return that would include the following information:

- . A concise description of each uncertain tax position in sufficient detail so that the IRS can determine the nature of the issue and understand the reasons for determining that the position is an uncertain tax position;
- . An indication of the U.S. Internal Revenue Code ("IRC") sections potentially implicated in the position;
- . A statement that the position involves an item of income, gain, loss, deduction or credit against tax;
- . A statement that the position involves a permanent inclusion or exclusion of any item, the timing of that item, or both;
- . A statement declaring whether the position involves a determination of the value of any property or right;
- . For each separate uncertain position, the maximum amount of U.S. federal income tax liability that would be due if the position were disallowed in its entirety; and
- . A statement declaring whether the position involves a computation of basis.

2010-9 states that the proposal does not require a taxpayer to disclose its risk assessment or tax reserve amounts, but cautions that the IRS has the ability to issue a summons requiring the production of this information. The IRS has indicated that it intends to retain its policy of restraint (articulated in *IRS Announcement 2002-63* n2) as it relates to requests for tax accrual work papers. In his remarks to the New York State Bar Association, IRS Commissioner Shulman explained that a "concise" description of the uncertain position was intended to mean "a few sentences that inform us of the nature of the issue, and not pages of factual description or legal analysis." Similar comments were reiterated by Chief Counsel Wilkins in his recent comments to the District of Columbia Tax Section. n3 He also indicated that taxpayer privileges now in place to withhold certain documents will remain in force. Wilkins referred to the Service's policy of restraint as protection for taxpayers from being required to disclose their own risk assessment or actual reserve amounts.

However, commentators have questioned the significance of retaining the policy of restraint, given the amount of information disclosure that would be required in the Schedule. For example, would the Schedule practically require a taxpayer to disclose that it has received an opinion of counsel on the matter and the contents thereof? Could this taxpayer instead simply disclose the arguments contained in counsel's opinion? It is unclear whether the description's request for a rationale and statement of reasons implicates legal analysis that is privileged or otherwise protected.

It would seem that the Schedule could require at least as much information as is contained in tax accrual work papers prepared by auditors in the financial statement process. The IRS historically has exercised a "policy of restraint" in asking for tax accrual work papers, but it is possible that this "policy of restraint" might be changing. It is necessary to briefly review the historical content of the tax accrual work paper debate.

Tax Accrual Workpapers: A Historic Context

In *United States v. Arthur Young & Co.*, n4 the U.S. Supreme Court held that the IRS has the authority (as part of its summons authority under *IRC Section 7602*) to summon tax accrual work papers. Despite this authority, however, the IRS announced its "policy of restraint," in which it will not request tax accrual work papers from taxpayers. The "policy of restraint" remained unchanged until 2002 when the IRS revised its policy to permit the request of tax accrual work papers relating to any "listed transactions." In *Announcement 2002-63*, the IRS stated its position that tax accrual

work papers -- even if prepared by a tax attorney or outside accountant-- are not generated in connection with seeking legal or tax advice, but are developed to evaluate a taxpayer's deferred or contingent tax liabilities in connection with a taxpayer's disclosure to third parties of the taxpayer's financial condition. According to the IRS, therefore, tax accrual work papers are not considered privileged communications. After initial losses in litigation on this issue at the district court and appellate panel levels, the U.S. Court of Appeals for the First Circuit (*en banc*) recently upheld the IRS's position regarding privilege and the application of the work product doctrine. n5[5] The *Textron* case involved an IRS request for tax accrual workpapers with respect to a listed transaction. The taxpayer in *Textron* filed a petition for a writ of *certiorari* in December 2009 with the U.S. Supreme Court.

Some practitioners speculate that the IRS anticipates that it will not prevail before the U.S. Supreme Court in *Textron*, and wants to create an independent basis for obtaining the information contained in tax accrual work papers. It can be argued, however, that if the Supreme Court reverses the First Circuit and agrees that such analysis is privileged communications, this could provide an additional basis for limiting the information provided to the IRS on the Schedule. It is well-established law that the summon power of the IRS is subject to traditional privileges and, therefore, a taxpayer may be able to claim privilege in respect of information to be disclosed in the Schedule.

What About "Business Taxpayers" Who Don't Prepare Financial Statements?

The trigger for disclosure in 2010-9 is the taking of a tax reserve under FIN 48 or similar accounting standard, unless a tax reserve was not taken because a taxpayer expected to successfully litigate a position or believed that the IRS had an administrative policy of not challenging such a position. It would, therefore, seem that a taxpayer who does not prepare financial statements, which are subject to US Generally Accepted Accounting Standards or other similar standards, would not be directly affected by 2010-9. This was informally confirmed by IRS special counsel Kathryn Zuba, who wrote 2010-9, added that the new regime will not require taxpayers who do not keep reserves or maintain an accounting system for reserves to change their practice in order to provide additional disclosure to the Service.

It is noted, however that FIN 48 (and consequently 2010-9) applies to many types of entities, including

- . C corporations that pay taxes at the business entity level;
- . not-for-profit corporations
- . pass-through entities (for which the owners generally pay the tax), such as partnerships, limited-liability companies and S corporations;
- . real estate investment trusts; and
- . regulated investment companies.

A comprehensive analysis of the application of 2010-9 is beyond the scope of this article, however, specific issues could be raised by certain entities and industries that should be parsed. It is useful, however, to take a brief look on specific issues in the private investment fund arena.

Private Investment Funds: A Whole New World

It is noted that many private investment funds prepare financial statements in accordance with U.S. GAAP, and are therefore subject to FIN 48. The Financial Accounting Standards Board has concluded that FIN 48 is effective for private investment funds that have not yet adopted FIN 48 for years beginning after December 15, 2008. n6

FIN 48 seemingly applies only to entity level taxes. Consequently, 2010-9 could certainly apply to an issue relating to a publicly traded partnership's entity level taxation. However it is unclear whether 2010-9 could apply to an uncertain tax position that would impact only a partners' tax return, which would be the case for the majority of tax

positions taken by private investment funds. If so, it is not clear whether this would be required to be disclosed in the partnership tax return or the partner's tax return. In the latter case, this would seem to be a very onerous requirement for fund partners who do not themselves prepare GAAP financials where the position was not itself covered by a Fin 48 filing by the private investment fund.

In cases FIN 48 could apply to a fund investor, such as for example, an institutional investor who prepares GAAP financials, it is important to note that many of the tax positions taken by the investment funds industry are a function of industry convention, and may not have a specific basis in law. This is not a function of aggressive tax planning (in most cases), but is rather simply the consequence of complex tax issues that have arisen and for which there is no specific legal answer. Presumably, the 2010-9 treatment will generally turn on whether an accounting reserve is taken. In addition, however, it should be noted that the investment fund industry often takes positions based upon conclusions that are not yet reached by a court, simply because many of their complex partnership mechanics have not yet been addressed by courts. It is not clear whether such positions would fall within the "expect to litigate" language of 2010-9. If so, it could result in numerous disclosures about matters as simple as the aggregate allocation method. n7 Clearly these are not the issues that the Service is hoping to have disclosed. Further guidance on this issue is necessary. Hopefully the Notice of Proposed Rulemaking will define more clearly what is meant by positions that the taxpayer expects to litigate.

Conclusion

2010-9 is part of a larger trend in both the United States and Europe towards greater disclosure of uncertain tax positions. n8 This is entirely consistent with the goal of better global tax law enforcement. However, significant concerns draw attention to whether 2019 disclosure:

- . could violate attorney-client or attorney work product privileges;
- . would be so broad that it would produce large quantities of irrelevant information, thereby impairing auditors' efficiency in sifting through it; and
- . could be applied consistently where international accounting standards differ and in industries such as the private equity/hedge fund industry, where many tax positions are a function of industry convention and not defined law.

Ultimately, the fairness and effectiveness of 2010-9 will be a function of how these issues are addressed.

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n1 2010 TNT 47-1 (March 11, 2010).

n2 See IRS Announcement 200263, 2002-2 C.B. 72.

n3 *Infra* Note 1.

n4 *United States v. Arthur Young & Co.*, 465 U.S. 805 (U.S. 1984)

n5 See *United States v. Textron Inc.*, No.072631 (1st Cir. Aug. 13, 2009)

n6 See Accounting Standards Update 2009-6, *Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities* (ASU 2009-6)

n7 Investment funds will typically allocate their income, deductions, gains and losses based upon an "aggregate allocation method." Under such a method, realized gains and losses based on the unrealized gains or losses allocated to a partner as a whole, rather than on a security-by-security basis. This minimizes the recordkeeping burden found in the layering method, while still minimizing book-versus-tax capital account disparities

n8 See e.g. draft report of the International Accounting Standards Board of March 2009, which would require disclosure of "major sources of estimation uncertainties" relating to tax including a description of the uncertainty.

RELATED LINKS: See Sheldon Laskin's Emerging Issues Analysis on Textron and on New IR-2010-9 Reporting Requirements

■ *United States v. Textron Inc.*, 577 F.3d 21 (1st Cir. R.I. 2009)

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New Tax Court Rules and Practices

2010 Emerging Issues 4880

New Tax Court Rules and Practices

By Ann Murphy

February 23, 2010

SUMMARY: There are a number of new Tax Court Rules of Practice and Procedure that took effect on January 1, 2010. It is quite important that practitioners be aware of these new rules. The impetus for the new rules was the Amendments made to the Federal Rules of Civil Procedure, that took effect on December 1, 2006. Those amendments incorporated changes for Electronically Stored Information (ESI).

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ARTICLE: There are a number of new Tax Court Rules of Practice and Procedure that took effect on January 1, 2010. For a list of these new rules (as well as the explanations for the new rules), see <http://www.ustaxcourt.gov/press/091809.pdf>. For a full list of the Tax Court Rules of Practice and Procedure (Rules), see <http://www.ustaxcourt.gov/rules/Rules.pdf>.

The impetus for the new Tax Court Rules was the Amendments made to the Federal Rules of Civil Procedure that took effect on December 1, 2006. Those amendments incorporated changes for Electronically Stored Information (ESI). A helpful article on those civil procedure rules is "The New Federal Rules of Civil Procedure: An ESI Primer" by Sharon Nelson and John Simek for the ABA Law Practice Magazine (December 2006 issue, Vol. 32, No. 8, p. 23).

Undoubtedly the most important change to the Tax Court Rules is Rule 26, which was derived from Interim Rule 22A (issued in December 2005 as part of a Tax Court pilot program). This rule allows taxpayers and practitioners to file court documents (submit, sign and verify) through electronic means. It parallels *Rule 5(d)(3) of the Federal Rules of Civil Procedure*. This rule change is especially significant given the nature of the Tax Court. The Court is based in Washington, D.C. and most practitioners are not able to personally file documents. In the past, practitioners were able to find an agent in Washington, D.C. to file documents on their behalf, or they could of course file by mail. This new rule recognizes that many times business is done through electronic means. Under the new rule, a practitioner in San Diego may file a Tax Court document with a few key strokes on her computer.

Interestingly, the Tax Court is also considering requiring filing by electronic means in the future. The Court invited comments on this proposal to be delivered to it by December 21, 2009. Exceptions to this required e-filing would be made in the following instances: (1) pro se petitioners; (2) practitioners granted relief from the requirement for good cause; and (3) documents not eligible for e-filing (exceptionally large documents)

It is important to note that the initial petition to the Tax Court may not be made electronically. "Initial filings, such as the petition, may be filed only in paper form." See http://www.ustaxcourt.gov/electronic_access.htm.

One other significant change in the Rules is the allowance of credit card payments to the Court. In the past, payment was allowed only by check, money order or other draft payable to the U.S. Tax Court. Again, this made it difficult for those practitioners outside the Washington, D.C. metropolitan area to pay fees. The new rule provides the following: "Payment may also be made by credit card presented at the Court in Washington, D.C.," which seems to indicate that one must actually appear in Washington. This is not the case. The payment of fees by credit card may be made by telephone. See Explanation to Rule 11. Payment by debit card is not allowed. Fees may be made by following the instructions available at: <http://www.ustaxcourt.gov/fees.htm>.

The Tax Court divided its explanations of the amendments to its rules into the following numbered categories:

I. Ownership Disclosure Statements

Under new Tax Court Rule 20, a nongovernmental corporation, a partnership, or a limited liability company must submit with its petition a new "disclosure statement." This "Ownership Disclosure Statement" is new Form 6, a copy of which is provided in the new rules. This rule was amended "to enhance the ability of Tax Court Judges and Special Trial Judges to timely identify matters in which automatic disqualification would be appropriate under the financial interest standard."

II. Service of Papers

Service of Papers is now allowed by electronic means, if the receiving party consents in writing. Service is considered complete upon transmission, unless the sending party learns that the document did not reach the person it served. This might happen if the serving party receives an email indicating that the "service" email did not go through. The Court has decided that it does not bear the responsibility to serve parties with electronically filed documents. It has placed that burden upon the serving party.

Rule 151 has been amended to provide that *seriatim* briefs must be served on the other party. The rule continues the practice that the Court itself serves simultaneous briefs. In addition, Rule 155(b) now provides that the Clerk of the Tax Court will no longer be required to serve an "unagreed computation" on the opposite party. This is the responsibility of the proponent of the unagreed computation.

III. Limitation on Number of Interrogatories

A very significant change in the rules is Rule 71(a), which states the following: "Unless otherwise stipulated or ordered by the Court, a party may serve upon any other party no more than 25 written interrogatories, including all discrete subparts but excluding interrogatories described in paragraph (d) of this Rule." This is the same rule as *Federal Rule of Civil Procedure 33(a)*. The limitation of 25 interrogatories is "to reduce the frequency and increase the efficiency of interrogatory practice."

IV. Depositions for Discovery Purposes

Former Rules 74, 75 and 76 have been deleted and replaced with new Rule 74. This new rule tracks *Federal Rule of Civil Procedure 30*. In the past, the rules did not permit a party to take a deposition of another party. This new rule changes that. Under new Rule 74, "a party may move to take the deposition of another party or the Court in the exercise of its discretion may order the deposition of a party *sua sponte*." This method of discovery is considered an "extraordinary" method, and a Court order is required. The explanatory comments to the rule indicate that "a Judge or Special Trial Judge should only order such a deposition where the testimony or information sought practicably cannot be obtained through informal communications or the Court's normal discovery procedures."

V. Electronically Stored Information

Rule 70 has been amended after consideration of *Federal Rules of Civil Procedure* 34, 26 and 37. It adds a discovery rule for electronically stored information (ESI). The Court indicates that, "the term "electronically stored information" is intended to be broad enough to cover all current types of computer-based information and flexible enough to encompass future changes and technological developments." The Court indicates in the rule (as it does in many rules) that it expects the parties to cooperate through informal consultation before utilizing discovery. With respect to the scope of this new form of discovery, the Court added new section (b) to the rule. Section (b) provides the following, "a party need not provide discovery of electronically stored information from sources that the party identifies as not reasonably accessible because of undue burden or cost." This is consistent with the Advisory Committee Notes to the amended Federal Rules of Civil Procedure. The Advisory Committee noted that the "burden and cost of locating, retrieving, and providing discovery of some electronically stored information may make such information not reasonably accessible." The Committee also discussed the difficulty with privileges (attorney-client and work product) and electronic discovery.

It is clear that the Tax Court had in mind Advisory Committee Notes from the Federal Rules of Civil Procedure when it added new paragraph (e) to Rule 104. Paragraph (e) provides that, "absent exceptional circumstances, sanctions may not be imposed under this Rule on a party for failing to provide electronically stored information that was lost as a result of the routine, good-faith operation of an electronic information system."

VI. Contemporaneous Transmission of Testimony from Different Location

With new paragraph (b) to Rule 143, the Tax Court allows testimony by "contemporaneous transmission from a different location" for "good cause in compelling circumstances." This is similar to *Federal Rule of Civil Procedure Rule 43*. One of the examples listed of good cause in compelling circumstances is an accident or illness of a witness if it would involve a substantial delay and significant additional costs if a trial was rescheduled. The Court indicates that it has a "high-tech" courtroom enabling the receipt of testimony from a remote location.

Rule 71 has been changed to clarify that the 30-day exchange of expert witness reports does not "serve to extend the time" under Rule 71 for answering interrogatories aimed at the identification and qualifications of the expert and the subject matter of his or her report.

VII. Disciplinary Matters

Rule 202 now requires a member of the Tax Court bar to notify the Court within 30 days of any of the following: 1) conviction of any felony or conviction of a lesser crime described in Rule 202(a)(1); 2) imposition of discipline by any other court; and 3) disbarment or suspension from practice before an agency of the United States government exercising professional disciplinary jurisdiction. This new rule is based on the Model Rules for Lawyer Disciplinary Enforcement, adopted by the American Bar Association House of Delegates.

VIII. Payment of Tax Court Fees and Charges by Credit Card

As mentioned above, Rule 11 now provides for the payment of fees by credit card. This is allowed "either in person at the Court, over the telephone, or through designated electronic payment systems."

The Tax Court also updated Form 13, "Notice of Intervention" "to require the intervenor to state the grounds for the intervention and the reasons therefor."

In addition to the new rules the Court now allows for "eAccess " of Court files and documents. An eAccess guide for petitioners and practitioners is available on the Tax Court website at: http://www.ustaxcourt.gov/eaccess/eAccess_User_Guide_for_Petitioners_Practitioners.pdf. There is no charge for viewing, saving or printing documents from the eAccess site, but practitioners and petitioners may view each document

only three times. Opinions, orders, docket sheets and decisions are available to the general public and may be accessed unlimited times. The eAccess allows access to more items, such as Tax Court files. Persons with eAccess may also request electronic service in their cases. Petitioners may not request access once a case is closed. The eAccess site also allows for the e-filing of documents. Each document filed in electronic form must state on the first page that it has been filed electronically. Certain documents are not allowed to be filed by electronic means. Those documents include a petition, stipulated decision, expert witness report, a notice of appeal, and a pretrial memorandum.

A new video entitled "Introduction to the U.S. Tax Court" It is available at:
http://www.ustaxcourt.gov/ustc_video_welcome.htm. This is especially helpful to those who are new to the Tax Court and pro se petitioners.

Tax Court Rules That Have Been Amended and Added

Rule 11 Payments to the Court

Rule 12 Court Records

Rule 20 Commencement of Case

Rule 21 Service of Papers

Rule 26 Electronic Filing

Rule 37 Reply

Rule 50 General Requirements

Rule 70 General Provisions

Rule 71 Interrogatories

Rule 72 Production of Documents, Electronically Stored Information, and Things

Rule 73 Examination by Transferees

Rules 74, 75 and 76

Rule 80 General Provisions

Rule 81 Depositions in Pending Case

Rule 85 Objections, Errors, and Irregularities

Rule 91 Stipulations for Trial

Rule 100 Applicability

Rule 102 Supplementation of Responses

Rule 103 Protective Orders

Rule 104 Enforcement Action and Sanctions

Rule 143 Evidence

Rule 147 Subpoenas

Rule 151 Briefs

Rule 155 Computation by Parties for Entry of Decision

Rule 181 Powers and Duties

Rule 200 Admission to Practice and Periodic Registration Fee

Rule 202 Disciplinary Matters

Rule 215 Joinder of Parties

Forms:

Form 5 Request for Place of Trial

Form 6 Ownership Disclosure Statement

Form 10 Notice of Change of Address

Form 13 Notice of Intervention

RELATED LINKS: For further information, see

- LexisNexis Tax Advisor -- Federal Topical § 5B:2.04

For further information, see

- 1-9 Federal Tax Practice and Procedure § 9.03

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UK Landmark Transfer Pricing Judgment Spells Victory for HMRC

2010 Emerging Issues 4870

Dialani on UK Landmark Transfer Pricing Judgment Spells Victory for HMRC

By Jyoti Dialani

February 18, 2010

SUMMARY: HMRC's battle with the UK's largest retailer group of consumer electronic appliances has recently ended in a settlement with the retail group agreeing to pay 52.7 million (\$87.1 million) in taxes. This EIA analyzes the ruling of the case, which is significant in terms of the new insights it presents on the complex transfer pricing regulations churning out some interesting and innovative methods of pricing and strategies.

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ARTICLE: Transfer pricing disputes arise when a transaction involving the sale of goods or services is entered into between two entities that are connected or closely held by virtue of common control or ownership or belonging to the same group, at a price, which in the eyes of the tax authorities is set at a level which will lead to tax avoidance by the parties involved in the transaction. Complex issues on pricing usually arise in transactions between same group and connected companies having a presence or operations across borders. Transfer pricing issues result when these companies divert their profits, with the motive of avoiding high taxes from regimes like the UK, to low-tax jurisdictions.

The UK's landmark decision on transfer pricing has created a flurry across companies in the country. The decision is delivered in *DSG Retail Ltd. v. Special Commissioners* (DSG), n1 where DSG is a UK subsidiary of DSG International Plc, one of the UK's largest retailers of consumer electronics and appliances owning chains of retail stores.

Background

DSG had been embroiled in a long-running dispute with HMRC on issues relating to certain intra-group trading arrangements in the years 1997 to 2005. The crux of the dispute centered on the company's profitable business of extended warranties and premiums paid on their insurance to related Isle of Man entities during the period. The crucial question involved was whether the business facilities provided were, in essence, set at arm's length price. The case was related to DSG's captive reinsurer, DISL (Dixons Insurance Services Limited), with respect to the customer's extended warranties located in the tax-friendly jurisdiction of the Isle of Man. This insurer was engaged in the business of reinsuring extended warranties for DSG customers. HMRC argued that DSG had entered into this network of offshore company arrangements merely for the purpose of using the reinsurer, which was its subsidiary, to avoid UK tax incidence. It had contended before the Special Commissioners that DSG had not been transfer pricing its extended

warranties correctly as the prices of the warranties were fixed in a manner that conferred a potential advantage as to UK taxation on the insurance of the extended warranties. The fee and commission arrangements between DSG and its Isle of Man subsidiary, DISL, were challenged in the case. The crucial contention raised by HMRC was that a benefit had been conferred upon DISL by DSL which would not have been possible had the parties involved in the transaction operated on an arm's length basis. Accordingly, it argued that this benefit derived by DISL represented a "business facility" extended by DSL within the meaning of section 770 of ICTA (ICTA). DSG contended that the arrangement of contracts between DSL and DISL was not a "business facility" to provide any benefits to DISL as Schedule 28AA described the term "provision" in a context different from the transactions or series of transactions entered into by DSL and the two could not be equated. The Special Commissioners ruled in favor of HMRC, holding that the arrangements between DSL and the parties were not at arm's length because if DISL and DSL were not closely connected, the pricing structure between them would have been different. On the meaning of the term "facility" it was held that Section 770 did not restrict the meaning to a contract but included an arrangement which conferred some form of benefit or advantage, even possibly the hope or expectation of profit or other advantage. Under Schedule 28AA, the "provision" had to be between two persons only and not between two or more persons. Therefore, the Special Commissioners held in favor of the HMRC that the arrangements between DSL and DISL were such that it resulted in an indirect provision of a business facility to DISL for which DISL made no payment. It was held that a "provision" made with respect to a series of transactions is separate from the series itself. This ruling establishes firmly that henceforth companies will be in a better position if they carry out an efficient transfer pricing analysis at every stage of the arrangements to ensure that the pricing is set at arm's length wherever there was a scope for existence of a "provision."

Facts of the case

DSG Group (all companies under the parent control of DSL International Plc except DISL) is the largest retailer of consumer electrical appliances in the UK. The retail company, DSG Retail Limited (DSG), offers extended warranties to its customers relating to goods sold. These warranties are sold to cover the goods after the expiration of the normal one-year manufacturer's guarantee for periods of an additional one to four years. The facts relate to two separate periods: first, "the Cornhill Period" running from May 1986 to April 1997 during which Cornhill Insurance plc (Cornhill), a third-party insurer, was the insurer of extended warranties sold to customers. Under this arrangement, the store arranged warranty insurance policies for its customers with Cornhill. Cornhill just undertook risk liability to the extent of only 5% with respect to the policies and in turn entered into an arrangement for the remainder 95% of the risk to be reinsured with another DSG company, DISL, which was a wholly-owned subsidiary of the DSG Group located in the Isle of Man. Thus, by this arrangement, Cornhill passed off 95% of its premiums to DISL and these premiums were held in a trust fund to support the security arrangements. Effective from the year 1990, Cornhill's profits from the insurance business were subject to a cap to the extent of 15% of the premiums receivable, and another arrangement was entered into between Cornhill and DISL. The caps of 15% became operative and this also limited the profits to DISL. Cornhill entered into an administration and repair services contract with a UK DSG group company called MSDL (Mastercare). The Cornhill period is relevant only with respect to reinsurance policies issued during 1996-97 ("scheme year 1996-97," which is different from the accounting period 1996-97) as the tax issues in respect of the previous accounting periods were settled between DSG and HMRC. Therefore, the only financial year in dispute as to the insured warranties business is the period from 1996 to 1997. Secondly, "the ASL Period" (April 1997 onwards), is relevant due to subsequent announcements of proposed changes in the IPT regime of the UK. This proposal was announced in the UK's November 1996 budget to increase Insurance Premium Tax (IPT) applicable to such appliance breakdown insurance from 2.5% to 17.5% with effect from April 1, 1997. Subsequent to these announcements, the DSG Group established a new structure to replace the insured extended warranties with non-insurance based service contracts to take advantage of the VAT claims deductions benefits. Therefore, as a part of this process, the contracts with Cornhill were terminated and the service contracts were issued to customers of its retail outlets through a new company, Appliance Serviceplan Limited (ASL), and DISL in turn insured the entire liability of ASL. ASL was also a company resident in the Isle of Man owned partly (40%) by the DSG Group's main insurance broker called Willis and two private

individuals to the extent of 30% each. Service contracts attracted VAT whereas warranty insurance contracts attracted IPT. Although the rates of IPT and VAT were the same, service contracts had an advantage over warranty insurance contracts in as much as the company could claim VAT in respect of the costs incurred towards repairs as deductible expenses. ASL entered into an administration and repairs contract with MSDL just like Cornhill and insured 100% of its risk with DISL, which quickly changed its regulatory authorization status from reinsurance business to conduct of insurance business. By this arrangement the DSG group effectively transferred the insurance risk subject to the two offshore entities in the Isle of Man and hence outside the boundaries of the UK, making the insurance outside the scope of the IPT. This arrangement was later upheld by the VAT and Duties Tribunal in the case of DSG International Insurance Services Ltd v. Revenue and Customs.ⁿ² The warranty service contracts were concluded by a company called MCSAL, a DSG Group entity, which was essentially a sales agent for ASL. Again, this time around, profits were capped under each separate arrangement by transferring profit commissions from DISL back to ASL, and then from ASL to MCSAL in the UK, and subsequently to DSG Retail. Thus, DISL basically retained only 15% of its premium income and the balance was used to pay off claims to ASL.

The warranty business thus returned generous profits as the loss ratios were really minor and a major part of the premium was actually the profit earned by DISL. The profits, mainly located in the jurisdiction of the Isle of Man, were also not subject to UK tax with the benefit of inapplicability of the CFC rules as the business carried out by DISL was under the exempt activities with reference to the insurance premium income from Cornhill and, later, ASL which were unconnected parties, thus satisfying the condition prescribed in ICTA, Schedule 25, Paragraph 6(2).

Issues involved

The main issues raised before the Special Commissioners were: (1) Whether business facilities provided by DSG Retail to its captive insurance companies insuring extended warranties for the former's customers were provided at less than the arm's length price under section 770 of ICTA 1988, and (2) If the answer to the above issue is yes, whether that provision differs from the arm's length provision under Schedule 28AA.

The legal position

During the first period, i.e., the period from 1996-1997 (Cornhill period) to 1998-1999 (covering part of the ASL period), the relevant law governing transfer pricing was provided in section 770 of the Income and Corporation Taxes Act 1988. During the second period from 1999-2000 to 2003-2004 (covering part of the ASL period), the relevant law on transfer pricing was governed by Schedule 28AA of the ICTA 1988. Under section 770, the details of the transaction are considered and the question raised is on the price which would be charged had the parties in the transaction been one at arm's length. Under Schedule 28AA, the issue that is considered is that if the parties to the transaction were at arm's length, would the terms and conditions of the transaction have been any different. During the period when the company had the insured warranties in operation, the relevant provision on transfer pricing in force was section 770, which essentially applied to property transactions between controlled parties where the prices were different from those which would have occurred between independent parties on an arm's length basis. In such a situation, section 770 stated that to arrive at the correct tax liabilities, the actual prices must be adjusted to one which is equal to an arm's length price in similar transactions. Under section 773(4), the transfer pricing rule was made applicable to the "giving of business facilities of whatever kind." As was also confirmed by the Special Commissioners, the "giving business facilities of whatever kind" is intended to cover a wide variety of things. In *Ametalco Ltd. v. Inland Revenue Commissioners*,ⁿ³ the Special Commissioners held that these words are a wide description and this view was also adopted in *Waterloo v. Inland Revenue Commissioners*,ⁿ⁴ in which it was held that where loans were given to trustees to grant employee

share options, the business facilities were made directly to certain offshore subsidiary companies despite the fact that there was no contractual relationship with those offshore companies. However, it is also worth noting that such a "facility" ought to be identified as such that confers some form of benefit or advantage. Such a benefit or advantage need not be an immediate monetary or financial benefit but can also include a hope or an expectation of profit or other advantage. With the insertion of a new section 770A and Schedule 28AA by the Finance Act 1998 into the ICTA 1988 with effect from accounting periods ending after June 30, 1999, the transfer pricing code in the UK was revised and accordingly for the second period in respect of DSG's non-insured warranties contracts, Schedule 28AA was relevant. Schedule 28AA is applicable to situations where a "provision" is made or imposed as between any two persons under a transaction or a series of transactions and the parties have a common control. If the actual provision is different from the arm's length provision (one which would have been made as between independent enterprises) and where such a provision "confers a potential advantage in relation to UK taxation on one of the affected persons" (that is, the affected person, reflects a smaller amount of taxable profits for any period as a result of that "provision" than the profits it would have earned had the transaction been one at arm's length), then that person's profits and losses are to be computed in a manner as if the arm's length provision had been made for tax purposes. Under Schedule 28AA, the term "transaction" includes arrangements, understandings and mutual practices, whether or not they are, or are intended to be, legally enforceable. In cases where there are a series of transactions, the rules are still applicable between any two parties even though there is no transaction in the series involving both parties. Since in the years prior to the disputed period from 1996 to 1997 DSG had entered into settlements with HMRC after much negotiation, HMRC turned its eye on the period and the years after, to bring to UK tax the substantial income arising to DISL in some way.

HMRC's arguments

A crucial point raised by HMRC was that a benefit had been conferred upon DISL by DSG Group which would not have been possible had the two parties not been closely connected or, in other words, had they been operating on an arm's length basis. Although the insurance and service warranty contracts were made between the customers and third parties, it was argued by the HMRC that such arrangements with third parties were entered into with the ultimate intent of transferring the benefit to DISL using the third parties, in this case, Cornhill and, later, ASL as nothing but mere conduits in the entire series of transactions. Accordingly, the main argument advanced by the HMRC was that this benefit conferred on DISL was one coming within the meaning of the phrase, "giving of a business facility" embodied in section 770 or a "provision" flowing from DSG Retail to DISL. Lastly, it was also argued that the benefit could at least be a "provision" classified in Schedule 28AA from the UK sales agent, MCSAL, to DISL during the repair services contract period. It was emphasized accordingly that in light of the arrangements involved and the apparent flow of benefit, it was necessary to attribute some fees or commission amounts back from DISL to the UK DSG group. It was also suggested that keeping in mind the risks undertaken and the responsibilities of DISL, a major proportion of the profits of DISL ought to flow back into the UK in the form of such fees or commission.

DSG's arguments

DSG argued that there was no business facility provided to DISL during the Cornhill period in the form of the opportunity to enter into the insurance arrangements as the warranty business was regarded to be high risk. When the ASL period commenced, there were no other insurers in the market who were prepared to take on risk of the size involved in the transactions and DISL was the only possible insurer at that point in time in the market. The decision to engage DISL in the transaction was made by ASL. Accordingly, it was also submitted that it was not possible to adjust the consideration between DISL and ASL and then between ASL and MCSAL as the revenue was resulting from two transactions between unconnected parties. Thus, it was submitted that it was incorrect to hold the series of transactions or contracts as one providing a "business facility" to benefit DISL or a "provision" to DISL. Under Schedule 28AA, the meaning assigned to the term "provision" was entirely different from the transactions entered into by the DSG group. There was no sufficient ground to equate the transactions in this case to a "provision" within the meaning of Schedule 28AA. Further, it was also important to identify specific times when the "business facility" or "provision" was extended

to DISL.

The specific timings identified by HMRC were: (1) During the Cornhill period in the year 1993 when a contractual cap was reduced on the profits earned by Cornhill, and (2) during the Cornhill period in the same year later, when a new reinsurance contract was executed between Cornhill and DISL.

DSG argued that both the events identified by the HMRC held no significance as the first event had no impact on DISL and as far as the second event was concerned, it was submitted that it was not resulting from any opportunity provided to DSIL by DSG Retail.

Furthermore, during the ASL period, on the new arrangements, it was contended that the premiums paid to DISL were not in excess of arm's length rates and also there was no evidence to prove that this arrangement could be called a "provision" by the DSG Group to DSIL within the meaning of Schedule 28AA.

In addition to these arguments against HMRC's identified events, DSG provided certain evidence based on market research on the comparable uncontrolled prices (CUPS) which evidently indicated that the premiums amounts paid to DISL were clearly within an acceptable arm's length range.

The decision

The Special Commissioners ruled in favor of the HMRC, holding that the arrangements between the DSG Group and DISL and the Isle of Man companies were not at arm's length because had DSL and DISL been unconnected parties, DISL would have to pay to DSG. It was held that the arrangements were in substance a "business facility" provided to DISL by DSG in which a benefit was conferred on DISL for no payment. DSG provided an opportunity in its retail stores for DSIL to enter into reinsurance contracts. In 1993, DSG indirectly provided certain business facilities to DSIL which made section 770 applicable to the facts as DISL made no payment to DSG for the facilities so provided.

During the ASL period, in respect of the many transactions between DISL, ASL and the DSG Group, a provision was held to have been made between DSG and DISL, making Schedule 28AA applicable to the transactions. It was not the series of contracts which was the "provision" between the parties but the structure or plan through which the contracts were executed, which was the "provision" within the meaning of Schedule 28AA. Thus, based on an in-depth analysis of certain comparables provided, as well as considering the bargaining position of the parties, the "provision" that was between DSG and DISL would be different from the "provision" which would have been made between unconnected or independent entities.

The Special Commissioners also reviewed the evidence presented on the CUPs and held that the same were not acceptable as comparable prices since certain comparables presented were not similar as far as circumstances were concerned. The Commissioners held that a profit-split method was the appropriate method as it had the combination of the "contribution" and "residual" analyses as prescribed in the OECD 1995 Transfer Pricing Guidelines. DISL's contribution could be valued by reference to cost of equity and, considering the strong position exercised by DSL, all the residual profits could be attributed to it. As per this method, the return to DISL was to be limited to a level to an extent to which an insurer would earn keeping in mind the risk involved in the capital and the residual profits to accrue to DSL. The Commissioners held that although the OECD Guidelines applied only to Schedule 28AA, they could be equally applied to section 770. It was accordingly ruled that the profits of DSG should be adjusted as to reflect higher profits from arrangements that are not at arm's length.

Regarding the law, the case has established the following transfer pricing principles in transfer pricing:

- Under section 770, a "facility" was not limited to a contract but was one that conferred some benefit or advantage, even a hope or expectation of profit or an advantage.
- Under Schedule 28AA, the identified "provision" was one which was between two persons only and not one between

two or more persons.

- A "provision" must be assigned the meaning similar to that of "condition" in Article 9 of the OECD Model and not one that is limited to formal or enforceable agreements.
- In order to arrive at the arm's length terms and prices, it was necessary to determine a single notional "provision."
- Under section 770 what was required was an arm's length price for a transaction actually entered into and under Schedule 28AA the notional arm's length price comparator could be different as to its terms and price.
- Paragraph 1(2) (a) Schedule 28AA had a requirement for consideration of the "provision" that would have been between unconnected entities in similar situations and having similar traits as the parties to the actual transaction.
- OECD guidance was not required to be relevant to the application of Schedule 28AA for the double tax treaty between the countries of the parties to the transactions to be in place.
- Where certain arrangements fell within the ambit of both section 770 and Schedule 28AA, and where it was possible to identify several possible arm's length comparators, some which led to duplications or omissions in calculations and some which did not yield such results, it was advised to adopt the ones which had no duplications or omissions.

Conclusion

This ruling is a benchmark in the transfer pricing world in the UK as it will surely strengthen the Revenue's position in its negotiations with similar other multinationals in the UK with respect to their transfer pricing issues. This case is also significant as it sets precedents in the field of transfer pricing by establishing certain new legal principles in the field apart from showing the way to taxpayers for developing their transfer pricing strategies. It is also the first ruling by the UK courts on transfer pricing methodologies, with in-depth examination and testing of comparables presented by the parties to arrive at a CUP. The ruling ultimately rejects the numerous comparables due to some defects and eventually it settles on a profit-split method. This is a significant development in this ruling as this method was, until now, not regarded as a favored method under the OECD Guidelines. The decision also provides a detailed picture on transfer pricing methodologies and a peak into the probable course of action to be adopted by the revenue authorities on the two most vital aspects in transactions of a similar nature -- that is, selection of an appropriate transfer pricing method and the identification of qualified comparables. This case also enlightens taxpayers in similar situations to plan effective transfer pricing methodologies to handle their disputes with the HMRC at various levels. It will however, be interesting to observe the developments as to HMRC's stand against similar other companies in the UK and the outcomes of these negotiations in the near future.

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n1 DSG Retail Ltd v Special Commissioners, HMRC.

n2 DSG International Insurance Services Ltd v Revenue and Customs, (2007) IPT 0013.

n3 Ametalco Ltd v Inland Revenue Commissioners, [1996] STC (SCD) 399.

n4 *Waterloo v Inland Revenue Commissioners*, [2002] STC (SCD) 95.

RELATED LINKS: For more discussion, see

- 2-18 Rhoades & Langer, U.S. Int'l Tax'n & Tax Treaties " 18.03

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Effective Roth IRA Conversions for 2010

2010 Emerging Issues 4859

Effective Roth IRA Conversions for 2010

By Philip Fink

February 5, 2010

SUMMARY: Until 2010, individuals with a modified adjusted gross income in excess of \$100,000 could not convert their traditional IRAs or 401(k) plans to a Roth IRA. For years after 2009, all taxpayers regardless of income can make the conversion. However, for those taxpayers making a conversion in 2010, there is a special rule which will let them defer paying tax on the amount of the conversion.

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ARTICLE: What is a Roth conversion?: A Roth conversion can be done in one of three ways:

- Rollover to a Roth IRA of a distribution from a traditional IRA or a 401(k) plan within 60 days of the distribution.
- Trustee-to-trustee transfer from the trustee of the traditional IRA or a 401(k) plan to the trustee of the Roth IRA.
- Transfer of an amount in a traditional IRA or a 401(k) plan to a Roth IRA maintained by the same trustee.

Once the funds are placed in a Roth IRA, all of the rules that apply to a Roth IRA are effective for the conversion. Note that a 401(k) conversion of a current employer's plan is not normally allowed. However, taxpayers can be employed and roll over a 401k from a prior employer.

Income limitation: Up until 2010, individuals with a modified adjusted gross income in excess of \$100,000 could not convert their traditional IRAs or 401(k) plans to a Roth IRA. For all years after 2009, all taxpayers regardless of income can make the conversion. However, for those taxpayers making a conversion in 2010, there is a special rule which will let them defer paying tax on the amount of the conversion.

Caveat: The income limitation to make annual contributions to a Roth IRA will continue to apply. That is, individuals who have a modified adjusted gross income in 2010 of \$120,000 or more are prohibited from making an annual contribution to a Roth IRA. For married taxpayers filing a joint return, the income limitation begins at \$177,000.

Advantage of making the conversion: There are several advantages to making the conversion. When distributions are made from a Roth IRA, they are excluded from gross income. In addition, there are no required minimum distributions from a Roth IRA. Also, for individuals who want to leave a legacy for future generations, a Roth

IRA is more effective, since it can grow tax-free indefinitely, regardless of the age of the owner at the time of his or her death.

One-time-only benefit during 2010: Individuals who make the conversion in 2010 will report half of the conversion amount on their 2011 tax returns, and the other half on their 2012 returns. It should be noted that there is an "election-out" of the deferral so that those individuals who would like to report the entire amount of the conversion on their tax returns in 2010, may do so.

Example: Heather began investing in a traditional IRA in 1990. The current value of the mutual funds in her IRA on March 10, 2010 is \$120,000. If she converts her traditional IRA to a Roth IRA on March 10, 2010, she will report \$60,000 on her 2011 return. Then, she will report the other \$60,000 on her 2012 return. If Heather elects out, she will report the entire \$120,000 on her 2010 return.

"Election-out":

Electing out involves certain considerations:

Tax planning: Electing out is advantageous if a taxpayer believes that he or she will be in a lower tax bracket in 2010 than in 2011 and 2012.

Example: Amy and Tyler are married and file a joint income tax return. For the last few years, each one has had a salary of about \$100,000. In January 2010, Amy's position at the company that she worked for was eliminated, so she did not work in 2010. Amy and Tyler each have about \$25,000 in their traditional IRAs. They decide to convert them into Roth IRAs. Since they are in an atypical low income tax year, they should consider electing out, and report the entire amount of income on their 2010 income tax return.

Caveat: The major disadvantage of electing out is that the entire tax bill on the conversion is due by the time individuals file their 2010 tax return. In contrast, if the general rule applies, taxpayers have more time to make plans that could reduce the tax burden, as well as providing the opportunity to increase tax withholdings and estimated tax payments.

Tax considerations: There are many tax and nontax considerations that must be analyzed before deciding on the best way to handle the conversion. Following are the more important tax considerations:

Tax rate in 2010, 2011 and 2012: Before making a decision on whether to defer reporting the income to 2011 and 2012 as a result of the conversion, or reporting all of it in 2010, individuals must consider their tax rate for 2010 to their projected tax rates for 2011 and 2012. As it stands now, the top tax rates are scheduled to go up in 2011 and 2012 to a level where they were in 2001. However, at this point (February 2010) there is much speculation as to what will indeed happen to tax rates in 2011 and 2012. There is some sentiment in Washington to not let the rates increase, or increase by a smaller amount than the scheduled increases.

Tax rate in retirement: Generally, individuals who will be in a lower tax bracket in retirement should not make the conversion since they will be paying tax at a higher rate in the year of conversion than they would if they received distributions during retirement.

Impact to taxation of social security benefits: The amount of social security benefits that are required to be reported in gross income is dependent on the level of an individual's income. In general, the greater the amount of income that an individual has, the higher the portion of social security benefits that have to be included in gross income.

Tax planning: Individuals who have not started receiving social security benefits should consider making a conversion before they start receiving benefits, since doing so can possibly result in a lesser amount of social security benefits being included in gross income.

Impact to AGI and itemized deductions: When the conversion is made, the extra income that is required to be reported may significantly increase a taxpayer's adjusted gross income ("AGI"). There are a few itemized deductions that are predicated on the amount of AGI such as the medical deduction, casualty and theft losses, and miscellaneous itemized deductions.

Medical expenses: Medical expenses are deductible to the extent that they exceed 7 $\frac{1}{2}$ % of AGI. Therefore, if an individual has a large amount of unreimbursed medical expenses in 2010, he or she should consider not electing out of the installment reporting of the amount converted.

Tax planning: If an individual has a substantial amount of unreimbursed medical expenses for 2010 and makes a Roth conversion, he or she should not elect-out of the installment method. Accordingly, the income from the conversion will be reported in 2011 and 2012. As a consequence, his or her AGI will not be increased in 2010, resulting in a larger amount of medical expenses that can be deducted in contrast to the situation where an individual would have made the election-out.

Example: During 2010, Maureen converted her traditional IRA into a Roth IRA. At the time of conversion, it had a balance of \$100,000. Her other amounts of AGI amounted to \$80,000. Normally she only has a few thousand dollars of reimbursed medical expenses, but due to some unusual circumstances, she had unreimbursed medical expenses of \$15,000 for 2010. If she elects-out of the installment reporting, she will have an AGI of \$180,000 (\$100,000 + \$80,000); and therefore, her allowable medical deduction will be \$-0- [\$15,000 - (\$180,000 x .075)]. In contrast, if she does not elect-out of the installment reporting, she will report \$50,000 of the amount converted on her 2011 return and \$50,000 on her 2012 return. Accordingly, she will report AGI of only \$80,000 in 2010, resulting in an allowable medical deduction of \$9,000 [\$15,000 - (\$80,000 x .075)]. In this case, the better strategy is to not "elect-out" of the installment method.

Casualty and theft losses: Casualty and theft losses for individuals are deductible to the extent that they exceed ten percent of AGI (after reducing such amount by \$100).

Tax planning: If an individual has a significant unreimbursed casualty loss for 2010 and makes a Roth conversion, he or she should consider not electing-out of the installment method.

Miscellaneous itemized deductions subject to the 2% limitation: Individuals who have a significant amount of miscellaneous itemized deductions subject to the 2% limitation in 2010 should not elect-out of the installment method. Examples of this type of deduction include professional dues, work clothes, investment expenses, job hunting expenses, etc.

Practice Tip:

If the IRA owner dies in 2010 or 2011, the entire conversion amount is included in taxable income in the year of death, unless the surviving spouse is the sole beneficiary and elects the two-year inclusion rule

Non-tax Considerations: In determining whether to make the conversion, there are several non-tax considerations. In many cases, the non-tax considerations may be more important than the tax considerations.

- **Time value of money.**
- **Available cash to pay taxes:** Although a conversion may make a lot of sense in theory, individuals simply may not have the available cash to pay the taxes that are owed on the conversion.
- **Need for funds in retirement versus leaving a legacy.**
- **Selection of Exchange Traded Funds (ETFs) and mutual funds:** Those individuals who are participating in a 401(k) plan typically have a limited amount of ETFs and mutual funds that they can choose to invest in. In contrast, if they convert their 401(k) to a Roth IRA, there are an unlimited number of funds to select from. This may result in

taxpayers being able to invest in funds that will achieve their financial goals.

Converting in a series of smaller amounts: Individuals don't have to convert the entire amount of their traditional IRAs and 401(k) plans. Instead, they can convert a smaller amount every year for several years. Although they can't take advantage of the deferred reporting that is available for conversions in 2010, by converting in a series of smaller payments, it probably will not throw individuals into uncharacteristically high tax brackets. Moreover, the tax on the smaller conversion will be smaller and easier for the average individual to manage.

Partial conversion: No one can predict what tax rates will be in 10, 20, or 30 years. As a consequence, individuals may want to convert only a portion of their traditional IRAs and 401(k) plans into Roth IRAs. Since no one can predict where rates will be in future years, individuals can "hedge" their position by converting a portion of the traditional IRA.

Tax strategies to accompany a conversion: If an individual makes a Roth conversion in 2010, there are several things that can be done to not only reduce the tax burden, but to pay for the tax whether or not an individual elects-out of the installment reporting. Some of these are:

- Prepay charitable commitments in the year that the conversion will be reported in gross income.
- If an individual makes a conversion in 2010 and does not make the election-out, pay any fourth quarter tax payments to state and local governments for 2010 in the first quarter of 2011.
- If an individual has been thinking about setting up a charitable remainder trust, the year of the conversion would be a good time to do so since the extra large charitable contribution deduction can offset the additional income reported from the conversion.
- If an individual who makes a conversion has funds that he or she is going to invest in taxable accounts, consider investing in state or local tax-free bonds rather than taxable bonds.
- If an individual who makes a conversion in 2010 and is considering starting to receive social security benefits, the commencement of the benefits should be delayed to a year after the conversion has taken place.

Reconversion: Reconversion gives individuals the benefit of hindsight. That is, if an individual makes a conversion of his or her traditional IRA in January, 2010, and the value of the underlying investments decreases later in the year, the conversion can be "undone." Accordingly, the amount of the conversion does not have to be included in gross income.

Caveat: It should be pointed out that if an individual makes a reconversion in 2010, and then makes a conversion in 2011, the deferred reporting will not be available.

State income taxes: Most states provide special relief for retirement distributions. The relief comes in three typical ways: a complete exclusion, a partial exclusion, or a credit against income from distributions. In the year that the conversion takes place, these benefits would apply.

Income tax form: Individuals who make a Roth conversion must file a Form 8606 along with their Form 1040.

RELATED LINKS: For more information, see

- LexisNexis Tax Advisor -- Federal Topical " 1C:5.04

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- 2-17 Federal Income Taxation of Retirement Plans " 17.11

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UK's Foreign Profits Reforms Cause Multinationals to Move to Other Countries

2010 Emerging Issues 4853

UK's Foreign Profits Reforms Cause Multinationals to Move to Other Countries

By Jyoti Dialani

January 30, 2010

SUMMARY: Recent changes to the UK's economic reforms and taxation of foreign profits have caused the holding companies of major US corporations (e.g., MacDonald's) to relocate their headquarters from the UK to other European countries (e.g., Switzerland). This EIA provides a comparative analysis of the tax regimes in Switzerland with the one in the UK and explains why this move presents a very viable solution in terms of tax savings for US corporations.

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ARTICLE: Big move of the Big Mac

On July 15, 2009, McDonald's announced its plan to move its European headquarters, first established in 1974, from London to Geneva, Switzerland. The decision of McDonald's is bad news for the UK economy and could lead to a cascading effect of negative consequences, including job losses, the consequent decrease in money circulation, and contribution to the economic downturn during the recession.

Why the move out of the UK?

What exactly could have triggered the decision of McDonald's to move its European headquarters out of the UK after almost a third of a century?

This announcement has come close on the heels of many other giant corporations' moves out of the UK. Why are we witnessing this trend in the recent months among huge multinational groups? This question has shifted focus from the glaring issue of the fast food chain to the more serious underlying issue.

The move of McDonald's out of the UK was not the first in the line of other large US corporations, which have already relocated their European headquarters from the UK to certain other European countries. Some of the large US companies who have recently made their moves to Switzerland are Yahoo, Google, Kraft, Proctor & Gamble and Colgate Palmolive. Some of the initial moves were kick-started around seven or eight years ago. The UK-based publishing company Informa also moved its tax residence from the UK to Switzerland in 2009. Informa's move from the UK mainly stemmed from the foreign profits reforms package announced by the UK government in that year's budget especially the changes in the taxation of foreign profits linked to intellectual property rights, including patents

and trademarks.

Under the new foreign profits tax reforms, the company's tax liabilities would have doubled because of the new tax introduced by the UK government on dividends from IPR held abroad. So grave is the impact of the new changes in the UK fiscal and tax policies that some of the domestic UK companies are also planning their relocation to other more favorable or less harmful tax jurisdictions. Regus, the office supplier company, has moved to Luxembourg; WPP, the advertising company, and Shire, the pharmaceutical company, have also relocated their headquarters to Ireland. The investment company Henderson has gone a step further and established a new parent company in Ireland to minimize its tax burden. Other major groups, Brit Insurance and Hiscox, and engineering firm Charter have also relocated outside of the UK.

Why the move to Switzerland?

The pertinent questions which need to be addressed are (1) why are these large companies moving out of the UK, and (2) why have these companies mainly selected Switzerland as the country for their European headquarters?

The response of McDonald's to questions regarding their reasons for moving to Switzerland from the UK was that the company needed to strategically manage its international intellectual property rights. It attributed the move to a need to control and manage the grant of master franchise agreements with the European countries from the Geneva office as against the current management from the US office.

Switzerland has a reputation of having some of the most stringent intellectual property laws in place and hence is a favored country for most companies for their IP location as it offers strong protection to their intellectual property rights. The country is a very attractive destination for multinational companies, especially to the regional European headquarters of US companies.

Some crucial characteristics of the Swiss tax regime which bring out the advantages as compared to the UK are as follows:

- The corporate income tax rate in Switzerland usually depends on a variety of factors such as the limits of its operations and business activities. However, an average rate of 20% is usually applicable to companies and, in some cases, the rates can also be much lower as the taxes are also often negotiated with the tax authorities. The UK corporate tax rate is 28%, which makes a significant difference to companies whose total tax liabilities can be enormous, running into millions of pounds.
- Unlike the UK, Switzerland does not have any Controlled Foreign Company (CFC) regulations in force.
- Personal income tax rates in Switzerland are also very attractive, with the highest federal tax rate of 11.5%. This also draws many transfers and moves of high level executives of multinationals to the country from the UK as the total tax borne by them in the UK will be significantly higher. The UK government's announcement to increase the maximum personal income tax rate to 50% has brought about strong adverse reactions from such groups.
- The employers in Switzerland have to pay a social security contribution of just 6.05%.
- The value added tax (VAT) in Switzerland is very nominal at just 7.6%, compared to 15% VAT applicable in the UK as per the lowest permissible rate prescribed by the European Union (EU) regulations. The rate in force in the UK was 17.5% and was reduced temporarily to 15% with a view to increase public spending and thereby encourage economic activity in the recession. However, the rate is again slated to go back to its original 17.5% by early 2010.
- Swiss authorities have exempted those incomes from the Swiss federal and regional taxes, which are attributable to a foreign branch or a permanent establishment of a Swiss company. This is also an incentive for companies looking to move to Switzerland as it also minimizes the administrative costs and procedures relating to returns and filings.

One of Switzerland's major strengths is that it is not a part of the EU and is hence not subject to stringent EU treaty rules and regulations. However, it also enjoys the benefits of trading with other EU nations without the complexities and burdens of following procedures and rules as it is not subject to EU law. The country therefore enjoys a freedom to frame and pass laws according to its requirements and needs and does not, therefore, constrain itself by the common EU

laws, which may be good for one member country but not for a different country. As a result, the country has been able to pass, and continue to hold in place, favorable domestic tax laws as well as a stable environment for its taxpayers. Switzerland, however, is in an enviable position where under several reciprocal arrangements with some European nations, it benefits from the favorable EU directives without suffering a negative burden in terms of rigid and burdensome tax laws.

UK tax regime: A candid picture

Although the UK has enjoyed a history of being the global financial capital with almost every big multinational company having a presence in the country, the tax system does in fact reflect some areas which do not paint a very encouraging picture from the perspective of foreign companies looking to have an economically viable operations system and business management in Europe through the UK. Some of the aspects in the UK tax systems, which immediately bring out a comparable with the other more tax friendly jurisdictions in Europe, are discussed immediately below.

The UK's 28% corporate tax rate is currently very prohibitive and discouraging to multinationals compared with the average 25% corporate tax rate in several European countries and is much higher than the very attractive rates of Switzerland and Ireland.

Currently, the CFC rules in the UK impose many restrictions on the functionalities and management by the multinational companies of their financial operations and intellectual property. Originally when introduced, the CFC regulations were mainly intended to target only those entities which were routing incomes through tax efficient jurisdictions or tax havens. However, since their introduction, these regulations and rules have been successively tightened and made more stringent by the governments, the result of which has been that many multinational companies operating in the UK have been impacted adversely as they are now faced with additional restrictions on their operations. The changes to the CFC regulations also hamper free circulation and flow of finances and capital within companies belonging to the same group. This has led to many large multinational groups announcing their moves out of the UK to other more tax efficient jurisdictions. Some of the concerns faced by companies are enhanced by the following changes:

- The top level executives faced the brunt of the announced changes to the tax rates of the high income earning groups since individual income tax rates for the highest income bracket and above will now be at 50%. Not happy with the huge tax bills imposed on them from 2010/2011 onwards, which are higher than most other countries, these executives are looking for transfers to other countries.
- To add to the woes of the high income groups, those non-domiciled individuals who are resident in the UK for more than seven years now have to bear an additional flat tax levy of £30,000 with effect from 2010/2011 if they want to take advantage of the remittance basis of tax. This new change has come into effect in 2008 and is also adding to the existing taxpayers' burdens.
- Another change in the rules is a proposed reduction in tax relief in respect of contributions to pension for an individual earning income over £150,000.
- Although the current VAT in the UK is at the lowest minimum rate prescribed by the EU rules at 15%, which is slated to increase back to 17.5% in January 2010, the 7.6% VAT rate in Switzerland, as stated above, compares favorably against the UK.

A combined result of the above changes has adversely impacted the image of the UK into one of a very high tax jurisdiction.

The road map post-relocation

The relocation of the European headquarters of these companies out of the UK has led to the relocation of jobs and also a shift of certain operations and management functions (including employees) to Switzerland. Apart from these companies named above, certain additional companies have also made announcements to move their headquarters out of the UK. The move will mainly affect the residence of the group holding company and will not impact the functions

of the European headquarters as these groups have mainly changed the residence of their parent company from the UK to another country in Europe. The best manner to avoid applicability of the UK CFC rules on any subsidiary company is to transfer the subsidiary to a new EU holding company as there is no capital gains charge on such a transfer provided the conditions required for a UK Substantial Shareholdings Exemption are fulfilled.

Tax issues affecting shareholders on reconstruction of companies

The companies which have moved or have announced their move from the UK will achieve this under a scheme of reconstruction or reorganization. Under a scheme of reconstruction, the shareholders exchange their shares in the existing UK company for shares in the new non-UK holding company. Under section 895 to section 899 of the Companies Act 2006, a scheme of arrangements is required to be drawn up and submitted for approval to the High Court. One advantage of a public company effecting a reconstruction under this scheme is that it does not hold the requirement to seek approvals from all shareholders to this transaction. For the High Court approval to this scheme, a company just needs to show the court that the scheme has been voted for in favor by shareholders who are a majority in number and who represent a minimum of 75% in value of the total shareholding of the UK company. Once the Court is satisfied on these two requirements, a sanction to the scheme is generally awarded. As a part of the reorganization process, the new foreign holding company usually effects a reduction in capital in order to enhance its reserve capital balances to ensure an assured dividend to its shareholders in the coming years.

The UK shareholders receive new shares in a foreign holding company in exchange for having given up their shares in the former UK holding company. This kind of transaction falls within the purview of section 135 n1 of the TCGA (Taxation of Chargeable Gains Act) 1992, n2 which does not regard the relinquishment of the shares by the shareholders in the old holding company as a disposal or sale of shares but treats the new shares received in the new foreign holding company as shares purchased by the shareholders in the previous UK holding company. This provision ensures that there is no charge of capital gains and hence no capital gains tax liability in the UK on the shareholders who receive shares under such a scheme of reconstruction.

However, an exception to this rule is that a capital gains tax liability could arise if the shareholder, who is a resident of the UK and owns, either on his own or jointly with other connected person(s), 5% or more of any class of shares or debentures of the old UK holding company. However, if the transaction of reconstruction is one which has been carried out purely for commercial reasons and not for reasons to avoid capital gains tax liability or corporate tax, no capital gains tax should arise. This is one of the reasons why it is advisable to obtain a clearance from the HMRC which clarifies that the reconstruction is being carried out for bona fide commercial reasons. Such a clearance is obtained by making an application to the HMRC under section 138 of TCGA 1992. Most generally, publicly listed companies do not have any shareholders or classes of shareholders who own more than 5% of the shares; therefore, these exceptional provisions usually do not come into the picture in most cases and, hence, such capital gains will not arise.

Private companies: Impact of reconstruction

In the case of closely held or privately owned groups of companies, there may not be a need to obtain an approval of the High Court to the scheme of reconstruction as the shares are usually owned by a small number of individuals, and it can be possible to secure the approval of all the shareholders to the scheme of reorganization. Thus, comparatively, it will be much easier and simpler to get an approval for reorganization in the case of privately held groups of companies. However, the flip side is that there is more likelihood that there are many shareholders who own more than a 5% shareholding in the UK holding company, thereby bringing them within the tax net for paying capital gains tax on the disposal of shares in the former UK holding company. This, however, can be prevented if the HMRC approves the scheme of reconstruction as one which is for pure and bona fide commercial reasons and not for an ulterior motive of tax avoidance as prescribed in section 137 n3 of TCGA 1992. Therefore, it would be best for privately owned groups of companies undergoing a scheme of reconstruction to first apply for a sanction from the Board of the HMRC under section 138 n4 of TCGA 1992, which will clarify that the exchange of shares or the scheme of reorganization has been

carried out for bona fide commercial reasons and not for avoidance of taxes. The outcome of such an application will largely depend on the facts of each case.

Stamp duty issues in the UK on sale or transfer of shares in new holding company outside the UK

A company can be incorporated in one country but it can move its tax residence to another. For instance, Shire and Henderson groups of companies chose their new foreign holding companies to be incorporated in Jersey but they had their residence in Ireland. In the case of sale of shares in a company not incorporated in the UK, where the register of shares is not kept in the UK, there is no liability of stamp duty or SDRT in the UK. Ireland also has the same rules and stamp duty is not payable on sale of shares in a company not incorporated in Ireland. Therefore, the steps taken by these companies in incorporating in Jersey is certainly beneficial as it minimizes the tax and duty costs on future transactions of sale of shares.

Conclusion

In the wake of the recent events and the changes to the UK Taxation of Foreign Profits and Economic Reforms Policy, multinational groups must ensure that they do not choose the UK as the country for their holding company's residence as to have a more tax-efficient structure, their holding companies must not have tax residence in the UK. For this purpose, the location where the directors meet, plan, and make strategic management decisions relating to the group is crucial. They must exercise caution to ensure that the companies do not hold their important Board meetings and pass resolutions in the UK because essentially a tax residence of a company also depends on the location where important and strategic business decisions in Board meetings of a company are made.

[Return to Text](#)

n1 Company reconstructions and amalgamations

135 Exchange of securities for those in another company

(1) Subsection (3) below has effect where a company ("company A") issues shares or debentures to a person in exchange for shares in or debentures of another company ("company B") and-

(a) company A holds, or in consequence of the exchange will hold, more than one-quarter of the ordinary share capital (as defined in section 832(1) of the Taxes Act) of company B, or

(b) company A issues the shares or debentures in exchange for shares as the result of a general offer-

(i) which is made to members of company B or any class of them (with or without exceptions for persons connected with company A), and

(ii) which is made in the first instance on a condition such that if it were satisfied company A would have control of company B.

(2) Subsection (3) below also has effect where under section 136 persons are to be treated as exchanging shares or debentures held by them in consequence of the arrangement there mentioned.

(3) Subject to sections 137 and 138, sections 127 to 131 shall apply with any necessary adaptations as if the 2 companies mentioned in subsection (1) above or, as the case may be, in section 136 were the same company and the exchange were a reorganisation of its share capital.

n2 Full text of the legislation can be found at
http://www.opsi.gov.uk/ACTS/acts1992/ukpga_19920012_en_1.

n3 137 Restriction on application of sections 135 and 136.

(1) Subject to subsection (2) below, and section 138, neither section 135 nor section 136 shall apply to any issue by a company of shares in or debentures of that company in exchange for or in respect of shares in or debentures of another company unless the exchange, reconstruction or amalgamation in question is effected for bona fide commercial reasons and does not form part of a scheme or arrangements of which the main purpose, or one of the main purposes, is avoidance of liability to capital gains tax or corporation tax.

(2) Subsection (1) above shall not affect the operation of section 135 or 136 in any case where the person to whom the shares or debentures are issued does not hold more than 5 per cent. of, or of any class of, the shares in or debentures of the second company mentioned in subsection (1) above.

(3) For the purposes of subsection (2) above shares or debentures held by persons connected with the person there mentioned shall be treated as held by him.

(4) If any tax assessed on a person (the chargeable person) by virtue of subsection (1) above is not paid within 6 months from the date when it is payable, any other person who-

(a) holds all or any part of the shares or debentures that were issued to the chargeable person, and

(b) has acquired them without there having been, since their acquisition by the chargeable person, any disposal of them not falling within section 58(1) or 171, may, at any time within 2 years from the time when the tax became payable, be assessed and charged (in the name of the chargeable person) to all or, as the case may be, a corresponding part of the unpaid tax; and a person paying any amount of tax under this subsection shall be entitled to recover a sum of that amount from the chargeable person.

(5) With respect to chargeable gains accruing in chargeable periods ending after such day as the Treasury may by order appoint, in subsection (4) above-

(a) for the words "the date when it is payable" there shall be substituted "the date determined under subsection (4A) below";

(b) for the words "the time when the tax became payable" there shall be substituted "that date"; and

(c) for the words "a sum" onwards there shall be substituted "from the chargeable person a sum equal to that amount together with any interest paid by him under section 87A of the Management Act on that amount";

and after that subsection there shall be inserted-

"(4A) The date referred to in subsection (4) above is whichever is the later of-

(a) the date when the tax becomes due and payable by the chargeable person; and

(b) the date when the assessment was made on the chargeable person."

(6) In this section references to shares or debentures include references to any interests or options to which this Chapter applies by virtue of section 136(3) or 147.

n4 138 Procedure for clearance in advance.

(1) Section 137 shall not affect the operation of section 135 or 136 in any case where, before the issue is made, the Board have, on the application of either company mentioned in section 137(1), notified the company that the Board are satisfied that the exchange, reconstruction or amalgamation will be effected for bona fide commercial reasons and will not form part of any such scheme or arrangements as are mentioned in section 137(1).

(2) Any application under subsection (1) above shall be in writing and shall contain particulars of the operations that are to be effected and the Board may, within 30 days of the receipt of the application or of any further particulars previously required under this subsection, by notice require the applicant to furnish further particulars for the purpose of enabling the Board to make their decision; and if any such notice is not complied with within 30 days or such longer period as the Board may allow, the Board need not proceed further on the application.

(3) The Board shall notify their decision to the applicant within 30 days of receiving the application or, if they give a notice under subsection (2) above, within 30 days of the notice being complied with.

(4) If the Board notify the applicant that they are not satisfied as mentioned in subsection (1) above or do not notify their decision to the applicant within the time required by subsection (3) above, the applicant may within 30 days of the notification or of that time require the Board to transmit the application, together with any notice given and further particulars furnished under subsection (2) above, to the Special Commissioners; and in that event any notification by the Special Commissioners shall have effect for the purposes of subsection (1) above as if it were a notification by the Board.

(5) If any particulars furnished under this section do not fully and accurately disclose all facts and considerations material for the decision of the Board or the Special Commissioners, any resulting notification that the Board or Commissioners are satisfied as mentioned in subsection (1) above shall be void.

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Recent Developments in Treasury's FBAR Program

2010 Emerging Issues 4849

Rufus Rhoades and Yariv Brauner on Recent Developments in Treasury's Report of Foreign Bank and Financial Accounts (FBAR) Program

By Rufus Rhoades and Yariv Brauner

January 29, 2010

SUMMARY: Rufus V. Rhoades and Yariv Brauner analyze new guidance regarding the requirement to report foreign bank and financial accounts ("FBAR"). Controversial new rules expanded the reporting requirement to some foreign persons and potentially to certain hedge fund and private equity fund accounts, creating much uncertainty among taxpayers and the Service. Taxpayers need to tread cautiously with their FBAR reporting.

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ARTICLE: As everyone who has not been vacationing in the South Pole knows by now, U. S persons must report to the IRS any financial interest in, or authority over, all foreign bank or financial accounts if the aggregate value of such accounts exceeds \$10,000. The report is actually a two-part report: once on the tax return of the U.S. person (reflecting the foreign source income as well as noting that the taxpayer has a foreign account) and the other by filing a separate FBAR form (form TD F 90-22.1). Since the FBAR reports are not tax returns, they are not subject to the limitations on disclosure under *IRC Section 6013* and therefore may be shared with other governmental agencies.

Recent Activity. The IRS recently issued a new version of the FBAR form (October 2008), and added new guidance in the form of frequently asked questions documents (September, June, and May 2009). That guidance is important as there are no traditional proclamations or guidance (beyond the Code and regulations) with respect to the FBAR rules. Three innovations included in the Q&A expand the scope of the FBAR rules and have caused quite a stir: (1) the inclusion of non-residents and foreign corporations doing business in the United States as "United States persons" for FBAR purposes, even though foreigners are normally not thought of as being United States persons; (2) the expansion of the reporting requirement beyond owners and those who have signature authority, to persons having "other authority" over the relevant foreign financial accounts; and (3) the expansion of the definition of financial accounts to include hedge fund and private equity fund accounts. The new guidance is particularly timely in light of a recent proposal by the Obama administration to expand the FBAR reporting requirement (currently, we only report on an FBAR form) by adding an FBAR schedule to the income tax return form.

Foreign Persons Covered. In what can only be described as borderline draconian, the IRS has stated that as of 2009, "United States persons," for FBAR purposes, includes foreigners "in and doing business in" the United States. (Internal Revenue Service, FAQs Regarding Report of Foreign Bank and Financial Accounts (FBAR) - United States

Person, available at: <http://www.irs.gov/businesses/small/article/0,,id=210252,00.html>.) That provision (assuming that the Service actually follows its stated intentions) means that U. S. branches of foreign corporations doing business in the United States are now treated as "U.S. persons" and need to file an FBAR report. Note, however, that only a foreign person's "regular and continuous" business activity within the United States triggers the filing requirement.

In addition to foreign corporation U.S. branches, non-resident alien (posted) workers and independent contractors who are engaged in business in the United State will also be considered U.S. persons for the purposes of the FBAR reporting requirement. The FBAR reporting requirement for persons who are not citizens, residents, or domestic entities will become effective (if at all), at the earliest, with the filing due on June 30, 2010 for the year 2009 [Announcement 2009-51, 2009-25 I.R.B. 1105].

What we don't know about the new rule is how far the Service intends to extend it. For example, does HKSB, the world's largest bank, need to file an FBAR report for *every* non-U.S. account it holds for itself and all of its subsidiaries merely because it has a U.S. branch? As that question suggests, the new interpretation is a potential nightmare for foreign corporations doing business in the United States.

Reporting Requirement. A United States person must report having a signature or other authority over a foreign bank or securities account. Signature authority must be reported whether or not the owner or beneficiary of the foreign account is also subject to the reporting requirement. "Other authority" exists in a person who can exercise power that is comparable to signature authority over an account by direct communication to the bank or other person with whom the account is maintained, either orally or by some other means. Such power must include the power of disposition of money or other property in the account, but does not include the power to direct investment. Thus, a French lawyer who may engage in practice for a brief time in the United States (but long enough to be considered as being in business here) would need to disclose all of his foreign accounts, including those as to which he is a trustee. If such a disclosure would violate French law, he may be in a bit of a quandary. One small piece of good news: bank employees are not required to report authority over accounts maintained by their bank employer if they have no personal financial interest in the account, provided that the bank is supervised by the appropriate Federal agency.

What is Reportable? Reportable "financial" accounts include banks, securities, securities derivatives, and other financial instruments accounts. A financial account is reportable even if it holds solely non-monetary assets, such as commodities, and even if it does not generate income in the reporting year. Other accounts in which assets are held "in a commingled fund," such as mutual funds, and the account owners holding equity interests in such fund should also be reported.

Note, however, that foreign financial instruments, such as stocks, bonds and other notes are not considered "financial accounts" and therefore are not subject to the reporting requirement. Additionally, debt of a foreign business that is not a financial institution is not a reportable financial account, whether it generates (interest) income or not. Note, however, that other key elements such as "equity interests" and "securities accounts" are still undefined and potentially difficult to apply.

Filing Requirements. The FBAR (Form TD F 90-22.1) must be filed for each calendar year during which a person has a financial interest in (or authority over) the foreign account. The FBAR must be mailed to U.S. Department of the Treasury, P.O. Box 32621, Detroit, MI 48232-0621. The IRS must *receive* the form by June 30 of the next year for it to be considered timely, and no time extensions are available. (It is not considered timely if it is *mailed* by June 30.) For 2008, however, the IRS extended the deadline to allow taxpayers to adjust to the new form and guidelines for persons with signature or other authority over but no financial interest in a foreign financial account, and to persons with signature or other authority over and/or financial interest in a foreign commingled fund. Such persons may file the FBAR regarding 2008 until June 30, 2010 (one-year extension). The notice cited above further announced that the IRS intends to issue regulations regarding the reporting requirement for those accounts, and invites public comments.

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Making the Most of Sale and Leasebacks in 2010 and Beyond

2010 Emerging Issues 4830

Making the Most of Sale and Leasebacks in 2010 and Beyond

By Philip Fink

January 21, 2010

SUMMARY: 2010 could be a good time for taxpayers owning appreciated property to take advantage of existing tax rates and consider a sale/leaseback transaction. The lease payments would be deducted at the higher rates in 2011 and subsequent years. In addition, there is strong sentiment in Washington to extend the additional first year depreciation on certain leasehold improvements, which expired at the end of 2009, for an additional year.

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ARTICLE: What is a sale and leaseback?: A sale and leaseback occurs when an individual or business sells a property and immediately leases it back. Typically, the property is an office building, factory, or warehouse.

Example: The American Co. purchased an office building and land in 1994 for \$10 million. It has taken \$3,150,000 of depreciation on the building. It is commencing an expansion program so it sells the property for \$17 million in 2010 to raise some cash. It then immediately enters into a ten-year lease on the building and land with an option to renew the lease for another five years. It will continue to use the property and pay rent to the purchaser/lessor.

Why engage in a sale and leaseback?: A primary motivation for a seller-lessee is to "unlock" the increase in the equity in the property and to deploy it in the business to finance an expansion, or perhaps, to decrease debt and the accompanying interest expense. As a result, the balance sheet of the seller-lessee is improved greatly. Another advantage of entering into this type of a transaction for the seller-lessee is that the company remains in the same property, which could be vital if it is engaged in a retail business where customers are used to coming in order to patronize the business.

From a tax standpoint it is advantageous for the seller-lessee to enter into such an arrangement because the appreciation over the original purchase price is generally taxed favorably as an *IRC Section 1231* gain. Moreover, if the seller of the property is an individual taxpayer, that part of the gain that is equal to the depreciation taken ("unrecaptured *IRC Section 1250* gain") is taxed at no more than 25%. Then, when the property is leased back, the entire amount of the lease payments is deductible at the ordinary rates. It should be noted that the lease payment presumably is for the entire property - building and land. In contrast, prior to the sale, the owner of the property could take depreciation only on the building. Thus, the lease payment deduction after the sale and leaseback has been entered into could be considerably larger than the depreciation deduction prior to its sale.

Example: Henry is a sole proprietor of a business which owns a property made up of land and building. He acquired this property in 1998 for \$3 million of which \$1 million was allocated to the land and \$2 million was allocated to the building. Since that time, he has taken \$591,900 of depreciation on the building, resulting in an adjusted basis for the building of \$1,408,100 (\$2,000,000 -- \$591,900). In years 2-39, he is allowed a depreciation deduction of \$51,280 (\$2 million x .02564) a year. Assume that he sells the property in 2010 for \$5 million of which \$3.5 million is allocated to the building and \$1.5 million is allocated to the land. He then immediately enters into a ten year lease agreeing to make a lease payment (covering land and building) in the amount of \$100,000 a year.

He will have an *IRC Section 1231* gain on the land of \$500,000 (\$1,500,000 -- \$1,000,000) taxed at 15%. Also, he will have a total gain on the building of \$2,091,900 (\$3,500,000 -- \$1,408,100) comprised of an *IRC Section 1231* gain of \$1,500,000 (\$3,500,000 -- \$2,000,000) taxed at 15% and an *IRC Section 1250* unrecaptured gain of \$591,900 (equal to the amount of depreciation taken) taxed at 25%. In addition, he will be allowed to take a deduction of \$100,000 for the lease payments, providing him a tax benefit at his top tax rate of 35%. It should be noted that the \$100,000 deduction for the lease payment is significantly greater than the depreciation deduction that he would have been allowed of just \$51,280 had he not entered into the sale and leaseback. This is because the lease payment covers both the land and building whereas depreciation covers the building, only. Also, the lease payment is based on the fair market value of the *entire* property as of the time the sale and leaseback is entered into whereas the depreciation is only on the building at its acquisition cost in 1998.

Present value of money: The results in the preceding example are even better than at first glance if the present value of money is taken into account. That is, the cash from the sale of the property is being currently received when the present value of money is at its greatest value. In contrast, the lease payments will be made over the next ten years as the present value of the dollar diminishes.

From the buyer-lessor's standpoint, it may want to diversify its investment portfolio and invest in real estate. This might be true for an endowment fund, private equity fund, a pension fund, etc whose investments are primarily in stocks and bonds. In a valid sale and leaseback, the buyer-lessor is entitled to take cost recovery deductions, and interest expense deductions if the property subject to the sale and leaseback is financed.

Tax environment in 2010-2011: There is a unique tax opportunity in 2010-2011. Both ordinary tax rates and long-term capital gains rates for individual taxpayers are scheduled to increase in 2011. For those individuals who own appreciated property who would like to enter into a sale and leaseback, they should enter into these transactions in 2010. That way, the gain will be taxed at the lesser rates that will be in effect in 2010. Then, the lease payments (which presumably would be greater than the depreciation deduction that they could have taken prior to the transaction) would be deducted at the higher rates in 2011 and subsequent years. Of course, the lease payments in 2010 will be deducted at the lower tax rates in effect for 2010.

There may be an opportunity to claim additional first year depreciation on certain leasehold improvements made in 2010. Although the provision for additional first year additional depreciation expired at the end of 2009, there is a strong sentiment in Washington to extend it for one more year until the end of 2010. If so, such improvements made after a sale and leaseback is entered into would result in a substantial tax break. This provision allows taxpayers who make leasehold improvements to write-off 50% of the cost in the year that the improvement is made. It applies to an interior portion of nonresidential real property. The improvement may be made by either the buyer-lessor, or the seller-lessee. The property to which the leasehold improvements are made must be at least three year old; and, the buyer-lessor and the seller-lessee must not be related. It should be noted that the following types of improvements do not qualify for this tax break:

1. enlargement of a building,
2. any elevator or escalator

3. any structural component that benefits a common area, or
4. the internal structural framework of the building.

Effect of state income taxes in 2010-2011: Because of diminishing revenues for almost all states, there is a likelihood that state income tax rates will be increasing in the future. As a result, individuals who would like to enter into a sale and leaseback are encouraged to execute such a transaction in order to have their gains taxed at a lesser rates that currently exist, and then make lease payments deducted at higher rates which are projected for the future.

Effect of a transaction that fails to be considered a sale and leaseback: The IRS scrutinizes sale and leaseback transactions very closely, especially if they are between related parties. If a purported sale and leaseback is held to be a mortgage loan instead, the parties will not be able to achieve their intended goals. Instead the seller-lessor will not be required to report the gain had it been a valid sale and leaseback. Likewise, the seller-lessee will be required to deduct depreciation (as it had been) rather than taking a deduction for lease payments (which it wanted to).

Criteria that must be met to qualify as a sale and leaseback: Whether a sale and leaseback will be recognized for tax purposes depends on not only the substance of the transaction, but the form of the transaction, as well. It should be noted that in any given case there could be tax advantages in entering into a sale and leaseback. However, the mere presence of tax advantages will not necessarily result in such a transaction being recognized as long as there are economic reasons for such an arrangement. The factors that have been used to determine whether a bona fide sale and leaseback has occurred are as follows.

Benefits and burdens of ownership must be passed on to the purported buyer: In determining whether a transaction is a sale and leaseback for tax purposes rather than a mere financing arrangement, it is important that the benefits and burdens of ownership be passed to the purported buyer.

Caveat: In order for a sale and leaseback to be respected for tax purposes, the buyer-lessor should be the party to insure the property and pay the real estate taxes.

Useful life of subject property: In order to be recognized as a valid sale and leaseback transaction, the useful life of the property in question must exceed the term of the lease. If it does not, it will be treated as a financing operation and not a sale and leaseback.

Caveat: Achieving this criteria should be much easier if the property in question is real estate rather than equipment or machinery.

Purchase option: If the seller-lessee may repurchase the property in question at the end of the lease term, the property must be repurchased at its fair market value, rather than a discount.

Caveat: In the terms of the original transaction, it is permissible to stipulate the option price of the property if it is a reasonable amount.

Example: ABC Corporation owns a warehouse and the land that it is on. In 2010, it enters into a sale and leaseback transaction with Capital Partners. The terms of the agreement are for ABC to sell the property to Capital Partners for \$3.5 million and then to lease the property for the first five years at a monthly rate of \$15,000, and then at a monthly rate of \$16,500 for the next five years. After ten years, ABC has an option to purchase the property for \$4 million. This arrangement should be respected as a bona fide sale and leaseback since it is fair to assume that in ten years the fair market value would be approximately \$4 million. On the other hand, if the option price was set at \$1,610,000 which is the purchase price (\$3.5 million) by Capital Partners less the amount of rental payments over the ten years $[(\$15,000 \times 60) + (\$16,500 \times 60) = \$1,890,000]$, the sale and leaseback would not be respected.

Renewals: If the transaction allows for renewals of the lease at the end of the original lease term, the renewal

rentals must be set at a fair market value.

Residual value: There must be a reasonable expectation that the residual value of the property at the end of the lease term will be sufficient to result in a pre-tax profit in the transaction taking into account the purchase price, income from lease payments, and the gain from the ultimate disposition of the property.

Caveat: In a challenging real estate market, such as in 2010, a buyer-lessor may lease property at a relatively low rental rate with the idea that over time market values of property will increase by such amount that the transaction "as a whole" will be profitable.

Lessor's equity in the property: It is important for the buyer-lessor to have some of its own equity in the property that is subject to the sale and leaseback. Accordingly, when the buyer-lessor acquires the property with a nonrecourse loan without a down payment, such a transaction is unlikely to be deemed to be a bona fide sale and leaseback.

Reasonable price paid by the buyer-lessor: For this type of a transaction to be considered valid for tax purposes, the purchase price paid by the buyer-seller should be at the fair market value of the property.

Caveat: It is important to have a credible appraisal so that the parties involved can prove that the selling price of the property was at fair market value. Such an appraisal is a deductible expense.

Business purpose: Both parties involved in a sale and leaseback transaction must show that they had a valid business purpose for entering into the transaction.

Caveat: A seller-lessee may want to enter into such a transaction to be able to generate some cash flow other than borrowing money. A buyer-lessor may want to enter into a sale and leaseback in order to diversify its investment portfolio.

Form makes a difference: In determining whether a transaction is a bona fide sale and leaseback, the form of the transaction is a very important criterion. Therefore, if two parties want to obtain the advantages of a sale and leaseback, then any documents related to such a transaction should be clearly labeled as a "sale and leaseback."

Related parties: When related parties enter into a sale and leaseback, it raises "red flags" for scrutiny by the IRS. In general, the same criteria must be present that is required of such a transaction between third party strangers. Taxpayers should make sure that they have documented the business purpose(s) for entering into a sale and leaseback and set a lease rate that is reasonable.

Caveat: A prudent course of action would be to obtain lease rates for similar properties. If the property in question is real estate, then it would be helpful to obtain lease rates for other similar properties that are geographically close to the property which is subject to the sale and leaseback.

RELATED LINKS: For more information, please see

- 1-4 Federal Taxes Affecting Real Estate § 4.05

For more information, please see

- LexisNexis Tax Advisor -- Federal Topical § 1G:1.02

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A More Permanent Section 409A Correction Program

2010 Emerging Issues 4814

A More Permanent Section 409A Correction Program

By T. David Cowart and Greta Cowart

January 14, 2010

SUMMARY: IRC Section 409A imposes severe consequences on the recipient of nonqualified deferred compensation for any violation of the Section's plan documentary or operational requirements. While initially transition rules provided some flexibility, and the first correction program provided some relief, this first permanent correction program (Notice 2008-113) provides more and welcome relief for inadvertent errors.

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IRC Section 409A imposes severe tax consequences on the recipient of nonqualified deferred compensation for any violation of the Code section's plan documentary or operational requirements. Documentary compliance was required for all existing arrangements by December 31, 2008, and it applies to all new arrangements from the inception of the arrangement.

A violation triggers the 20% penalty tax and interest penalty tax for not only the amount of the violation and the arrangement involved, but for all arrangements or plans in the same category of "plan" under *Treasury Regulations Section 1.409A-1(c)* and all deferrals under those combined plans. A minor slip can have dire and disproportionate federal income tax consequences for the recipient of nonqualified deferred compensation. Thus, some of the drivers that were behind creating the employee plan compliance resolution system (EPCRS) for qualified plans are now in place for nonqualified deferred compensation, but only some. Congressional endorsement of nonqualified deferred compensation and potentially broad-based negative consequences of noncompliance are missing as underpinnings for this program, and that gap has contributed to a different tone and more restrictions even under this new, expanded effort.

While initially transition rules provided some flexibility, and the first correction program provided some relief, this first permanent correction program (Notice 2008-113) provides more and welcome relief for inadvertent operational errors. Correction is unquestionably preferable to being subject to the severe potential Section 409A penalties.

General Requirements for Using Correction Program in Notice 2008-113 n1

[1] General

The first signs of flexibility about strict compliance with the requirements of *IRC Section 409A*, as amended (the "Code") in practice were found in the transition rules in *Notice 2005-1* n2 and the subsequent extensions of the transition relief in *Notice 2006-79*, n3 *Notice 2007-86*, n4 and the preambles to the final regulations n5 and to the proposed regulations. n6 As the transition relief and the first transitional correction program expired n7 the IRS issued the first permanent correction program. The first permanent program is found in *Notice 2008-113*. n8

Notice 2008-113 clarified that reliance on the transition relief in any of the above guidance will not preclude a taxpayer from qualifying for the relief from operational violations of section 409A of the Code provided in *Notice 2008-113* so that an operational slip that occurred while relying on the transitional rules is correctable if it fits within the corrections available under *Notice 2008-113* and *Notice 2008-113*, if it applies, might be another avenue to correct an error that qualifies for transitional relief. n9 Thus, a plan that used a transition rule to change the time or form of payment could also correct under *Notice 2008-113* a payment made more than thirty days early, if it is corrected in the same tax year and *Notice 2008-113* is otherwise appeased.

Notice 2008-113 presumably applies to corrections for taxable years beginning on or after January 1, 2009. It does not have a stated effective date. *Notice 2007-100* is obsoleted by *Notice 2008-113*, effective for taxable years beginning on or after January 1, 2009. n10 Taxpayers expressly may rely on *Notice 2008-113* for taxable years beginning before January 1, 2009. n11 It applies in addition to the transition rules for periods since January 1, 2005. No express effective date is given, but arguably the unlimited pre-2009 reliance allows reliance after 2008. The corrections allowed under *Notice 2007-100*, however, cannot be relied upon for taxable years beginning on or after January 1, 2009.

For service providers who use *Notice 2008-113* for relief from an operational violation, their obligation to report and withhold described in prior guidance n12 is modified by the reporting and withholding provisions in *Notice 2008-113*. n13

Notice 2008-113 does not provide any relief for failures that result when the document providing the nonqualified deferred compensation has not been amended to comply with section 409A of the Code. *Notice 2008-113* also provides no relief for violations of the funded plan rules under section 409A(b) of the Code (plans funded upon a financial trigger of the service recipient, plans funded offshore and plans funded while the service recipient's qualified defined benefit plan is insufficiently funded). The operational failures that qualify for correction are limited to the set categories provided in *Notice 2008-113*. The categories, while limited in number, can cover a variety of operational mistakes.

While there is no formal program to correct the failure of a plan document to comply with the requirements of Section 409A, once there is a legally binding right to the amount deferred, there is hope if the amount is not yet vested or is still subject to a substantial risk of forfeiture. Document failures may be corrected if the amount is subject to a substantial risk of forfeiture and the plan is corrected to provide a compliant time and form of payment before the amount is vested, as long as the facts and circumstances do not indicate that there is a pattern or practice of permitting impermissible changes in the time or form of payment under one or more plans. n14 It is not clear what it will take for there to be a pattern or practice of permitting impermissible changes in the time or form of payment, *e.g.*, whether similar failures found in non-compliant, non-vested plans of acquired entities during separate unrelated corporate acquisitions constitute a pattern or practice?

[2] Eligibility to Use the Correction Program in *Notice 2008-113*.

[a] Commercially Reasonable Steps to Prevent Recurrence.

The relief provided by *Notice 2008-113* is available only if all of the requirements for the applicable correction method are satisfied. In addition to any unique requirements for each specified type of correction, the following general requirements must also be satisfied in *every* case. n15

The service recipient must take commercially reasonable steps to avoid recurrence of the operational failure, and if the same (or a substantially similar) operational failure has occurred previously, relief is not available for any taxable year of the service provider beginning after December 31, 2009, unless the service recipient (or service provider) demonstrates the service recipient (i) had established practices and procedures reasonably designed to ensure that such an operational failure would not recur, (ii) had taken commercially reasonable steps to avoid recurrence of the operational error, and (iii) had suffered the operational error despite the service recipient's diligent efforts. n16 The scope of those practice and procedures, the specifics about what constitutes commercially reasonable steps, and the prerequisites to be diligent efforts are not delineated in *Notice 2008-113*. *Notice 2008-113* does not preclude subcontracting or delegating the compliance practices and procedures. As audits of nonqualified deferred compensation arrangements under Code Section 409A develop and experience grows, it is likely the scope of the required practices and procedures will evolve.

[b] Federal Tax Return is Not Under Exam.

The ability to correct operational errors under Code Section 409A is not available to a service provider if the service provider's federal income tax return for the year in which the operational error occurred is "under examination with respect to the plan." n17 A service provider's return is presumed to be "under examination with respect to the plan" if the service provider's Form 1040 individual income tax return is under examination by the IRS for the taxable year in which the operational error arose. n18 It is not clear what the supposedly limiting phase "with respect to the plan" is to mean in the face of the presumption stated in the Notice. The "under exam" rule means the service recipient who discovers an error that is correctable must ask the service providers involved in the error if their tax returns for that year are under examination by the IRS before embarking on unilaterally correcting, for example, a failure to pay some deferred compensation. The service recipient can correct for a service provider only if they have determined the service provider's income tax return is not under an IRS examination, a requirement which is intended to preclude stealth corrections and does so by effectively requiring close coordination with the service providers.

[c] Plan Terms Complaint with Code Section 409A.

It is implied that plan terms must be compliant with Code Section 409A in order to be able to use one of the corrections provided in *Notice 2008-113*. The Notice expressly cannot be used to cure defects in "plan terms and provisions" that do not satisfy Code Section 409A. n19 Only those errors addressed in *Notice 2008-113* can be corrected. n20 A logical conclusion can be that a compliant document is encouraged by this structure. After all, in light of all of the program's notice requirements, why would a non-compliant document want this kind of official attention? There is another way, however. If the service provider is not vested and does not yet have a legally binding right to the deferred compensation, an imperfect plan document may still be corrected, according to the proposed regulations on income inclusion due to Code Section 409A, as long as there has not been a pattern or practice of noncompliance. n21 Still, the plan document is advised to have been in compliance with at least the Code Section 409A documentary requirements by December 31, 2008 if the plan wants to use this program to correct operational failures.

[d] Failure Does Not Relate to Exercise of a Stock Right.

To use the Notice, the error cannot be an error associated with the exercise of any stock right, if the exercise would otherwise result in a failure to comply with Code Section 409A. n22 *Notice 2008-113* can be used to correct one error with respect to stock rights in two limited circumstances, but only for this one error.

[e] Inadvertent and Unintentional Operational Failure.

The relief only applies to operational failures that are inadvertent and unintentional failures to comply. n23 An "inadvertent and unintentional" failure is not following plan provisions that comply with Code Section 409A(a), or is an inadvertent and unintentional violation under Code Section 409A committed during the operation of the plan. n24 What is the real difference between inadvertent and unintentional?

[f] No Listed Transaction.

The operational failure must not be directly or indirectly related to participation in any listed transaction under *Treasury Regulations section 1.6011-4(b)(2)* (e.g., it must not be related to an abusive tax avoidance transaction or an "ATAT"). n25

[g] If Repayment is Required, Full Repayment is Made.

For the corrections requiring a service provider to repay an amount in sections IV.A, IV.B, V.B, V.C, VII.B and VII.C of *Notice 2008-113* (deferred too little and corrected in same year, paid too much and corrected in same year, deferred too little and corrected in next tax year with no insider involved, paid too much and corrected in next taxable year with no insider involved, deferred too little and not corrected in same tax year for insider, paid too much and not corrected in same tax year for an insider), the entire ("gross") amount erroneously paid or made available, before reduction by any withholding taxes, must be repaid, or the service recipient must reduce the service provider's future compensation by an equivalent amount no later than the applicable deadline. n26

If the employer reduces the service provider's compensation to fulfill the repayment requirement, the amounts by which her pay is reduced must still be taxed as income to the service provider in the year in which they are deducted from compensation as if the amounts were paid to the service provider and must still be treated as wages for withholding purposes if she was an employee. n27

Importantly, no amount will be treated as repaid under the program if the service recipient pays an amount or provides a benefit (including committing to an obligation to pay an amount in the future) that is intended as a substitute for all or part of the amount that has to be repaid. n28 What criteria will be relevant in making this correction remains to be seen, but expect the inquiry, and beware unintended corrections based on coincidentally similar dollar amounts.

[h] Not for Erroneous Payments in Year of Substantial Financial Downturn.

Relief will not be provided for an erroneous payment paid during any taxable year of the service provider in which the service recipient either (i) experienced a substantial financial downturn that indicated a significant risk that the service recipient would not be able to pay the deferred compensation when due, or (ii) otherwise experienced financial or other issues that indicated a significant risk that the service recipient would not be able to pay the amount deferred when due. n29 This means that the correction must not be to fix an early payment made when the service recipient had a significant risk it would not be able to pay the amount deferred due to a substantial financial downturn or had another issue that presented a significant risk to payment of the deferred compensation. This caveat may severely limit the availability of the corrections of early payments during the current economic downturn, since many companies have experienced substantial financial downturns, and the program's availability may turn on whether the financial downturns were or were not substantial or whether the company's financial issues present a risk to payment of the deferred compensation.

[i] Other Considerations.

Use this Notice carefully, in strict compliance with its terms at least initially, because any use of this Notice is subject to examination by a suspicious Service, n30 and because the taxpayer has the burden to prove eligibility to use the program and compliance with

[Return to Text](#)

n1 *Notice 2008-113, 2008-51 I.R.B. 1305* (December 22, 2008) ("Notice 2008-113").

n2 *2005-1 C.B. 274*.

n3 *2006-2 C.B. 763*.

n4 *2007-46 I.R.B. 990*.

n5 *72 Fed. Reg. 19234*.

n6 *70 Fed. Reg. 57930*.

n7 *Notice 2007-100, 2007-52 I.R.B. 1243* (December 26, 2007).

n8 *2008-51 IRB 1305* (December 22, 2008).

n9 *Notice 2008-113, fn 1* (December 22, 2008).

n10 *Notice 2008-113, § X*.

n11 *Notice 2008-113, § X*.

n12 *Notice 2006-100, 2006-2 C.B. 1009; Notice 2007-89, 2007-46 I.R.B. 998*.

n13 *Notice 2008-113*, § X.

n14 *Prop. Treas. Reg. § 1.409A-4(a)(1)(ii)(B)*; 73 *Fed. Reg.* 74380, 74382 (Dec. 8, 2008).

n15 *Notice 2008-113*, § III.A.

n16 *Notice 2008-113*, § III.B.

n17 *Notice 2008-113*, § III.C.

n18 *Id.*

n19 *Notice 2008-113*, § III.D.

n20 *Id.*

n21 *Prop. Treas. Reg. § 1.409A-4(a)(1)(ii)(B)*; 73 *Fed. Reg.* 74380, 74382 (December 8, 2008).

n22 *Notice 2008-113*, § III.D.

n23 *Id.*

n24 *Id.*

n25 *Id.*

n26 *Notice 2008-113*, § III.E.

n27 *Id.*

n28 *Id.*

n29 *Notice 2008-113*, § III.F.

n30 *Notice 2008-113*, § III.A.

RELATED LINKS: For more information, see

■ 2-14 Federal Income Taxation of Retirement Plans § 14.05

For more information, see

■ LexisNexis Tax Advisor -- Federal Topical § 1C:6.04

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Value-in-Use, Special Purpose, Other Factors Disputed in Meijer Store Assessment

2009 Emerging Issues 4748

Value-in-Use, Special Purpose, Other Factors Disputed in Meijer Stores Assessment

By Joseph Calvanico

December 23, 2009

SUMMARY: A 2009 Supreme Court of Ohio decision is in possible conflict with the *Uniform Standards of Professional Appraisal Practice*. *Meijer Stores L.P. v. Franklin County Bd. of Revision*, 122 Ohio St. 3d 447 (Ohio 2009). The assessment turned on several fundamental issues. One of several factors critical to the decision was consideration of the subject property's Value-in-Exchange characteristic principles, as opposed to its Value-in-Use.

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ARTICLE: A 2009 Supreme Court of Ohio decision is in possible conflict with the Uniform Standards of Professional Appraisal Practice. *Meijer Stores L.P. v. Franklin County Bd. of Revision*, 122 Ohio St. 3d 447 (Ohio 2009). The assessment turned on several fundamental issues. One factor critical to the decision was consideration of the subject property's Value-in-Exchange principles, as opposed to its Value-in-Use.

The undisputed facts.

The subject property is 193,000 square feet situated on 24.03 acres. It was built in 2002 by Meijer under specifications for its own use. The auditor valued the property at nearly \$13.3 million; the taxpayer asked that it be reduced to \$9.5 million.

Both parties submitted a real estate appraisal report in support of their respective contentions. Meijer did not provide their original construction costs for the subject. Both appraisals placed the greatest weight on the Market Data Approach and the Income Approach.

Conflicting appraisal evidence cuts against the taxpayer.

The Court discussed, "...conflicting appraisal evidence" in setting forth its understanding of the appraisal reports. The taxpayer's appraiser recognized an important inherent assumption in the definition of Market Value; viz., the property's value to an alternative purchaser - not the current owner. The appraiser for the School Board joining the county in defending the assessment, however, considered the subject property's value to Meijer. This is Value-in-Use methodology.

Value-in-Use v. Market Value (Value-in-Exchange).

Appraisal theory defines terms of art separately, as follows:

Market Value (Value in Exchange) - The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self interest, and assuming that neither is under undue stress. n1

Value-in-Use - The Value has a specific use. A value based on the current use, not on its market value considering alternative uses.

Ohio defines its True Value/Market Value under ORC Ann. 5713.03 as the fair market value or current market value of property - the price at which property should change hands on the open market between a willing buyer and seller.

It is important to note here that the Ohio value definition most closely approximates the definition that appraisers use for Market Value as articulated above. In contrast, the Supreme Court of Ohio blessed the Board of Tax Appeal's (BTA) acceptance of the methodology set forth in the school board's appraisal, pronouncing that the "BTA weighed the probative value of two appraisals and found one to be more probative than the other. This decision rests within the core of the BTA's competence as fact-finder and deserves the highest degree of deference from this court." *Meijer Stores L.P. v. Franklin County Bd. of Revision*, 122 Ohio St. 3d 447 (Ohio 2009).

The Taxpayer's Arguments Are Refuted.

One by one, the court rejected the taxpayer's arguments. The arguments were ineffectual in that they danced around the issue of the correct usage of the definition of Market Value. For instance, the taxpayer claimed that the BTA had accepted the taxpayer appraisers' similar contentions in other cases. The Court was swift in its reply: "BTA accepted [the school board's appraiser's report], and we affirmed." *Meijer Stores v. Franklin County Bd. of Revision*, 2009 Ohio 3479 (Ohio July 22, 2009). The Court rejected the relevance of the taxpayer appraiser's analysis, and gave him no credit insofar as his cogent valuation skills articulated in previous trials. Instead, the court relied on a string of decisions that perpetuate the myth that USPAP's definition of Market Value is simply an aberration and not to be given any credence.

Meijer argued that using comparables that have been subject to long-term above-market leases is tantamount to valuing "...speculative 'leased fee' rather than fee simple." The taxpayer might have added, but did not, that a lease cannot enhance the value of the property. The most recent edition of the *Appraisal of Real Estate* published by the Appraisal Institute goes a long way in explaining this phenomenon. When a lease is "above market," there is indeed a leased fee advantage. The advantage does not, however, translate to great value of the real property, but to the rights of the leased fee....an intangible. The taxpayer sought to persuade the Court to reject the methodology employed by the school board. In rejecting Meijer's contention, the Court instead contradicted nearly 100 years of valuation theory, relying on the theory "...that at some point the store could be held as a rental property subject to an above-market lease that would enhance its value." *Meijer Stores v. Franklin County Bd. of Revision*, 2009 Ohio 3479 (Ohio July 22, 2009)

The Court differentiated Value-In-Use from the "current use" of the subject: "...[W]e have also held that the constitutional prohibition does not bar consideration of current-use value in the context of the 'special-purpose property' doctrine." *Dinner Bell Meats, Inc. v. Cuyahoga County Bd. of Revision*, 12 Ohio St. 3d 270 (Ohio 1984). But since when is a "big box" retail property special purpose? The *Dictionary of Real Estate Appraisal*, defines "Special Purpose

Property," in part, as property that has a limited market.

It is true that the store was constructed specifically for Meijer, and the building probably contains some characteristics that are conducive to the business Meijer conducts. It would not, however, be unrealistic to consider the potential market for the subject to include other "big box" retailers. Several recently closed Circuit City stores were purchased for re-use by another retailer. "Big box" retail properties can be utilized for many different occupancies and alternative activities. It is absurd to characterize them as special purpose.

The Court went on to support its flawed contention, relying on *Dinner Bell Meats, Inc. v. Cuyahoga County Bd. of Revision*, 12 Ohio St. 3d 270 (Ohio 1984). Dinner Bell Meats, Inc. was a meat packer, and the court's reliance on the *Dinner Bell* decision was misplaced. A meat packing plant is really a "special purpose" occupancy, and in this respect is wholly dissimilar to a retail property. For example, a meat packing plant is designed such that the live animal enters a specially designed room that starts the process; it contains drains and low ceilings with conveyors or trap doors. Next, in several segmented chambers throughout the plant, various operations occur that require further handling and partitioning. These chambers are generally sanitary with air conditioning. The design, in other words, is specifically tailored to the process.

On the other hand, a retail store is a big box, generally few to no partition walls, adequate lighting and little plumbing. Any "big box" retail facility can be easily reconfigured to fit, certainly, another retail use or perhaps an office or call center with minor modifications. This is why the Court erred in comparing Dinner Bell Meats' special purpose facility with the easily modified Meijer facility.

Here, in upholding the BTA's decision, said "...in utilizing the cost approach for a special purpose building [the appraiser] simply considered the Highest and Best Use" of the subject. The Court essentially contradicted itself because in the instant case the BTA and the court said the Cost Approach was not useful yet both appraisals considered the current use as the Highest and Best Use .

The last argument to be refuted was the notion of obsolescence. It can only be assumed the Court was negating the existence of External Obsolescence since it was not stated expressly. Here the Court rejected Meijer's computation of obsolescence because of its "special-purpose situation."

"Economic Obsolescence" or "External Obsolescence" is defined as the loss in value from external influences. Functional Obsolescence is the loss in value resulting from functional inadequacies or super-adequacies. ⁿ² This is important because the court rejected Meijer's claim of external obsolescence, incongruently citing its predisposition to Functional Obsolescence. In other words, they used a malapropistic argument. The Court did not have evidence to support recognition that external economic factors resulted in poor performance for a grocery store.

Special purpose facilities, when valued for market value purposes (i.e., for alternative use or users), often exhibit some functional obsolescence. By nature of their design, they are specifically designed for a particular user. Here, the Court interpreted the construction of the subject by the taxpayer to be indicative of special purpose. In fact, the Court ignored that it is simply a retail box. The Court rejected the relevance of external obsolescence by using an argument for functional obsolescence, but still did not grant the economic penalty. Here the Court, believing that it was correct in labeling the subject as "special purpose," could have granted a deduction for "Functional Obsolescence."

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ⁿ¹ *The Dictionary of Real Estate Appraisal 2nd Edition*, Appraisal Institute

n2 Appraisal of Real Estate, 13th Edition

RELATED LINKS: For more information about property assessment principles, see Bender's State Taxation: Principles and Practice Section 20.01



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Property Tax Gaffe: Purchase Price Equated With Market Value

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Property Tax Gaffe: Purchase Price Equated With Market Value in Three State Supreme Court Cases

By Joseph Calvanico

December 23, 2009

SUMMARY: Three recent Supreme Court of Ohio property tax decisions purport to examine the propriety of using the purchase price of a particular property as prima facie evidence of market value for property tax assessment purposes. In each case, the Court decided that the purchase price was equivalent to the property's market value, despite accepted appraisal practice standards, GAAP pronouncements, and actual legal contractual arrangements.

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ARTICLE: The Honorable Chief Justice Thomas Moyer wrote the majority opinion for the Ohio Supreme Court decision in *AEI Net Lease Income & Growth Fund v. Erie County Bd. of Revision*, 119 Ohio St. 3d 563 (Ohio 2008) and in *St. Bernard Self-Storage, L.L.C. v. Hamilton County Bd. of Revision*, 115 Ohio St. 3d 365 (Ohio 2007). Similarly, the Honorable Justice Terrence O'Donnell wrote the majority opinion in *Rhodes v. Hamilton County Bd.*, 117 Ohio St. 3d 532 (Ohio 2008). What is notable about these cases is their commonality. All of these cases purport to examine the propriety of using the purchase price of a particular property as *prima facie* evidence of market value for property tax assessment purposes.

In every instance, the court decided that the purchase price was equivalent to the property's market value. These decisions were made despite the guidance of accepted appraisal practices, GAAP pronouncements, actual legal contractual arrangements, and in some respects common sense. Furthermore, the Supreme Court of Ohio also decided that it is within its provenance to opine on the quality of business negotiations with respect to factual information presented as evidence without having any knowledge of the actual negotiations themselves.

Many may feel the foregoing to be harsh criticism. One may feel differently, however, in learning the details contained herein. First, a few basics such that certain points discussed below are considered within the correct context, as follows:

Accepted appraisal practices and useful definitions should be considered.

The Appraisal of Real Estate (13th Edition, The Appraisal Institute 2008), states that "[t]he terms *price*, *cost*, and *value* are used and defined carefully by appraisers... Many people use *cost* and *value* synonymously, but appraisal practice requires more precise definitions." This resource defines "market value" as "[t]he most probable price, as of a

specified date, in cash,... for which the specified property should sell ... in a competitive market..." Further guidance provides that "[b]ecause the standard measure of these activities is in cash, the increases or diminutions in market value caused by financing and other terms of sale are measured against an all-cash value."

In other words, the most widely recognized textbook on real estate valuation instructs readers that cost and price might not necessarily be commensurate with value. Additionally, market value is measured in cash terms, and must be so if financing obfuscates the terms of a particular transaction. Some may say it this way: "Price does not always equal value!"

Certainly, one must look beyond a purchase price to ascertain value. However, the Supreme Court of Ohio has not, as discussed below.

GAAP purchase price allocation.

The Financial Accounting Standards Board (FASB) has issued certain guidance on accounting for business combinations in FAS 141. In its summary, it states that "All business combinations in the scope of this statement are to be accounted for using one method, the purchase method." The benefits, it states, will be financial statements that "...better reflect the investment made in an acquired entity". As part of its guidance, paragraph 7 instructs the financial community that "Acquiring assets in groups requires not only ascertaining the cost of the asset group, but also allocating the cost to the individual asset." For those individual assets, the statement further instructs the practitioner in paragraph 36 that plant and equipment should be valued at "...current replacement cost for similar capacity..." and that goodwill, if identified, must be accounted for as a separate asset.

Here, GAAP recognizes that goodwill is a separate asset and must be accounted for in a business transaction. In most cases, the accounting literature suggests that an amount above the cost of a certain asset is a good indication of goodwill.

These principles were consistently ignored, in one way or another, in all three decisions handed down by the Supreme Court of Ohio.

Contractual arrangements are relevant signposts.

Black's Law Dictionary defines a contract as "[a]n agreement between two or more persons which creates an obligation to or not to do a particular thing." It is classified as "*entire*" where it consists of many parts which may be considered as parts of one whole. Of course, all regulatory matters must be considered in any contract.

At least one of the cases discussed ignores the provisions of a perfectly legal contract that follows financial reporting guidelines discussed above. In other words, several provisions of a particular contract outlined financial reporting matters for the benefit of the seller and purchaser alike.

Contracts are legal documents and must follow sound legal principles to be valid. Why would a court then ignore its contents?

Three case decisions clash with established appraisal principles outlined.

Here all three cases will be discussed in chronological order, such that the genesis of this flawed foundation of thought can be understood.

In *St. Bernard Self-Storage, L.L.C. v. Hamilton County Bd. of Revision*, 115 Ohio St. 3d 365 (Ohio 2007), the Court wrote, "At issue are approximately 4.04 acres, used for the operation of a self-storage **business** (emphasis added).... [with] 352 non-climate -controlled storage units of vary sizes, along with 63 outside spaces on a gravel lot...."

115 Ohio St. 3d 365. The Court outlined the conditions of sale along with an allocation of the purchase price: "Real Estate and Personal Property (other than goodwill) -- \$1,000,000 and (b) Goodwill -- \$950,000." *115 Ohio St. 3d 365, 366*. The closing statement echoes the foregoing according to the court and in addition allocates \$25,000 to tangible personal property, thus leaving \$975,000 for the real estate.

At the Board of Tax Appeals (BTA), the taxpayer's two experts, a business appraiser and a real estate appraiser each confirmed the allocation within allowable tolerances. The county auditor relied on statutory authority: "... when the property has been the subject of a recent arm's-length sale between a willing buyer and a willing seller, the sale price of the property shall be the true value for taxation purposes."

To support his argument, the auditor brought in as expert witness Professor Norman Miller, PhD from the University of Cincinnati's Finance Department. (Professor Miller's career research has been grounded in housing; he has not been published on the valuation of commercial properties or self-storage facilities, in particular.) Although Professor Miller asserted without support that the claim of business value or goodwill "made no sense at all," his view was accepted by the Board of Tax Appeals.

The taxpayer appealed, ultimately, to the Supreme Court of Ohio. One of the taxpayer's main arguments was the existence of the contract that allocated the purchase price. (allocation of purchase price is necessary to financial reporting as mentioned earlier). The Court dismissed this argument: "Even in cases where those purposes are fully legitimate, the amount allocated to a particular parcel does not necessarily reflect the true value of money." *115 Ohio St. 3d 365, 368*. Doesn't this contradict Ohio Rev. Code Ann. 5713.03 if the contract outlines the purchase price of the real estate? Not so, said the Supreme Court of Ohio: "[S]uch an allocation is not to be taken as indicative of the value of the real property at issue unless other indicia on the face of the contract, the circumstances attending the allocation, or some other independent evidence establishes the propriety of the allocation."

From this, it would appear that the independent corroboration supplied by the appraisers was not considered to be "some other independent evidence." Additionally, the mere existence of financial reporting guidelines was also ignored.

In *Rhodes v. Hamilton County Bd.*, *117 Ohio St. 3d 532 (Ohio 2008)*, the Honorable J. O'Donnell wrote for the majority.

In this case MA Richter purchased a building that was leased to Walgreens for retail operations. The county auditor used the purchase price as the true value of the property for the 2004 tax year. The Board of Revision agreed with the taxpayer and reduced the value. However, the county auditor appealed to the BTA, which reversed the reduction, finding that the sale price reflected the true value of the subject as of the assessment date. MA Richter appealed to the Supreme Court of Ohio.

Richter advanced three arguments; all are inter-related and involved important valuation principles. They can be synthesized into one overriding cohesive point: The subject property was encumbered by a long-term lease that commingled the existing business of a nationally-known retailer. The resulting sale price reflected these facts and conditions.

In other words, the subject property housed a Walgreens store, which was the lessee in a long-term lease with the owner. In its new store construction activities, Walgreens enters into sale-leaseback arrangements with the developer and pays a premium in this financing vehicle. The sale price reflects this arrangement and the underlying retail lease and any percentage rent terms that it contains. Percentage rent is the rent a landlord receives when the retail tenant achieves revenue over and above a mutually agreed threshold.

The Supreme Court of Ohio rejected the taxpayer's arguments. One of the arguments was a repeat of the *St. Bernard* holding, asserting that "...the sale price here also reflects the true value of the property." *117 Ohio St. 3d 532, 535*. The Court "...decline[d] to adjust the sale price... on basis of the long-term lease held by Walgreens." *117 Ohio St. 3d 532, 536*. Finally, to add insult to injury the Court revisited *St. Bernard*. Here the Court indicated that there was no

basis for the contention of business value, and that therefore there could not be any here. However, the taxpayer's appraisal expert did in fact demonstrate the difference in the contract rent versus the market rent.

Interestingly, as if to set the stage for the next relevant case, the Court punctuated its decision, also misinterpreting at least one appraisal mainstay. The Court asserted that "...the 'principle of substitution' has no application when a recent arm's length sale price between a willing buyer and seller demonstrates the true value of the property." *117 Ohio St. 3d 532, 541*. The *Appraisal of Real Estate* (page 39) warns that in limited situations where the principle of substitution may not apply have to look beyond the unique pricing for such a property and employ the appropriate analytical techniques to arrive at Market Value.

Finally, the Court followed its thinking to the next level, setting a foundation that may confound taxpayers for years to come. *AEI* raises questions and concerns about taxpayer reliance upon the integrity of the appraisal process and upon established property appraisal principles.

In *AEI*, the Court rejected most of the arguments based on *Rhodes* and *St. Bernard*, with some of the more foundational cases used in both as support. The contention that a sale-leaseback as a financing vehicle contains elements not present in typical market transactions was summarily rejected: "The fact that the rent rose in accordance with the amount of cash financing...does not mean that the sale-leaseback ...is anything but an arms-length transaction." *AEI Net Lease Income & Growth Fund v. Erie County Bd. of Revision, 119 Ohio St. 3d 563, 568 (Ohio 2008)*. Interestingly, the Court relied somewhat on a case that was overturned in Wisconsin - *Darcel, Inc. v. Manitowoc Bd. of Review, 137 Wis. 2d 623 (Wis. 1987)*, where the Supreme Court of Wisconsin hypothesized that a sale-leaseback can only be tainted if it is below-market! The Court also concluded that the taxpayer's appraisal evidence couldn't possibly be competent because it sought to distinguish the sale-leaseback price from predominant market behavior.

Taxpayers lost in Ohio, three Supreme Court decisions to none.

Summing up, taxpayers have been the biggest losers in Ohio. The courts have ignored accepted appraisal practices, GAAP pronouncements, actual legal contractual arrangements, and arguably common sense. It is troubling that each decision legitimized the succeeding decision, such that the faulty logic was presumed dogmatic. Certainly, it was magnified in the result of *AEI*.

Taxpayers beware - It will be a Herculean task to win an appeal on accepted appraisal principles in Ohio. Even in instances where the local Board of Revision has competent, appraisal minded members, success in further appeal efforts is doubtful. Taxpayers that rely on the comfort of a sale price lower than a current assessment may face the adverse results, as experienced by *AEI* in the misapplication and misinterpretation of *Darcel* from the Wisconsin Supreme Court. Interestingly, the Supreme Court of Wisconsin sought to plug any misinterpretation by its assessment community in *Walgreen Co. v. City of Madison, 2008 WI 80 (Wis. 2008)*. It is worth noting that this decision was eerily similar to *Rhodes*.

RELATED LINKS: For more information about property assessment principles, see Bender's State Taxation: Principles and Practice Section 20.01

■ 2-20 Bender's State Taxation: Principles and Practice " 20.01

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The Decision of the Kentucky Supreme Court in Miller v. Johnson Controls

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Broken Promises -- The Decision of the Kentucky Supreme Court in Miller v. Johnson Controls

By Erica L. Horn

November 12, 2009

SUMMARY: Johnson Controls and other corporate taxpayers challenged Kentucky legislation that barred refund claims based on the state's change from separate return to combined filing. The Kentucky Supreme Court denied the taxpayers' contention that the legislation was unconstitutional in denying them a meaningful refund remedy and that it was excessively retroactive. The U.S. Supreme Court denied Johnson Controls' petition for certiorari on May 24, 2010.

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ARTICLE: The jurisprudence of the United States Supreme Court provides taxpayers with two promises -- (1) a meaningful post-payment remedy, and (2) limits on the retroactivity of certain statutes. In *Miller v. Johnson Controls*, 296 S.W.3d (Ky. 2009, *pet. for reh'g denied*, 2010 U.S. Lexis 4206 (U.S. May 24, 2010)(09-981), however, the Kentucky Supreme Court broke both promises.

Johnson Controls and other corporate taxpayers (referred to collectively with the other affected businesses as "Taxpayers") challenged the constitutionality of legislative amendments made to KRS § 141.200 through H.B. 541 passed by the 2000 Kentucky General Assembly. The Taxpayers maintain that the legislation eliminates, in an unconstitutional manner, refund claims filed by them based on a change from separate return to combined filings, which change was required by a 1994 decision of the same Court in *GTE and Subsidiaries v. Revenue Cabinet*, 889 S.W.2d. 788 (Ky. 1994). While unsuccessful at the trial court, on appeal, the Court of Appeals agreed with the Taxpayers' contention that the legislation deprived them of due process. (See *Johnson Controls, Inc. v. Rudolph*, 2006 Ky. App. LEXIS 132, *20 (May 5, 2006)). The Kentucky Supreme Court reversed the Court of Appeals in a 4-2 decision.

I. The Events Giving Rise to H.B. 541.

In 1972, if not before, the Revenue Cabinet (now known as the "Department of Revenue") began to rely on the definition of "business income" found at KRS § 141.120 (Kentucky's adoption of UDITPA's definition of "business income") as authority to combine the income of multi-state, multi-corporate groups that the Cabinet determined to be "unitary." The Cabinet started this combination policy by targeting selected multi-corporate taxpayers to be placed on a combined filing methodology when it resulted in additional tax.

Starting in 1988, the Revenue Cabinet no longer allowed the filing of combined returns. Through Revenue Policy

41P225, effective November 27, 1988, the Cabinet declared that combined returns would no longer be accepted as a filing method when the members of the unitary group were bona fide (as opposed to sham) corporations. In the *GTE* case, GTE Corporation challenged this policy shift and, on December 22, 1994, the Kentucky Supreme Court ruled in GTE's favor. The Court's ruling meant that unitary businesses would be required to resume the practice of filing combined returns.

II. The Taxpayers' Refund Claims and H.B. 541.

In response to the *GTE* case, the Taxpayers filed amended returns seeking a refund of taxes they overpaid during the time the Cabinet's policy prohibited the filing of combined returns. The Cabinet acted on some, but not all, of these requests. A number of the requests were still pending before the Cabinet in 2000 when the Kentucky General Assembly, apparently concerned about the impact these claims would have upon the state's treasury, enacted H.B. 541.

The legislation decreed:

No claim for refund or credit of a tax overpayment for any taxable year either on or before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return shall be effective or recognized for any purpose.

No corporation or group of corporations shall be allowed to file a combined return under the unitary business concept or a consolidated return for any taxable year ending before December 31, 1995, unless on or before December 22, 1994, the corporation or group of corporations filed an initial or amended return under the unitary business concept or consolidated return for a taxable year ending before December 22, 1994.

Sections 9 and 10 of H.B. 541, codified at KRS §§ 141.200(17) and (18)(2009). Thus, the 2000 bill attempts to abolish the refund claims of the Taxpayers for tax years ranging from approximately 1990-1994; that is, the bill's retroactive effect is 6-10 years. (The dissent in the case, filed by Justice Abramson, defines the period of retroactivity as 6-12 years because, "KRS §141.200(18) actually stretched back twelve years to the 1988 adoption of *RP 41P225*." (296 *S.W.3d* at 416, *fn. 7*.)

III. The Arguments of the Parties.

While the Taxpayers have made numerous arguments attacking H.B. 541 (unlawful special legislation, an unconstitutional "taking", etc.), the primary arguments are that the legislation results in a deprivation of the Taxpayers' due process and equal protection rights. The Commonwealth, on the other hand, has argued (1) there is no violation of the due process or equal protection rights of the Taxpayers, and (2) H.B. 541 was a revocation of the Commonwealth's consent to be sued for a refund claim and therefore, under the doctrine of sovereign immunity, no refunds are owed to the Taxpayers.

A. The Taxpayers' Due Process and Equal Protection Arguments.

The Taxpayers' due process and equal protection rights arise from the Fourteenth Amendment of the U.S. Constitution, which provides that no state shall "deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws." U.S. Const. amend. XIV § 1.

1. The Taxpayers' Due Process Rights.

There are multiple cases that address the due process rights of taxpayers, but two U.S. Supreme Court cases are

particularly applicable here—*McKesson Corp. v. Division of Alcoholic Beverages & Tobacco*, 496 U.S. 18 (1990) and *United States v. Carlton*, 512 U.S. 26 (1994).

a. *McKesson* -- The Promise of a Meaningful Refund Remedy.

In *McKesson*, the U.S. Supreme Court held, "Because exaction of a tax constitutes a deprivation of property, the State must provide procedural safeguards against unlawful exactions in order to satisfy the commands of the Due Process Clause." (496 U.S. at 36.) Consistent with due process, a state may offer these procedural safeguards either in the form of pre-deprivation relief—i.e., a taxpayer is authorized to challenge its tax obligation prior to paying the tax purportedly owed to the state—or in the form of post-deprivation relief—i.e., a taxpayer is compelled to "pay first, litigate later." (*Id.*) However, when a state deprives a taxpayer of a meaningful pre-deprivation remedy, due process requires the state to provide backward-looking, or post-deprivation, relief. (*Id.* at 31.)

The Kentucky Supreme Court determined that the Commonwealth's statutory tax scheme does not provide taxpayers with a meaningful pre-deprivation remedy for the overpayment of taxes because it is "pointedly designed to coerce taxpayers into remitting taxes before challenging any liability to avoid potential economic disadvantage." (*Revenue Cabinet v. Gossum*, 887 S.W.2d 329, 333 (Ky. 1994).) The Court held, "It follows from *McKesson* that due process requires the Commonwealth to offer taxpayers a meaningful post-deprivation remedy." (*Id.* at 332, citing *McKesson*, 496 U.S. at 31.)

An examination of Kentucky's statutes reveals refund statutes both general in nature (see KRS § 134.580) and specific to a certain tax (see KRS § 141.235 for income tax refund statute). Therefore, Kentucky appears to have satisfied its due process obligation to taxpayers. However, this is only the case if Kentucky's courts require the General Assembly and taxing authority to comply with the statutes.

b. *Carlton* -- The Promise of Limited Retroactivity.

The United States Supreme Court also has established that a tax statute violates due process if the retroactive reach of the statute extends beyond "short and limited periods required by the practicalities of producing" the legislation. (*Carlton*, 512 US at 32-33, quoting *United States v. Darusmont*, 449 US 292, 296-297 (1981).) In *Carlton*, the taxpayer had taken advantage of an estate tax deduction enacted by Congress in 1986. Congress quickly recognized that the statute was overbroad, so, a little over a year later, it enacted a curative amendment limiting the deduction such that it would no longer apply to the taxpayer and doing so on a retroactive basis. Thus, the advantageous deduction taken by the estate was denied.

The Court upheld the retroactive application of the estate tax amendment due to Congress's promptness in the enactment and -- importantly -- the "modest" 14 month retroactive period. (*Id.* at 31.) In upholding the amendment, the Court used the familiar "rational basis" test, that is, whether the amendment was rationally related to a legitimate legislative purpose. If the answer to the inquiry is "yes", then due process is not violated.

Justice O'Connor wrote separately to stress that Congress does not possess "unlimited power to 'readjust rights and burdens . . . and upset otherwise settled expectations.'" (*Id.* at 37.) She opined:

The governmental interest in revising the tax laws must at some point give way to the taxpayer's interest in finality and repose Because the tax consequences of commercial transactions are a relevant, and sometimes dispositive, consideration in a taxpayer's decisions regarding the use of his capital, it is arbitrary to tax transactions that were not subject to taxation at the time the taxpayer entered into them

* * *

In every case in which we have upheld a retroactive federal tax statute against due process challenge, however, the law applied retroactively for only a relatively short period prior to enactment. See *United States v. Hemme*, *supra*, at 562

(1 month); *United States v Darusmont*, *supra*, at 294-295 (10 months); *United States v Hudson*, 299 U.S. 498, 501, 81 L. Ed. 370, 57 S. Ct. 309 (1937) (1 month) . . . Given our precedents and the limited period of retroactivity, I concur in the judgment of the Court that applying the amended statute to respondent Carlton did not violate due process.

(*Id.* at 37-39.) Assuming adherence to *McKesson*, without enforcing the limited retroactivity standard set forth in *Carlton*, the post-deprivation remedy required by *McKesson* becomes meaningless.

When applying the rational basis test to H.B. 541, the Taxpayers maintain the enactment is based on an illegitimate, discriminatory motive and is excessively retroactive. Stated otherwise, there is no legitimate legislative purpose to the bill, and 5-10 years of retroactivity is immodest and unconstitutional.

(i) There is no legitimate legislative purpose for H.B. 541.

Based on the fiscal explanation for the bill, the purpose of H.B. 541 was to prevent the state from having to pay "the unanticipated refund claims" relating to the unitary method of filing based on the *GTE* decision. The Cabinet testified in front of the House Appropriations and Revenue Committee and the Senate Appropriations and Revenue Committee that H.B. 541 was to avoid the huge "unanticipated revenue loss" to the general fund of nearly \$200 million.

Although the *Carlton* court found that an "unanticipated revenue loss" provided a legitimate purpose for retroactive tax legislation, the record reflects that the refund claims filed after *GTE* were not "unanticipated." The Revenue Cabinet was aware of and tracked the refund claims of the Taxpayers beginning no later than October 1995-five years before H.B. 541 was passed. In 1997, the Chairman of the House Appropriations and Revenue Committee asked that special counsel be retained to evaluate the merits of the claims. Finally, the Legislature specifically budgeted for the *GTE* refund claims prior to H.B. 541. Thus, contrary to the situation in *Carlton*, the Commonwealth was not facing an "unanticipated revenue loss," but rather appears to have been acting with an improper motive by targeting this group of specific Taxpayers.

(ii) H.B. 541's ten-year period of retroactivity is not "modest."

Although the U.S. Supreme Court did not specify what period of retroactivity would violate the rule of "modesty", the Court indicates that the general intent of the retroactivity period is to accommodate the legislative process. Unlike the facts in *Carlton*, however, the General Assembly in this case did not act in the first legislative session after which it became aware of the "unanticipated revenue loss" in 1996, which would have been in 1998. Instead, H.B. 541 was passed in 2000, and whether the retroactivity period is calculated as the six years from 1994 to 2000 (date of *GTE* to date of passage of H.B. 541), or the ten years of affected taxes, that is from 1990 to 2000, such a period is in excess of a "modest" period necessary to accommodate the legislative process.

2. The Taxpayers' Equal Protection Rights.

The law favors equality, uniformity and impartiality in taxation. (*Delta Air Lines, Inc. v. Commonwealth, Revenue Cabinet*, 689 S.W.2d 14, 18 (Ky. 1985).) And, while states are not prohibited from exercising discretion in classification for purposes of tax legislation, there are limits.

[T]he classification must be reasonable, not arbitrary, and must rest upon some ground of difference having a fair and substantial relation to the object of the legislation, so that all persons similarly circumstanced shall be treated alike.

F.S. Royster Guano Co. v. Virginia, 253 U.S. 412, 415 (1920).

Based on the expired deadlines in the legislation, H.B. 541 could not apply either retrospectively or prospectively to other unitary taxpayers. Instead, it applies only to those who filed refund claims on a unitary or combined return basis after *GTE* and whose claims had not been processed by the Revenue Cabinet before passage of H.B. 541. These select Taxpayers lost their tax refund claim rights, while other similarly situated corporate taxpayers did not, because: (1) they

complied with Revenue Policy 41P225 before *GTE* and paid their taxes on a separate return basis; (2) they relied upon the refund statutes found in Kentucky law to recover their overpayment; and (3) their refund claims were not processed by the Cabinet during the nearly 5 year period between *GTE* and H.B. 541. These factors do not provide a rational basis for the discriminatory effect on the Taxpayers' refund claims that has the required "fair and substantial relation to the object of the legislation." (*Id.* at 415.) The Taxpayers maintain this is *the* discriminatory treatment by a state that is forbidden by the equal protection guarantees of the U.S. Constitution.

B. The Commonwealth's Defense and Sovereign Immunity Argument.

The Commonwealth defends the enactment of H.B. 541 by maintaining that (1) *McKesson* only applies to claims arising from statutes found unconstitutional, and (2) the bill was rationally related to the legitimate public purpose of avoiding a "massive loss of tax revenues". Additionally, the State maintains that there is no modesty requirement under the rational basis test.

The Commonwealth's primary argument, however, is that no constitutional violation occurs by reason of the enactment of H.B. 541 because the statute constitutes a revocation of the Commonwealth's right to be sued for a refund, and such a waiver of sovereign immunity may be revoked at the will of the General Assembly. The Cabinet maintains that the power of the General Assembly "knows no limitations."

With this argument, the Commonwealth holds the General Assembly above the supreme Law of the Land as established by the United States Constitution, and above the judicial branch of the government. Numerous cases make clear that state sovereign immunity is secondary when federal constitutional principles are involved. Further, the judicial branch always has the constitutional authority to determine whether a legislative act violates the U.S. Constitution or Kentucky Constitution, and no legislature can circumvent this constitutionally mandated "separation of powers". The Commonwealth's argument was rejected by both the *Kentucky Court of Appeals* (2006 Ky. App. LEXIS 132 *26) and the *Kentucky Supreme Court* (296 S.W.3d at 397).

IV. The Decision of the Kentucky Court of Appeals.

The Court of Appeals analyzed the Taxpayers' due process claim under the rational basis test used by the United States Supreme Court in *Carlton*. Under the first part, the Court of Appeals found that H.B. 541 was rationally related to the Kentucky General Assembly's legitimate purpose of avoiding the potential loss of revenue that would result from allowing the unitary businesses to file combined returns for the years before 1995. (2006 Ky. App. LEXIS 132 at *20.)

However, the Court of Appeals determined that H.B. 541 failed the "second prong of the *Carlton* test", which requires retroactive tax legislation to be promptly enacted and that a legislature employ "only a modest period of retroactivity." (*Id.* at *18.) In reaching its decision, the Court recognized that "at some point, the rights of a taxpayer to proceed under particular provisions of a taxation code become settled enough so that a taxpayer must be permitted to order his financial affairs in regards to those laws." (*Id.* at *19.) The Court noted that "nearly all" of the post-*Carlton* cases in which retroactive legislation has been upheld involved retroactive periods of less than one year while this case involved a retroactive period greater than five years, and that the outcome could have been different had the General Assembly enacted H.B. 541 in 1996, in its first session following *GTE*, but that the delay until 2000 to extinguish claims filed more than five years earlier was excessive. (*Id.* at *24.) Accordingly, the Court held that "the retroactivity period of H.B. 541 is so excessive as to violate due process." (*Id.* at *31.)

V. The Opinion of the Kentucky Supreme Court.

The Kentucky Supreme Court reversed the Court of Appeals holding that H.B. 541 furthered a "legitimate governmental purpose" and the bill was "rationally related to that purpose." (296 S.W.3d at 403.) While the Supreme Court acknowledged that "the length of the period of retroactivity is to be considered as part of the test of whether the statute is a rational means of achieving the government's goal," the Court concluded that the retroactivity of H.B. 541 was not excessive. (*Id.* at 398.) Additionally, the Court distinguished this case from *McKesson* by agreeing with the

Commonwealth that *McKesson* applied only to claims arising from statutes held to be unconstitutional. (*Id.* at 402.) The Taxpayers maintain that to reach these conclusions, the Court misconstrued the facts and misapplied the law.

A. The Court's Factual Errors.

The opinion of the Court is premised on three key factual findings that are unsupported by the record of the case. First, the Court states that "[t]he General Assembly was not apprised of, or at least was not able to address these problems [*i.e.*, tax refund claims] until late in the 1998 Regular Session," so that "the first chance to deal with the problem with direct legislation would come two years later." (*Id.* at 395.) The opinion then says that in 2000 (when H. B. 541 was enacted) there was an "emerging problem" created by corporations filing amended returns. (*Id.*) However, the undisputed facts from the record demonstrate that in 1996 and 1997 the General Assembly was fully aware of the refund claims filed following the decision in *GTE*, and that the General Assembly had a full opportunity to deal with the refund claims well before the year 2000.

Second, the Court misconstrues H.B. 541 as a clear legislative intent "to supersede *GTE*" and that the General Assembly was acting to "correct what it viewed as a mistake in *GTE*'s interpretation of the law." (*Id.* at 400.) However, this is not what actually transpired. In 1995, after *GTE*, the Revenue Cabinet began considering regulations to formalize the unitary business concept. It was the business community, and not the General Assembly, that had difficulties with the concept -- because the determination of whether a business is "unitary" is very fact specific and can lead to costly litigation.

Additionally, had the General Assembly believed *GTE*'s "interpretation of the law" to be erroneous: (1) In 1996, the General Assembly would not have passed H. B. 599 allowing a single return for multi-corporate groups (*i.e.*, consolidated returns); instead, legislation would have been passed requiring separate returns for back years and prospectively; (2) The 1998 General Assembly would have acted to reverse the *GTE* decision; and (3) The 1998 Budget Bill would not have included a provision barring payment of the pending refund claims as such a provision necessarily recognizes the state's underlying liability.

Third, and perhaps most significantly, the Court was under the misimpression that *GTE* granted Taxpayers the option to file "the most advantageous return." (*Id.* at 402.) However, *GTE* did not create, or allow, any optional filing method under the statutes. Instead, *GTE* declared that for unitary corporate groups the only legal method of calculating their taxable income (and thus filing their tax returns) was on a combined basis.

B. The Court's Legal Errors.

The Court erred in applying the due process requirements of both *McKesson* and *Carlton*.

1. The Court's Failed Analysis of *McKesson*.

In rejecting the Taxpayers' arguments under *McKesson*, the Court held, "The remedy provided by the refund statute was not affected at all; it simply no longer applies to the [Taxpayers] in this case because the underlying tax law has been changed ..." (296 S.W.3d at 403.) In reaching this conclusion, the Court ignores Section 9 of H.B. 541 and focuses, instead, on Section 10. Section 9 states:

No claim for refund or credit of a tax overpayment for any taxable year either on or before December 31, 1995, made by an amended return or any other method after December 22, 1994, and based on a change from any initially filed separate return or returns to a combined return under the unitary business concept or to a consolidated return **shall be effective or recognized for any purpose.**

(KRS §141.200(17)(emphasis added).) By this section, the General Assembly directed that there be no refund claims; that is, the Taxpayers' post-payment remedy is revoked. The Court's conclusion that the refund remedy was "not affected at all" is erroneous.

Section 10, on the other hand, purports to modify Kentucky's filing methodologies by directing that:

No corporation or group of corporations **shall be allowed to file a combined return under the unitary business concept** or a consolidated return for any taxable year ending before December 31, 1995, unless on or before December 22, 1994, the corporation or group of corporations filed an initial or amended return under the unitary business concept or consolidated return for a taxable year ending before December 22, 1994.

(KRS §141.200(18)(emphasis added).) The mandatory language of each section-no claim for refund shall be recognized (Section 9) and no corporation shall be allowed to file (Section 10)-provides the key to discerning the action intended by the General Assembly. By focusing on the prohibition against combined filing, the Court fails to give any meaning to Section 9 of H.B. 541, which is a fundamental error of statutory construction. (*See Ross v. Board of Education*, 196 Ky. 366, 372, 244 S.W. 793,796 (Ky. 1922) ("All provisions of the statutes must be harmonized if it can be reasonably done, and effect and enforcement given to each clause, unless the provisions of the statute are irreconcilably incongruous.").)

Also, the Court adopts one of the arguments of the Revenue Cabinet holding that *McKesson* only applies in cases in which a refund claim arises from a statute found to be unconstitutional. (*Id. at 402.*) There are two problems with this holding. First, the attempted withdrawal of a taxpayer's refund remedy by a legislature should be a due process violation regardless of whether the overpayment of tax arises from payment under a statute later held to be wrongfully interpreted and administered by the taxing authority or from a statute later found to be unconstitutional. Second, as the dissent notes, *McKesson* "cites earlier United States Supreme Court cases where due process mandated the refund of taxes collected, not in violation of the Constitution, but in violation of federal laws." (*Id. at 414* (internal citations omitted).)

2. The Court's Failed Analysis of *Carlton*.

While the Court's description of the *Carlton* standard is not wholly objectionable, the Court failed to apply the standard as articulated by it. The Court described the *Carlton* standard as follows:

Retroactive application of a statute need only be (1) supported by a legitimate legislative purpose (2) furthered by rational means, which includes an appropriate modesty requirement.

* * *

Thus what is "modest" or acceptable for due process purposes *depends on the facts of the case, including notice, settled expectations, detrimental reliance*, etc.

(*Id. at 399* (emphasis added).) However, when applying the "notice, settled expectations, detrimental reliance" criteria, the Court's analysis is superficial and incomplete, and, again, what analysis there is focuses on H.B. 541's alleged elimination of combined filing (Section 10), rather than elimination of the Taxpayers' refund claims (Section 9). The only full statement of the Court applying the criteria to the facts of this case is as follows: "Further, to prevent a significant and unanticipated revenue loss, [Taxpayers] had been on notice of the revenue intent [to prohibit combined filing] from 1988 when *RP 41P225* was issued until 1994 when *GTE* was decided, and could not have had any "settled expectations" to the contrary." (*Id. at 400.*)

Application of the "notice, settled expectations, detrimental reliance" criteria to the elimination of the Taxpayers' refund claims brought about by Section 9 leads to a conclusion quite different from that reached by the Court. The Taxpayers had *no* "notice" that the General Assembly would terminate its refund remedy-the remedy promised by the U.S. Supreme Court in *McKesson*, the Kentucky Supreme Court in *Gossum* and KRS §134.580 and KRS §141.235. Conversely, the Taxpayers had absolute "settled expectations" about both their refund rights (as just described) and the tax law. As set forth in *GTE*:

Any business selecting a multi-corporate unitary form of operation from 1972 to 1988 would have done so in the

belief that the Kentucky tax laws allowed such businesses to file a combined income tax return. They would have been surprised to learn in 1989 that the Revenue Department had reversed its decision retroactively.

887 S.W.2d at 791-92. The Taxpayers assumed that the Revenue Cabinet would follow both the law, as set forth in the refund statutes and *GTE*.

Finally, the Taxpayers "detrimentally relied" on both the Executive and Legislative branches of Kentucky's government in filing their tax returns in accordance with Revenue Policy 41P225, believing that a refund remedy was available. The six (6) litigants alone paid over \$5 million to Kentucky by relying on (1) the Cabinet's authority to issue Revenue Policy 41P225; (2) their right to file post-*GTE* refund claims based on KRS §134.580 and KRS §141.235; and (3) their expectation that Revenue would timely process their refund claims, as statutorily required.

3. The Court's erroneous reliance on *Montana Rail Link*.

In addition to the legal errors related to *McKesson* and *Carlton*, the Taxpayers assert that the Court improperly relied on *Montana Rail Link, Inc. v. United States*, 76 F.3d 992 (9th Cir. 1996) ("*MRL*"). The Court describes *MRL* as "upholding a law that was very similar in effect to this one." (296 S.W.3d at 399.) Yet, the case is distinguishable on at least two fronts.

First, in *MRL* the retroactivity of the statute was upheld based on policy concerns for innocent members of the public. Specifically, the court relied on a House Conference report to conclude that restricting the retroactivity period to one or two years "would have severely hurt workers who had retired expecting that they would receive a level of benefits based in part on the tax payments made from 1983 through 1987." (76 F.3d at 994.) Thus, the retroactive legislation in *MRL* was supported by a very different governmental purpose than protecting the state treasury from an unproven "unanticipated substantial loss."

Second, as pointed out by the dissent:

Montana Rail [] addressed only the retroactive clarification of a valid tax which the taxpayer had voluntarily overpaid through its own misinterpretation of an ambiguous statute. While the Cabinet may find Montana Rail's approval of a clarifying amendment stretching back six years appealing, the Ninth Circuit decision makes clear that it is not addressing the due process issues that arise when a tax has been unlawfully exacted and then retroactive tax laws are passed.

(296 S.W.3d at 419.) Thus, the Court's reliance on *MRL* is misplaced.

C. Equal Protection.

In response to the Taxpayers' equal protection argument the Court re-emphasizes its opinion that the General Assembly had a legitimate legislative purpose in passing H.B. 541 (preventing a substantial loss in state revenue), and then, summarily states: "Having found that such a purpose exists in this case, there is no merit to the [Taxpayers'] claims." (*Id.* at 403.) Thus, the Court fails to address the critical facts that support the Taxpayers' equal protection claim.

The Taxpayers maintain that H.B. 541 did not apply to the following:

1. At least twenty (20) taxpayers who filed unitary refund claims before *GTE* and had their claims processed and settled by Revenue. Some were settled before, and some after, the *GTE* decision.
2. Seven (7) taxpayers who filed unitary refund claims after the *GTE* decision and had their claims processed before H.B. 541.
3. One (1) taxpayer who filed a refund claim after the *GTE* decision had its claim processed and settled after H.B. 541 (and after the commencement of this litigation).

4. As of April 1997, the Revenue Cabinet had issued refunds totaling \$21,185,227 in unitary tax refunds.

5. The remaining 26 Taxpayers with unitary refund claims had their claims targeted and eliminated by H.B. 541.

These facts demonstrate that similarly situated unitary taxpayers are treated differently under H.B. 541, and that the Taxpayers' equal protection rights were violated.

VI. CONCLUSION

On May 24, 2010, the United States Supreme Court denied the Taxpayers' petition for writ of certiorari. Thus, the erroneous decision will stand as part of Kentucky law.

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USC Gould School of Law 2009 Tax Institute: Nonresident Alien Estate Planning

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USC Gould School of Law 2009 Tax Institute: Karlin and Peebles on Estate Planning for Nonresident Aliens

By Jane Peebles and Michael Karlin

November 5, 2009

SUMMARY: The United States remains a magnet for foreign investment, troubled times notwithstanding. Whether the wealth coming into the U.S. is accompanied by its owners, whether or not the owners intend to remain here indefinitely, or whether the investments are owned by wealthy multinational families, the family migration patterns of the modern era present a variety of challenges and opportunities for estate planners.

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ARTICLE: The United States remains a magnet for foreign investment, troubled times notwithstanding. Whether the dollar is weak and assets appear cheap or the dollar is strong because of the flight to safety, foreign investor dollars continue to pour into the United States.

Current U.S. tax laws act paradoxically both as a tremendous incentive for foreigners to invest their wealth in the United States and as a tremendous disincentive for such individuals to immigrate. We may therefore expect large amounts of foreign private wealth to continue to come to the United States unaccompanied by its owners or accompanied by owners who have no intention of remaining here indefinitely. We also will continue to see wealthy multinational families, with some family members in the United States and others living abroad. In the modern era of increased mobility, U.S. nationality laws, under which anyone born in the United States or to a U.S. citizen parent is U.S. citizen, will continue to result in the proliferation of U.S. citizens with diminished personal but undiminished fiscal ties to the United States. The family migration patterns of the modern era present a variety of challenges and opportunities for estate planners.

Determining Whether a Non-Citizen is a Resident or Nonresident for Income and Transfer Tax Purposes

The starting point in any estate planning involving non-citizens is determining whether they are resident or nonresident for purposes of income and transfer taxes. n1 The relatively objective tests contained in the definition of "resident alien" in *IRC § 7701(b)* apply for all purposes of the Internal Revenue Code except for purposes of the U.S. estate and gift taxes. Rather, an alien is considered a U.S. resident for purposes of the estate and gift tax purposes if he or she is domiciled in the U.S. at the time of his or death or at the time of a gift. If an alien enters the U.S. for even a brief period of time, with no definite present intention of later leaving the U.S., he or she is deemed to be domiciled in the U.S. and, therefore, is considered a U.S. resident for estate and gift tax purposes. n2 Since the rules for income tax

purposes are quite different, an alien may be considered a nonresident for estate tax purposes and a U.S. resident for income tax purposes, or vice versa. n3

Assets Subject to U.S. Estate and Gift Tax

Generally, nonresident aliens are subject to Federal estate tax only on "U.S.-situs" property, with no credit for foreign death taxes paid. n4 (The foreign country may allow a credit against its death taxes for Federal estate tax paid. n5) Nonresident aliens are also subject to Federal gift tax on lifetime gifts of U.S.-situs property, but not on gifts of U.S.-situs intangible property, with exceptions if the individual is a former U.S. citizen or long-term resident. n6

U.S.-situs property includes the following: (i) real property located in the United States; n7 (ii) tangible personal property located in the United States n8 (including cash, n9 short-term U.S. Treasury Bills, n10 cars, furniture, jewelry, artwork n11, etc.); (iii) shares of stock issued by a U.S. corporation; n12 (iv) subject to certain exceptions (set forth below), any debt obligation, the primary obligor of which is a U.S. person or the United States, a state or any political subdivision of the United States, or the District of Columbia, or any agency or instrumentality of any such government; n13 (v) the cash value of life insurance on another individual issued by a U.S. insurer and owned by the nonresident alien; (vi) property that is gratuitously transferred by a nonresident alien decedent while he or she is alive, by trust or otherwise, if (1) the nonresident alien decedent retained for his or her life (or for a period that cannot be ascertained without reference to his or her death) some type of possession, control, or enjoyment of said property or its income or the right to designate who will possess or enjoy the property, (2) possession or enjoyment of the property could be obtained only by surviving the decedent and the decedent retained a reversionary interest in the property that exceeds 5% of the value of the property at the time of the decedent's death, (3) said property was, on the date of the nonresident alien decedent's death, subject to his or her right to alter or revoke the transfer (or if such a power was relinquished by the NRA decedent within three years of the date of his or death), or (4) the decedent transferred within the three year period prior to his or her death an interest in property that would have been included in his or her estate under any of the foregoing rules, and the property so transferred was situated in the United States at the time of the transfer or at the time of the decedent's death. n14

Examples of assets that are deemed to be situated outside of the United States are: (i) shares of stock issued by a foreign corporation; n15 (ii) deposits with persons carrying on the banking business, deposits or withdrawable accounts with a federal or state chartered savings institution (if the interest on such accounts is withdrawable on demand subject only to customary notice requirements), and amounts held by an insurance company under an agreement to pay interest thereon, as long as, in each case, the interest on such deposits or amounts is not effectively connected with the conduct of a trade or business in the United States by the recipient thereof; n16 (iii) deposits with a foreign branch of a domestic corporation or partnership engaged in the commercial banking business; n17 (iv) obligations the interest on which would be treated as exempt from tax under *IRC § 871* as portfolio interest, as long as the decedent was a nonresident alien for income tax purposes (a portfolio debt obligation will be considered U.S.-situs property if the decedent was a resident for income tax purposes, even if he or she was a nonresident alien for estate tax purposes); n18 (v) interest on short-term (183 days or less) obligations carrying original issue discount, so long as the original issue discount would not be treated as effectively connected with a trade or business; n19 (vi) proceeds from a life insurance policy on the nonresident alien decedent's life owned by the decedent, whether insured by a U.S. or non-U.S. insurer; n20 and (vii) works of art which are in the United States if they were imported solely for exhibition, were loaned to a nonprofit public gallery or museum and were on exhibition or *en route* to or from exhibition at death. n21

Although nonresident aliens are also subject to gift tax on gifts of U.S.-situs property, gifts of U.S.-situs intangible property by a nonresident alien are generally exempt from the gift tax. n22 Property which is not considered intangible property, and is therefore subject to federal gift tax when given away by a nonresident alien, includes; (i) real property situated within the United States; n23 (ii) tangible personal property situated within the United States at the time of the gift; n24 and (iii) U.S. or foreign currency or cash situated within the United States at the time of the gift. n25

Property which is considered intangible personal property and is therefore not subject to federal gift tax when

given by a nonresident alien includes: (i) shares of stock issued by a U.S. or foreign corporation; n26 and (ii) debt obligations, including a bank deposit, the primary obligor of which is a U.S. person, the United States, a State, or any political subdivision thereof, the District of Columbia, or any agency or instrumentality of any such government. n27

One area in which there is substantial uncertainty, in part because of the IRS' incomprehensible unwillingness to provide any guidance, relates to interests in domestic and foreign partnerships. The principal uncertainties concern, first, whether it is the partnership interest or its assets that are subject to gift or estate tax (entity v. aggregate) and, second, if the partnership is treated as an entity, how the situs of the partnership interest is to be determined. n28 The authors have concluded that a gift or bequest of a partnership interest is a gift or bequest of an intangible asset rather than of its underlying property but that there is simply no reliable answer to the question of situs. Under the estate tax regulations, the situs of an intangible asset (other than a bearer instrument) is in the United States if it is enforceable against a resident of the United States. So when is a partnership resident in the United States? Unfortunately, a 2004 change to the entity classification regulations under *IRC* § 7701 removed the only regulatory guidance on what constituted a resident partnership. n29 Before the change, the regulations provided that a partnership was resident in the United States if it was engaged in a U.S. trade or business. But in 2004, the IRS removed the regulation and adopted a temporary regulation with the same number. The regulation, finalized in 2006, addressed the completely unrelated question of whether a business entity is domestic or foreign, primarily where the entity was organized both in the United States and under the laws of a foreign country. As a result, no regulation defines what is a resident partnership. n30 An ancient IRS ruling states that an interest in a partnership is located where the partnership does business, but the ruling relates to a domestic partnership which conducted all of its business in the United States and is not very reliable authority on the treatment of a partnership that is foreign or, whether foreign or domestic, conducts only part, perhaps only a small part, of its business in the United States. n31 The authorities we cite are all over the map -- a partnership interest is located where the partnership does business, where the partnership is organized, where the owner is domiciled (*mobilia sequuntur personam*).

Estate and Gift Tax Credits and Deductions

The estate of a nonresident alien receives a credit of only \$13,000 against the federal estate tax (the equivalent of a \$60,000 exemption), an exemption level that has stayed unchanged since 1988. n32 There is no credit for gifts made during the lifetime of a nonresident alien. Nonresident aliens do, however, receive the benefit of the so-called annual exclusion from gifts (currently \$13,000 per donee) n33 and unlimited gifts to pay tuition and medical expenses.

The estate of a nonresident alien may deduct from the gross estate the value of property passing to the decedent's surviving spouse, to the same extent as the estate of a resident alien or U.S. citizen. n34 Consequently, if the nonresident alien decedent's spouse is a U.S. citizen, a marital deduction will be permitted if all of the requirements of *IRC* § 2056 (covering bequests to surviving spouse) are satisfied. n35 If the surviving spouse is not a U.S. citizen (regardless of whether he or she resides in the United States), as with the estate of a resident alien or U.S. citizen, in order for the estate of the nonresident alien to take advantage of the marital deduction, the provisions of *IRC* § 2056(d) must be satisfied (which provides that a bequest to a surviving spouse will not qualify for the marital deduction unless the property is held in a qualified domestic trust, as provided in *IRC* § 2056A, or unless the surviving spouse becomes a U.S. citizen within a specified period of time after the decedent's death). n36 In addition, the gift tax marital deduction is generally not allowed for property passing to a spouse who is not a U.S. citizen, except that a donor can give his or her non-U.S. citizen spouse up to \$100,000 per year (indexed for inflation to \$133,000 for 2009) without the imposition of any gift tax. n37

As to other deductions, estates of nonresident aliens are entitled to deduct a portion of the expenses, losses, indebtedness, and taxes set forth in *IRC* §§ 2053 and 2054, which include funeral and administration expenses, claims against the estate, mortgages on, and indebtedness with respect to, property included in gross estate, and uninsured casualty losses suffered by the estate. n38 The portion of these expenses which the nonresident alien's estate may deduct is determined by multiplying the expenses by a fraction, the numerator of which is the value of gross estate situated in the United States, and the denominator of which is the value of all property, wherever situated, included in

the gross estate. n39 Whether the amounts that are to be deducted were incurred in the United States is irrelevant for purposes of the deduction.

Consequently, a recourse note secured by a mortgage on U.S.-situs property is only partially deductible, notwithstanding the fact that the mortgaged property is includible in full. If, however, the property is subject to a mortgage as to which the mortgagor has no personal liability, only the value of the property less the mortgage or indebtedness is included in the gross estate, thus, in effect, giving a 100% deduction of the mortgage. n40

Assets Subject to U.S. Estate and Gift Tax under Treaties

The United States is party to treaties dealing with the estate tax with Australia, Austria, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland and the United Kingdom. A limited number of these treaties also deal with gift tax: Austria, Denmark, France, Germany, Japan and the United Kingdom. In the case of Australia, there is a separate treaty dealing with gifts. n41 Our agreement with Canada relating to the estate tax is contained in the income tax treaty, as Canada does not have an estate tax but does impose tax on capital gains at death.

The United States has not updated any of these treaties since the early 1980s, with the exception of Canada, France and Germany. The treaties with France and Germany were updated by protocols in 1998 and 2004, respectively, and are the only gift and estate tax treaties with a savings clause that refers to former long-term residents.

In part, this rather small number of treaties reflects the fact that many countries with which we have an income tax treaty do not impose taxes on gifts and bequests. In fact, the United States has terminated treaties with countries that have repealed such taxes, most recently our estate and gift tax treaty with Sweden, terminated effective at the beginning of 2008. Nevertheless, our remaining treaties are with countries with which we have significant flows of individuals and investment.

U.S. treaties dealing with transfer taxes generally fall into two broad types:

- Older treaties, which do not explicitly limit the right of either party to impose taxes but have two principal operative provisions: The first, a set of rules that determine the situs of property; the second, provisions confirming that each country will provide tax credits to its domiciliaries for taxes paid to the other country. In some cases, the treaty also requires the situs country to allow to non-domiciliaries (or their estates) an exemption from situs country tax comparable to the one allowed for domiciliaries of the situs country, but usually based on the proportion of the non-domiciliary's assets in the situs country to worldwide assets.
- Newer treaties, which generally explicitly limit situs country taxation of gifts and estates of non-domiciliaries to real property located in the situs country and property attributable to a permanent establishment of the non-domiciliary in the situs country.

These newer domicile-based treaties afford their residents estate planning opportunities not available to residents of countries with which the United States does not have transfer tax treaties or with which the United States has older, situs-based treaties. Under the domicile-based treaties, however, certain property may be taxed by the country in which it is situated. Even the domicile-based treaties as issue can differ in this regard, which may afford even greater planning opportunities for residents of one of these countries over another.

Some of the clear benefits to alien residents of countries with which the United States has a domicile-based treaty are that they can own a U.S. business or real property through a corporation formed in a U.S. jurisdiction and, generally speaking, shelter that property from U.S. estate tax.

Since shares of stock in a U.S. corporation owned by a nonresident alien n42 are generally subject to the U.S. estate tax, residents of countries with which the United States does not have domicile based treaties can achieve such

estate tax protection by only owning shares of stock in a foreign corporation that owns shares of stock in a U.S. corporation, which ultimately owns the U.S.-situs real property or business. The downside to the use of this structure is that the entity may be considered a "personal holding company" ("PHC"). The PHC rules are generally intended to prevent the avoidance of shareholder level taxes by the accumulation of certain types of earnings by certain closely-held corporations (this is beyond the scope of this paper). The rules impose a penalty tax at the corporate level on the "undistributed personal holding company income" of a PHC. n43 Even if the PHC rules are inapplicable, this structure results in double taxation of income, because the United States will also impose income tax at 30% (or lower treaty rate) on dividends paid by the PHC to its nonresident alien shareholder.

Nevertheless, even for an alien who is a resident of a country with which the United States has a domicile-based treaty, owning a business in the United States or U.S.-situs real property through a U.S. corporation is not an ideal solution. Since such a corporation would not be able to make an election to be treated as a so-called "S corporation" under *IRC § 1362(a)* of the Code (because a corporation may not make such an election if any of its shareholders are nonresident aliens), n44 which election generally avoids taxation at the corporate level, n45 the earnings of the corporation would be taxed at both the corporate level and the individual level when dividends are paid. n46 In addition, the corporation would not receive preferential capital gains tax treatment, otherwise available to an individual. n47

In light of the foregoing, another solution might be to hold the U.S.-situs real property or business through a partnership or limited liability company that is taxed as a partnership. n48 Gifts of such interests should be sheltered from the gift tax, assuming that a partnership interest qualifies as an intangible asset. Without treaty protection, however, an interest in a partnership may or may not be subject to the U.S. estate tax, depending on the outcome of the uncertainties concerning partnership interests discussed above. n49

Generation-Skipping Transfer Tax

If a U.S. citizen or resident alien creates a generation-skipping trust, the generation-skipping transfer tax ("GST") will be payable on a taxable termination or distribution with respect to trust assets located anywhere in the world even though the trustees, income beneficiaries and remaindermen are all nonresident aliens. Treasury regulations clarify the treatment of generation-skipping transfers ("GSTs") made by nonresident aliens. n50 Nonresident aliens are entitled to claim a lifetime \$1 million GST exemption and the same GST exemption on death as U.S. citizens and residents and are subject to the automatic allocation of exemption to generation skipping transfers. The Regulations establish two rules for the applicability of Chapter 13 of the Code, which contains the GST rules, to transfers by nonresident aliens. Chapter 13 is applicable to transfers at death by nonresident aliens to the extent that the transferred property is situated in the United States for purposes of the estate tax laws. Chapter 13 also applies to lifetime transfers to the extent that the transferred property is situated in the United States for purposes of the gift tax laws and is subject to tax under *IRC § 2501(a)*. Subsequent taxable distributions and taxable terminations with respect to property held in trust are subject to Chapter 13 if the original transfer by the nonresident alien of the property to the trust was subject to Chapter 13. n51 An "anti-abuse" rule makes Chapter 13 applicable without regard to any transaction or other activity if the effect of such transaction or activity is to transfer U.S.-situs property from the transferor to the transferee.

The estate and gift tax treaties presently in effect either expressly refer to the GST or provide that they will cover subsequently enacted taxes which are of a substantially similar character to the taxes expressly covered by treaty. For these purposes, the GST should be "substantially similar" to the estate tax. However, the general situs rules which serve to exempt many types of U.S. property from estate taxation under the various treaties may not shield such property if it is owned by a generation-skipping trust.

Strategies to Reduce or Eliminate U.S. Transfer Taxes

Gift Tax Strategies. It is generally easier for nonresident aliens, especially those not protected by treaties, to avoid gift tax than estate tax. Among the most common strategies to avoid U.S. gift tax are:

1. making gifts of U.S.-situs intangible assets;
2. transferring U.S. real property to a corporation, partnership or a limited liability company to convert the holding to an intangible and, after a period of time (generally at least a year), making gifts of interests in the entity, outright or in trust, to children who are U.S. transfer tax residents;
3. setting up offshore grantor trusts for the benefit of children who are U.S. transfer tax residents;
4. making gifts of U.S.-situs assets within gift tax annual exclusion amounts; n52
5. making gifts of U.S.-situs assets for tuition and medical expenses; n53 and
6. making gifts of U.S.-situs property to a spouse, subject to the \$100,000 adjusted for cost of living annual cap if the spouse is not a U.S. citizen.

Estate Tax Strategies. Among the most common strategies for minimizing or avoiding U.S. estate tax are:

1. not holding at death any assets that have a U.S. situs for estate tax purposes;
2. releasing all general powers of appointment granted under U.S. trusts; and
3. holding any U.S. real property through a U.S. corporation, partnership or limited liability company that is, in turn, owned by an offshore corporation.

Impact of Other Countries' Laws

Estate and gift tax treaties will often affect such planning, so any applicable gift and/or estate tax treaty must be thoroughly reviewed. In gift tax planning for nonresident aliens, confer with counsel in the client's home jurisdiction to be sure that a transfer will not cause liability for foreign gift taxes or give rise to adverse income tax results under the laws of the home jurisdiction.

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n1 For additional discussion of the rules relating to residence and domicile, see MICHAEL J. A. KARLIN and JANE PEEBLES, "Residence and Domicile," 61-15 USC Law School Institutes on Major Tax Planning P 1502 (2009).

n2 *Treas. Reg. §§ 20.0-1(b) and 25.2501-1(b)*.

n3 *IRC § 7701(b)(1)(A)*.

n4 IRC §§ 2101, 2103, and 2106.

n5 See, e.g., Article 784 A of the Code General des Impôts (France); Section 21 Erbschaftsteuer- und Schenkungsteuergesetz (Germany); Inheritance Tax Act 1984 (United Kingdom), sections 158 (treaty relief) and 159 (unilateral relief) (if unilateral relief is more favorable than treaty relief, the taxpayer chooses the former).

n6 IRC §§ 2501(a)(1) and (2) and 2511(a).

n7 Treas. Reg. § 20.2104-1(a)(1).

n8 Treas. Reg. § 20.2104-1(a)(2).

n9 See Treas. Reg. §§ 20.2104-1(a)(7)(ii) and 25.2511-3(b)(4)(iv), which provide that currency is not a debt obligation of the United States, implying that it is tangible personal property. See also *Rev. Rul. 55-143, 1955-1 C.B. 465*, where the decedent died with funds which he had placed in a safe-deposit box, and the IRS held that "[s]ince the funds in the safe-deposit box on the date of decedent's death [did] not represent moneys deposited with a person carrying on the banking business within the meaning of IRC § 863(b) of the Code, they [were] includible, for Federal estate tax purposes, in the decedent's gross estate situated in the United States." See *Blodgett v. Silberman, 277 U.S. 1 (1928)*, where the Supreme Court held "... that money, so definitely fixed and separated in its actual situs from the person of the owner...is tangible property..." See also *PLR 8138103, 1981 PLR LEXIS 4981 (June 25, 1981)* and *PLR 7737063, 1977 PLR LEXIS 1327 (June 17, 1977)* (cash is tangible property).

n10 See *PLR 8138103, 1981 PLR LEXIS 4981 (June 25, 1981)*, *PLR 9422001, 1993 PLR LEXIS 2735 (February 16, 1993)* and IRC § 871(g)(1)(b).

n11 See IRC §§ 2501(a)(1) and (2) and 2511(a).

n12 IRC § 2104(a) and Treas. Reg. § 20.2104-1(a)(5).

n13 *Treas. Reg. § 20.2104-1(a)(7)*.

n14 *IRC § 2104(b)*.

n15 *IRC § 2104(a)* and *Treas. Reg. § 20.2105-1(f)*.

n16 *IRC § 2105(b)(1)* and *Treas. Reg. § 20.21051(h)*.

n17 *IRC § 2105(b)(2)* and *Treas. Reg. § 20.2105-1(j)*.

n18 *IRC § 2105(b)(3)*. Portfolio interest is interest on bonds, debentures, notes or other forms of debt which meets specific formal requirements of *IRC § 871(h)*. Most U.S. corporate bonds and Treasury obligations having a term greater than 183 days meet these requirements; many private obligations can readily meet the requirements although, in the authors' experience, private issuers and their advisors are often unaware of the requirements. The principal exceptions to the exemption in the case of debt that otherwise meets the formal requirements relate to interest effectively with the conduct of a U.S. trade or business; interest paid to controlled foreign corporations by U.S. affiliates; interest paid to "10-percent shareholders" and "10-percent partners"; and interest described as contingent interest in *IRC § 871(h)(4)*. Where an obligation carries both non-contingent interest and contingent interest, an "appropriate portion" of the obligation, determined in a manner prescribed by the IRS, is to be treated as U.S.-situs property. The IRS has not in fact prescribed how the determination is to be made.

n19 *IRC § 2105(b)(4)*.

n20 *IRC § 2105(a)*.

n21 *IRC § 2105(c)*; *Treas. Reg. § 20.2105-2(b)*.

n22 See IRC §§ 2501(a)(1) and (2) and 2511(a).

n23 Treas. Reg. § 25.2511-3(a)(1) and (b)(1).

n24 Treas. Reg. § 25.2511-3(a)(1) and (b).

n25 Treas. Reg. § 25.2511-3(b)(4)(iv)(provides that currency is not a debt obligation for purposes of applying the gift tax to the transfer of property owned by a nonresident alien; Treas. Reg. §§ 25.2511-3(b)(2) and (4) provide that debt obligations are intangibles).

n26 IRC § 2511(b)(1) and Treas. Reg. § 25.2511-3(b)(3).

n27 IRC § 2511(b)(2) and Treas. Reg. § 25.2511-3(b)(4).

n28 For a review of the issues, see Karlin, Cassell, McCaffrey and Streng, "U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests," 99 *Tax Notes* 1683 (June 16, 2003). See *Blodgett v. Silberman*, 277 U.S. 1, 11 (1928) ; *Sanchez v. Bowers*, 70 F.2d 715 (2d Cir 1934); *GCM* 18718, 1937-2 C.B. 476 ; *Rev. Rul. 55-701*, 1955-2C .B. 836, *PLR* 7737063 (6/17/1977); 2 Rhoades and Langer, U.S. International Taxation and Tax Treaties, § 33.01[2][iii] (gift tax) and 33.02[2][a][vi]; "Disposition of U.S. Partnership Interests by Nonresident Aliens," 8 *Journal of Partnership Taxation* 133 (1991); *Rev. Rul. 91-32*, 1991-1 C.B. 107; Glod, "United States Estate and Gift Taxation of Nonresident Aliens: Troublesome Situs Issues," 51 *Tax Law*. 110 (1997); Robert F. Hudson, Jr., "The Tax Effects of Choice of Entities for Foreign Investment in U.S. Real Estate and U.S. Businesses," *Business Entities*, March/April 2002. The IRS will not even rule on whether a partnership interest is an intangible asset for estate tax purposes. *Rev. Proc. 2009-7*, 2009-1 I.R.B. 226 § 4.01(27).

n29 Treas. Reg. § 301.7701-5, adopted in temporary form by *T.D. 9153* (2004) and, with minor modifications, in final form by *T.D. 9246* (2006).

n30 But see Treas. Reg. § 1.861-2(a)(2), which treats a partnership as resident in the United States if it is domestic or, if foreign, it is engaged in a trade or business within the United States. This regulation interprets

IRC § 861(a)(1), under which interest has a U.S. source if paid by a "noncorporate resident" of the United States, a phrase found nowhere else in the Code. *See, also, IRC § 865(g)*, which defines a "United States resident" for purposes of the sourcing rules on sales of property without referring to partnerships at all.

n31 *Rev. Rul. 55-701, 1955-2 C.B. 836.*

n32 *IRC § 2102(b)(1)*, as amended by Pub. L. 100-647, § 5032(b)(1)(A) (1988).

n33 *IRC §§ 2503(b)(1) and 2503(e).*

n34 *IRC § 2106(a)(3).*

n35 *Treas. Reg. § 20.2106-1(a)(3).*

n36 *Treas. Reg. § 20.2106-1(a)(3).*

n37 *IRC § 2523(i). Rev. Proc. 2008-66, 2008-45 I.R.B. 1107 , § 3.30(2).*

n38 *See IRC § 2106.*

n39 *IRC § 2106 and Treas. Reg. § 20.2106-2(a)(2).*

n40 *Treas. Reg. § 20.2053-7.*

n41 A helpful table of our estate and gift tax treaties may be found on the IRS website at <http://www.irs.gov/businesses/small/article/0,,id=186064,00.html> (viewed October 24, 2008).

n42 *IRC § 2104(a)*.

n43 *IRC § 540*.

n44 *IRC § 1361(b)(1)(C)*.

n45 *IRC § 1363(a)*.

n46 *IRC § 11 and 301(c)(1)*.

n47 *IRC § 2101(a)*.

n48 *See Treas. Reg. § 301.7701-3*.

n49 *See discussion at footnotes 28-31 and accompanying text*.

n50 *Treas. Reg. § 26.2663-2*, effective for transfers made on or after December 24, 1992.

n51 *Treas. Reg. § 26.2663-2(b)*.

n52 IRC § 2503(b).

n53 IRC § 2503(e).

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USC Gould School of Law 2009 Tax Institute: Attributional Nexus

2009 Emerging Issues 4522

USC Gould School of Law 2009 Tax Institute: The Current State of "Attributional Nexus": When May a State Use the Presence of an In-State Entity to Claim Jurisdiction over an Out-of-State Seller?

By Thomas Steele and Kirsten Wolff

November 3, 2009

SUMMARY: The poor economy has created a budgetary crisis for many state governments. One solution is to expand a states taxes to include companies earning income or with benefits that are seen occurring in the state. There are controversies on "attributional nexus," relating to the lines that govern a states reach to impose taxes on out-of-state sellers with customers but no employees or property in the state.

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ARTICLE: The downturn in the national economy has triggered a budgetary crisis for many state governments. Undoubtedly, legislatures will seek increased revenues as part of the solution to the budgetary shortfalls. One politically easy solution is to expand the reach of the state's taxes to sweep in companies that earn income or enjoy other benefits that can be viewed as occurring within the state's boundaries, *i.e.*, by expanding the state's jurisdiction to tax to more out-of-state entities.

In this article, we review controversies involving the limits of "attributional nexus," with an eye toward plotting the lines that currently govern a state's reach to impose its use taxes on an out-of-state seller that has customers but no employees or property within the state. Seventeen years ago, the United States Supreme Court established a "bright-line" standard that required, quite simply, that a taxpayer be physically present (beyond a de minimis presence) within the state as a condition for being subject to its taxing regime. n1 Notwithstanding the "bright-line" rule, the battles continue to this day and there is little reason to believe they will be resolved soon. n2

The question in the cases decided under *Quill* and *Bellas Hess* is: What constitutes physical presence under *Quill*? And in the current world, the particular issue is often: Can the physical presence of a party other than the remote seller be attributed to the remote seller to provide the necessary nexus, and, if so, under what circumstances?

To begin to answer these questions, we first explore the ways in which courts have applied two factors courts have drawn from United States Supreme Court decisions to support the theory of attributional nexus, namely: i) whether an in-state entity is acting "on behalf of" an out-of-state seller, and ii) whether the in-state entity is performing activities in support of the marketing or sales activities of that out-of-state entity. n3 We then outline a list of principles intended to provide guidance in evaluating whether an out-of-state entity may be viewed as physically present within a state by

reason of the activities of a third party that is plainly present in the state.

THE ATTRIBUTIONAL NEXUS TEST

Courts have relied on the United States Supreme Court's decisions in *Scripto, Inc. v. Carson* ("Scripto")ⁿ⁴ and *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue* ("Tyler Pipe")ⁿ⁵ for the proposition that an out-of-state seller will have nexus by attribution of a third party's in-state activities when: 1) the third party is acting "on behalf of" the out-of-state seller, and 2) the third party's activities are "significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales."ⁿ⁶

While this attributional nexus test is clear in theory, application of the test by the courts has yielded less than fully predictable results. Courts have tended to interpret both factors expansively and have implicitly situated the parts in an inverse relationship to one another. Thus, where the court finds that the in-state entity has a close relationship with the out-of-state seller, either because their business operations are extensively integrated or the in-state entity's actions are substantially controlled by the out-of-state entity, then the court will likely place less emphasis on the degree to which the in-state entity's activities are associated with establishing and maintaining the out-of-state seller's market. On the other hand, where a court determines that the in-state entity's activities are very significantly associated with establishing and maintaining a market for the remote seller, the question regarding the extent to which the in-state entity is acting "on behalf of" the remote seller will be less critical. As a consequence, the court opinions considering nexus often have a certain gestalt quality reflecting a test that apparently turns on all the facts and circumstances rather than a surgical examination of two independent factors. Nonetheless, taking each of the factors in turn provides a useful discipline for making judgments as to the risk that certain activities will result in nexus.

A court's examination of "whether substantial business activities have been carried on in the taxing state *on the taxpayer's behalf*" is likely to begin with a determination as to whether the two entities are under common ownership, on the theory that an in-state entity is more likely to represent the interests of its out-of-state affiliate if the two entities are commonly owned.^{n7 n8} However, it is clear that common ownership does not by itself result in attributional nexus.^{n9 n10} As a corollary, the absence of common ownership is not sufficient to prevent nexus, particularly if the in-state entity is acting on behalf of the out-of-state entity.ⁿ¹¹

Likewise, it does not appear that the in-state entity must actually be viewed as a formal agent of the out-of-state entity under state law to support a finding of attributional nexus. *Dell (La.)*, 922 So. 2d at 1264. Rather, where the court finds that the out-of-state seller "retained control over many of the significant aspects of the services to be provided by [the in-state entity]," or that the remote seller "relies heavily" on an in-state company to perform critical functions in support of the sale, including, for example, accepting and depositing payment, a court is likely to find that the in-state entity is acting on behalf of the out-of-state entity. *Dell (La.)*, 922 So. 2d at 1264, 1266; *Arco*, 209 S.W.3d at 74.

As to the second factor, the courts have found that a wide variety of activities are "significantly associated with the taxpayer's ability to *establish and maintain a market* in this state for the sales." *Tyler Pipe*, 483 U.S. at 250 (emphasis added).ⁿ¹² For example, the Tennessee Court of Appeals concluded that the various functions performed by an in-state manufacturer for an out-of-state vendor, ranging from "the preparation of price quotes[,] to drawing up blueprints[,] to fabricating the product[,] to arranging for shipment of the product[,] to accepting final payment from the customer," satisfied that standard. *Arco*, 209 S.W.3d at 74. Two courts examining Dell's business model have determined that in-state warranty repair services sold by Dell in connection with its remote mail order sales of computers, and provided by a third-party contractor, should be viewed as supporting Dell's efforts to obtain sales in the markets where the warranty repair services are provided. *Dell (La.)*, 922 So. 2d 1257; *Dell (NM)*, 199 P.3d at 872.ⁿ¹³

APPLICATION OF THESE PRINCIPLES TO THE BOOKSELLER CASES

Three cases involving Borders and Barnes & Noble, two booksellers with apparently similar business models, provide a useful opportunity to examine how the courts have determined whether the in-state entity is acting on behalf

of the out-of-state entity and whether in-state activities should be viewed as creating or maintaining a market. In those cases, the fundamental facts were the same: each involved stores operating within the state (so-called "brick & mortar" operations) owned by one corporation and a separately incorporated operation that provided sales over the Internet (and that was not physically present in the state seeking to impose the tax) (the "Internet seller"). In each case, the taxing authorities sought to impose use tax collection over the remote Internet sales operation based upon activities of the brick & mortar stores in the state. n14

In the *Borders* case, decided by the California Court of Appeal, the in-state retailer: 1) accepted returns from, and provided refunds and exchanges to, the remote seller's customers; 2) issued receipts to its customers with the message "Visit us online at www.Borders.com"; and 3) encouraged its employees to refer customers to the remote seller's website. *Borders*, Cal. App. 4th at 1199. The court concluded that the in-state operation acted on behalf of the out-of-state operation and that these activities were significantly associated with the remote seller's "ability to establish and maintain a market" in California and so created nexus with the out-of-state seller. *See Borders*, 129 Cal. App. 4th at 1184, 1190-92, 1199 (citation omitted).

In contrast, in the first Barnes & Nobles case, *B&N (Cal.)*, the trial court concluded that the brick & mortar store did not act on behalf of the Internet seller. The court focused upon the fact that the brick & mortar company did not control the remote seller. n15 The court also noted that, unlike in the *Borders* case, the sole activity that the brick & mortar store performed for the Internet seller was to distribute coupons for purchases from the Internet seller that had been inserted into the store's shopping bags by a third-party vendor. *Id.* § II. The court found that this activity was not enough to create an agency relationship, so that the Internet seller did not have nexus with California. *Id.* § III(a), (b).

In the second Barnes & Noble case, a U.S. District Court in Louisiana decided that the in-state activities of the brick & mortar store did not establish and maintain a market for the sales of the remote seller. n16 There, the brick & mortar operation and the Internet seller participated in a "membership program," and a gift card program, whereby customers could receive certain discounts and redeem gift cards at the brick & mortar store, with the Internet seller, or at any other participating retailer. *B&N (La.)*, 481 F. Supp. 2d at 578-79. However, the court found that these activities did not "produce[] revenue to Online by virtue of sales made or orders taken by the entity that is physically present in the Parish," since the revenue from the programs was simply divided among participating entities on a pro rata basis. *Id.* at 581. The court did not see that it was justified in "treat[ing] Booksellers as acting as a marketing presence for Online," merely because the brick & mortar store filled orders for merchandise from the Internet seller's distribution center, since the brick & mortar store also filled orders from many wholesalers and did not treat the remote Internet seller any differently from those other wholesalers. *Id.*

Unlike in the *Borders* case, the brick & mortar stores did not refer customers to the remote Internet seller or otherwise promote that entity's business, except in connection with the membership and gift card programs. *Id.* at 580. However, similar to the brick & mortar retailers in *Borders*, Barnes & Nobles stores accepted returns of merchandise purchased from the remote Internet seller, treated that merchandise "as if it were its own," and gave it preferential treatment over merchandise purchased from third parties. *Id.* at 582. The court nonetheless distinguished the *Borders* case on this point, on the grounds that the Barnes & Noble stores "initiated the return policy to generate goodwill and to serve the convenience of its customers," implying that the activity was associated with establishing and maintaining the store's own market, not that of the remote Internet seller. *Id.*

Thus, these cases provide a pointed example of the variety of conclusions courts can reach when deciding attributional nexus questions, even in the face of seemingly parallel facts.

GUIDELINES FOR AVOIDING ATTRIBUTIONAL NEXUS

Because the battle lines continue to shift and because the cases that have recently considered this issue often turn on specific facts, it is difficult to develop any practical rules for avoiding attributional nexus based solely on corporate structure or even operational limits. However, notwithstanding the variation among individual cases, we believe it is

possible to establish at least four guidelines that can be used to analyze the risk that an in-state business operation may produce nexus for an out-of-state sales operation.

First, common ownership of a remote seller and an in-state entity, by itself, should not result in attributional nexus. *See, e.g., Current, Inc., 24 Cal. App. 4th at 385*; n17 The absence of common ownership may go a long way to establishing that the in-state entity is acting in its own interest and not on behalf of the out-of-state entity and, thus, may be very helpful in avoiding attributional nexus.

Second, contracting with an entity that is plainly not involved in the success of the marketing and sales activity of the out-of-state entity should not result in attributional nexus. n18 This principle will be strongest where the in-state entity is engaged in an obviously unrelated business, for example, where the in-state entity is a professional service provider (*e.g.*, lawyer or accountant), n19 or where the in-state activities provide no meaningful assistance or are, in fact, detrimental to the out-of-state seller's sales. *See, e.g., Tax Determination No. 08-0128, Wash. Dep't of Revenue* (May 14, 2008, released Jan. 28, 2009) (finding no attributional nexus in part because the in-state entity's promotions of sales of products to retailers may have, in fact, reduced the market share of the out-of-state seller).

Third, as a corollary to this principle, merely placing an advertisement in a local newspaper or other media should not result in nexus over the out-of-state entity that places the advertisement. *Current, Inc., 24 Cal. App. 4th at 386, 391*. n20

Fourth, using a common carrier or similar entity to provide delivery in the state (and even accept payment for the product) should not result in nexus over the out-of-state entity. n21

Undoubtedly, the operations of many taxpayers will not fit neatly within these guidelines. And, while it is useful to think of these guidelines as providing "safe harbors," the law is probably not yet sufficiently developed to ensure that all courts will adhere to these principles. As a result, at least until the United States Supreme Court weighs in to fully reconcile the holdings of its decisions in *Quill*, *Bellas Hess*, *Scripto*, and *Tyler Pipe*, there will always be a measure of risk that the tax authorities, at least, will construe any substantial relationship with an in-state entity as providing attributional nexus over a remote seller.

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n1 *See Quill Corp. v. North Dakota, 504 U.S. 298 (1992)* ("Quill") (citing *Nat'l Bellas Hess, Inc. v. Illinois Dep't of Revenue, 386 U.S. 753 (1967)* ("Bellas Hess"))

n2 Indeed, Dell's recent petition for writ of certiorari with the United States Supreme Court to obtain the Court's guidance on the very issues addressed by this article was denied. *Dell Catalog Sales L.P. v. Taxation & Revenue Dep't, 199 P.3d 863 (N.M. Ct. App.), cert. denied, 189 P.3d 1215 (N.M. 2008), cert. denied, 129 S. Ct. 1616 (U.S. Mar. 23, 2009) (No. 08-770)* ("Dell (NM)").

n3 It is worth noting that judicial decisions concerning whether a state has jurisdiction to tax a remote seller often begin by determining whether jurisdiction exists under the state's statutes or regulations. Often the statutory analysis will closely mirror, and effectively substitute for, the constitutional analysis since many state

statutes extend the state's jurisdiction to tax to the full limits permitted by the U.S. Constitution or articulate their limit using logic articulated in the court cases discussing the constitutional standards. *Compare* Me. Rev. Stat. Ann. tit. 36 § 1754-B.1.G, *and* Ohio Rev. Code Ann. § 5741.01(I), *with* N.M. Stat. Ann. § 7-9-10.A. Where the constitutional and statutory standards are not identical, and if the state statute is satisfied, the court must then determine whether the constitutional standard is also met because the Commerce Clause and the Due Process Clause requirements must be met in every instance. *See generally* *Borders Online, LLC v. State Bd. of Equalization*, 129 Cal. App. 4th 1179 (2005). (evaluating the constitutional requirements after determining that the statutory requirements were met).

n4 *Scripto*, 362 U.S. 207, 211 (1960).

n5 *Tyler Pipe*, 483 U.S. 232, 250 (1987) (quoting the Washington Supreme Court decision on appeal, 715 P.2d 123, 126 (Wash. 1986)).

n6 Although the Court found that the out-of-state seller had nexus, the Court nevertheless struck down the tax at issue because it failed the internal consistency standard of the Commerce Clause. *Tyler Pipe*, 483 U.S. at 247-48.

n7 *Arco Bldg. Sys., Inc. v. Chumley*, 209 S.W.3d 63, 74 (Tenn. Ct. App.), *appeal denied*, No. M2004-01872-SC-R11-CV, 2006 Tenn. LEXIS 1002 (Oct. 30, 2006) ("*Arco*") (internal quotation marks omitted; emphasis original)

n8 *See generally* *St. Tammany Parish Tax Collector v. Barnesandnoble.com*, 481 F. Supp. 2d 575, 580-81 (E.D. La. 2007) ("*B&N (La.)*").

n9 *See, e.g., Current, Inc. v. State Bd. of Equalization*, 24 Cal. App. 4th 382 (1994) ("*Current, Inc.*");

n10 *See also* *SFA Folio Collections, Inc. v. Tracy*, 652 N.E.2d 693 (Ohio 1995); *SFA Folio Collections, Inc. v. Bannon*, 585 A.2d 666 (Conn.), cert. denied, 501 U.S. 1223 (1991).

n11 *See State v. Dell Int'l, Inc.*, 922 So. 2d 1257, 1266 (La. Ct. App.), *reh'g denied*, No. 2004 CA 1702,

2006 La. App. LEXIS 867 (2006) ("*Dell (La.)*").

n12 The authors are unaware of any decision in which the Supreme Court has articulated a rationale for why the third party's activities must be related to support for sales and marketing activities as opposed to support for other, more general activities of the remote seller in order for those activities to create attributional nexus for sales tax purposes. Nonetheless, as a common-sense matter, this limitation makes sense, given that jurisdictional issues that arise in the context of sales and use taxes are ultimately triggered by sales to the in-state consumer.

n13 State tax administrators predictably have taken an even more expansive view of the definition of activities in support of obtaining or maintaining a market. The Kansas Department of Revenue, for example, has concluded local third-party contractors that installed security locks and related equipment sold by an out-of-state seller should be viewed as creating and maintaining the market for the remote seller. Kan. Dep't of Revenue Priv. Ltr. Rul. P-2005-016 (June 20, 2005); *see also, e.g.*, Hearing No. 46,541, Texas Comptroller of Public Accounts (May 10, 2006) (concluding that in-state independent contractors that "perform maintenance and repair services" result in attributional nexus with an out-of-state seller).

n14 *See Borders*, 129 Cal. App. 4th 1179; *Barnesandnoble.com LLC v. State Bd. of Equalization* ("*B&N (Cal.)*"), Cal. Tax Rep. (CCH) 404-488 (Cal. Super. Ct. Oct. 12, 2007); *B&N (La.)*, 481 F. Supp. 2d at 578-79.

n15 Cal. Tax Rep. (CCH) 404-488, § III(a).

n16 The record in the Louisiana Barnes & Noble case appears to differ slightly from the facts relied upon by the California Superior Court case, discussed above, although both courts reached the same conclusion. The differences in the factual record apparently may be traced to the different years at issue in each decision.

n17 *See also* Hellerstein & Hellerstein, *Cases and Materials on State and Local Taxation* 19.02(8)(e) (8th ed. 2005).

n18 *See, e.g.*, Tax Determination No. 08-0128, Wash. Dep't of Revenue (May 14, 2008, released Jan. 28, 2009) (concluding the presence of an in-state entity did not result in attributional nexus in part because the in-state entity's promotions of sales of products to retailers may have, in fact, reduced the market share of the out-of-state seller by allowing local retailers to compete with the out-of-state entity's sales over the Internet and telephone).

n19 Michigan Dep't of Treasury, Revenue Administrative Bulletin 1999-1, *Use Tax Nexus Standards* I.6(c) (May 12, 1999).

n20 See also *In re Laptops Etc. Corp.*, 164 B.R. 506, 521 (Bankr. D. Md. 1993).

n21 *AT&T Commc'ns of Md., Inc. v. Comptroller of the Treasury*, 950 A.2d 86 (Md. 2008) (finding no attributional nexus where common carrier accepted payment from customer for charges by remote information service providers).

RELATED LINKS: For more information, see

- 1-12 Bender's State Taxation: Principles and Practice 12.04

For the full text of the conference paper, see

- 61-2 USC Law School Institutes On Major Tax Planning P 200 et seq

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Mandatory Combined Reporting and Corporate Tax Avoidance Strategies

2009 Emerging Issues 4023

Mandatory Combined Reporting as a Counter to Corporate Tax Planning Strategies

By Andrew Swain

November 3, 2009

SUMMARY: Many multi-state corporations operate in states that do not require combined reporting and that employ one or more tax-minimization strategies to reduce their overall tax liability, causing significant declines in corporate tax revenues for the states. Mandatory combined reporting counters such strategies by treating businesses composed of multiple entities, such as a parent corporation and its subsidiaries, as a single entity for tax purposes.

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ARTICLE: Over the past several decades, many states have seen a significant decline in their corporate tax revenues allegedly due in large part to the perceived aggressive employment of sophisticated tax-avoidance strategies by multi-state corporations. n1 States that claim to have been particularly affected are those that do not require combined reporting of income by these businesses. In these states, multi-state corporations have employed one or more of several tax-planning strategies, exploiting tax loopholes to significantly reduce their level of taxable business activity in a state and thus their state tax liability. Mandatory combined reporting or unitary reporting, as it is called in some states, counters most of these strategies by treating a business composed of multiple entities such as a parent corporation and one or more subsidiaries as a single entity for tax purposes. n2

This commentary discusses the merits of mandatory combined reporting as a possible solution to problems states experience in determining the true earnings of multi-state corporations or unitary businesses. The commentary first analyzes the nature and scope of the problem: many multi-state corporations operating in states that do not require combined reporting and that employ one or more tax-planning strategies to reduce their overall tax liability, contributing to declines in corporate tax revenues for the states. Second, this commentary examines how mandatory combined reporting works and the implications of a state's enacting such a system. Finally, this commentary discusses North Carolina's recent failed legislation that, if enacted, would have added the state to the growing list of states requiring combined or unitary reporting and the approach of Maryland which has taken a more thoughtful approach by studying the impact of combined reporting before leaping headfirst into the topic.

Reporting of Corporate Income in Non-Combined Reporting States

Businesses in non-combined reporting states, whether operating entirely within the state or as part of a multi-state corporation, are only required to report the revenue and profit activity of their parts that have nexus with the state. n3 If,

for instance, a taxpayer operates within a non-combined reporting state and makes transfer payments to a subsidiary for the licensed use of intangible property, the taxpayer can deduct the payments from his income, significantly reducing his tax liability to the state. If the subsidiary lacks nexus with the taxpayer's state, the taxpayer has to report only his income, not that of his subsidiary, even though the income of the subsidiary contributes to the taxpayer's overall earnings. As of April, 2007, approximately 19 states, including Indiana, have separate or non-combined reporting requirements. n4 A review of the relevant statutes for each of these non-combined reporting states is required to determine what authority, if any, each state has to require a multi-state business to make a combined return rather than a separate one and under what circumstances it can do so.

A review of the relevant literature suggests that many multi-state corporations operating in non-combined reporting states have engaged in one or more of many tax planning strategies to shift their profits from high-tax states to low-tax states. There are at least three corporate strategies that many multi-state businesses commonly use; n5 each strategy relies on the parent company's creation of one or more subsidiaries that are expressly or effectively exempt from corporate income taxes in the states in which they are formed. n6 Once the parent corporation creates the subsidiary, it shifts taxable profits to the subsidiary, usually in the form of deductible payments, creating revenue for the subsidiary that is taxed at a lower rate or that is exempt from tax in the subsidiary's state. n7

This happens when the operational part of the corporate group pays the subsidiary for the right to use assets, such as real estate or a trademark. This payment is tax deductible, so it reduces the taxable profit of the operational part of the corporate group. In addition, the resulting profit for the subsidiary is not taxed by the state in which the subsidiary is located, either because that state has no corporate income tax or because the state exempts that particular form of subsidiary from the tax. n8

In late 1996, Wal-Mart employed a captive Real Estate Investment Trust (REIT) tax strategy when it created the subsidiary, Wal-Mart Real Estate Business Trust (WM REBT), and transferred to it all its real property pertaining to the premises of its stores, including freeholds and leaseholds. n9 Various subsidiaries of Wal-Mart, such as Wal-Mart Stores East, Inc. (WM East), subsequently leased land and buildings from the newly created and endowed WM REBT for their store premises. n10 In 1997, WM East filed a corporate income tax return in North Carolina disclosing over \$3.1 billion in total state net income to which it applied a deduction of over \$1.6 billion for rent paid to WM REBT. n11 Ultimately, through a series of other deductions and state apportionments, WM East calculated its tax liability to North Carolina at an amount less than two tenths of one percent of its total state net income. n12 The Secretary of Revenue in North Carolina, believing that the return did not accurately reflect WM East's activities in the state and exercising his statutory authority, n13 required WM East to file a combined or unitary report. The North Carolina Court of Appeals upheld the Secretary's exercise of authority. n14

Though the state won against Wal-Mart, it spent 13 years in costly litigation. Despite the win, the state, like other non-combined reporting states, is not assured that the corporation will not employ another legally permissible tax-planning strategy in the future. Non-combined reporting states can be assured, though, that other multi-state corporations are employing similar tax planning strategies as yet undiscovered by the states. These states face a continuing decline in their corporate tax revenues.

Mandatory Combined Reporting

States that require or mandate combined reporting for multi-state corporations operating within their borders negate or at least counter many of the tax strategies by treating the taxpayer within the state, a parent company, and any subsidiaries as one entity. n15 Having nexus over the taxpayer, one entity in a unitary group, the state has nexus over other members of the group. n16 A taxpayer must report its profits and deductions and the profits of any of its subsidiaries as those of a single entity. Payments made between the taxpayer and a subsidiary, as between WM East and WM REBT (discussed above) are combined in a single report and used in calculating the taxpayer's tax liability to the state. The state then taxes a portion of the total profits based on statutorily provided apportionment formulas. n17

In addition to negating tax strategies such as the use of passive investment companies (PICs) or REITs, mandatory combined reporting also counters a related tax-planning strategy called transfer pricing,' in which a parent corporation sells its products to an out-of-state subsidiary, which in turn sells them to the final customers. n18 Corporate manipulation of transfer prices paid to subsidiaries in tax-haven states will not affect state corporate tax revenues in a combined reporting state [s]ince the profits of a corporation's components are added together to determine the corporation's taxable base[.] n19

Mandatory combined reporting proves to be a better means of nullifying tax-avoidance strategies than the tactics currently used in non-combined reporting states such as ad hoc litigation or targeted legislation intended to close specific tax loopholes and their resulting tax consequences. n20 Though these measures are useful stop-gaps, they are costly, time consuming, and ultimately inadequate. n21

Combined reporting is not without its problems. States that rely on mandatory combined reporting may still experience declining corporate tax revenues. The combined-reporting laws themselves can contain loopholes or other deficiencies. n22 In addition, most combined-reporting states are still vulnerable to tax issues posed when a taxpayer has significant business operations outside the United States. n23 Similarly, combined reporting can reduce a state's tax revenues when the combined reporting "pulls in" out-of-state businesses with little to no presence in the combined reporting state. This impact occurs when the dilutive impact on the combined group's apportionment factor outweighs the increase in the taxable income base or elimination of intercompany transactions.

Despite these flaws, some states have successfully employed combined reporting for many years, and the U.S. Supreme Court has twice upheld its legality. n24 As of October, 2007, 21 states had mandatory combined reporting and another seven states were considering enacting a combined reporting requirement. n25

Reporting of Corporate Income in North Carolina

North Carolina is currently a separate or non-combined reporting state. n26 Corporations operating in the state are required to report income activity only for those parts of the corporation that have nexus with North Carolina. n27 A multi-state business files a consolidated return only if North Carolina's Secretary of Revenue specifically requires that it do so. n28 The Secretary is authorized by statute n29 and recent case law n30 to require this if it finds as a fact that a non-combined report that the corporation filed fails to disclose the true earnings of the corporation.

2009 Legislation Sought to Mandate Combined Reporting

On February 18 of this year, the General Assembly of North Carolina passed the Current Operations and Capital Improvements Appropriations Act of 2009. n31 With a stated purpose to permanently provide for mandatory combined reporting for corporate income tax purposes effective January 1, 2010, n32 the Act, in relevant parts, amends North Carolina's tax code by including the term unitary business group in the definition of corporation, n33 defining the terms unitary business n34 and unitary business group, n35 and providing that a unitary business group with business activity in this State must file an income tax return that includes the State net income of the unitary business group n36 Some North Carolina businesses and their lobbying organizations protested the unitary reporting provision of the pending legislation and claimed that [it would] result in some companies leaving the state or shunning [North Carolina] for new investment. n37 A recently published report by the Center on Budget and Policy Priorities, however, found these concerns to be unwarranted. n38 The study found that at least 60 of the 75 largest North Carolina manufacturers examined maintain facilities in at least one combined reporting state. n39 The study concluded in part that the compliance burdens' and tax liabilities arising from combined reporting cannot be that great if these manufacturers or the parent corporation that controls their decision-making have willingly maintained a facility in one or more combined reporting states [in some cases for nearly 20 years]. n40

Mandatory combined reporting is an effective way for a state to counter sophisticated tax-planning strategies employed by multi-state corporations operating within the state's borders. By treating a corporate taxpayer, its parent

company (if any), and any subsidiary as a single entity for tax reporting purposes, a state is able to examine a taxpayer's complete revenue and profits picture, and, therefore, more accurately assess the taxpayer's tax liability in the state.

Combined reporting is not a panacea for all potential tax-planning strategies utilized by multi-state corporations. Combined-reporting states may still, for instance, be at risk of experiencing declining corporate tax revenues due to business operations outside the United States. Unitary reporting is a strong alternative, however, to separate reporting and the ad hoc litigation and legislation states have pursued with varying success.

Despite a strong push from various lobbying groups, the bill ultimately signed into law by Governor Perdue did not contain the mandatory unitary reporting provision. Therefore, taxpayers will have to wait at least one more year before finally joining the unitary reporting trend.

Maryland -- A More Thoughtful Approach

Maryland is another separate reporting state, which like other such states, has been considering the potential gains from mandatory combined corporate income tax reporting for a number of years. Rather than rush headfirst into the combined reporting tent, Maryland took the approach of requiring extensive information be provided by corporate taxpayers with their 2007 corporate income tax returns. Using such data, Maryland studied what the actual fiscal impacts would have been from adopting combined reporting. On October 1, 2009, the Maryland Comptroller released a report outlining the findings of such analysis. This report showed that an increase in corporate tax revenues would have occurred had Maryland employed a combined reporting scheme, however, the report is careful to warn that the changing economic conditions would have caused significant impact to such outcome. It is unclear at this time, how the Maryland legislature will utilize this report to address the combined reporting question. n41

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n1 See Inst. on Taxation and Econ. Policy, *Combined Reporting of State Income Taxes: A Primer*, (2009), available at <http://www.itepnet.org/pb24comb.pdf>.

n2 See Michael Mazerov, Ctr. On Budget and Policy Priorities, *State Corporate Tax Shelters and the Need for Combined Reporting*, (2007), available at <http://www.cbpp.org/files/10-26-07sfp.pdf>.

n3 See *Combined Reporting of State Income Taxes*, *supra* note 1.

n4 See Inst. on Taxation and Econ. Policy, *Combined Reporting: How Does Your State Stack Up?*, (2007), available at <http://www.itepnet.org/crstates2007.pdf>

n5 See Mazerov, *supra* note 2 (identifying the three most common corporate tax shelters as passive

investment companies, (PICs), Real Estate Investment Trusts (REITs), and captive insurance companies).

n6 *Id.*

n7 *Id.*

n8 *Id.* at 2.

n9 *See Wal-Mart Stores East, Inc. v. Hinton*, 676 S.E.2d 634, 639 (N.C. Ct. App. 2009).

n10 *Id.*

n11 *Id.*

n12 *Id.*

n13 *See* N.C. Gen. Stat. Ann. §105-130.6 (1998).

n14 *Id.*

n15 *See* Maserov, *supra* note 2.

n16 *Id.*

n17 *Id.*

n18 *Id.* at 4.

n19 *Id.*

n20 *Id.*

n21 *Id.*

n22 *Id.*

n23 *Id.*

n24 *Id.* at 5.

n25 *See Combined Reporting of State Income Taxes, supra* note 1; Maserov, *supra* note 2.

n26 *See* G.S. §§ 105-130.6, 150-130.14 (1998).

n27 *See Combined Reporting of State Income Taxes, supra* note 1.

n28 See N.C. Gen. Stat. Ann. § 105-130.6.

n29 *Id.*

n30 See *Wal-Mart Stores East, Inc. v. Hinton*, *supra* note 9 (holding that the Secretary had statutory authority under G.S. §105-130.6 to order that store operator, Wal-Mart Stores East, Inc., file a combined return with related real estate trust (REBT), Wal-Mart Real Estate Business Trust, and operator's subsidiary, Wal-Mart Property Company, a passive investment company (PIC)).

n31 See Current Operations and Capital Improvements Act of 2009, S.B. 202, 2009-2010 Sess. Laws, Reg. Sess. (N.C. 2009).

n32 *Id.*

n33 *Id.* (codified as amended at N.C. Gen. Stat. Ann. §105-130.2(1b)).

n34 *Id.* (codified as amended at N.C. Gen. Stat. Ann. § 105-130.2(8)).

n35 *Id.* (codified as amended at N.C. Gen. Stat. Ann. § 105-130.2(9)).

n36 *Id.* (codified as amended at N.C. Gen. Stat. Ann. § 105-130.3A(a)).

n37 See Michael Maserov, Ctr. On Budget and Policy Priorities, *Most Large North Carolina Manufacturers Are Already Subject to Combined Reporting' in Other States* (2009), available at <http://www.cbpp.org/files/1-15-09sfp.pdf>.

n38 *Id.*

n39 *Id.* at 2.

n40 *Id.*

n41 A copy of the report can be accessed at the following website:
<http://business.marylandtaxes.com/pdf/Analysis%20of%20TY2006%20MD%20Corporate%20Information%20Reports.pdf>.

RELATED LINKS: For additional discussion and analysis of combined tax reporting and returns, see
■ 1-3 Bender's State Taxation: Principles and Practice § 3.12

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USC Gould School of Law 2009 Tax Institute: Target Partnership Allocations

2009 Emerging Issues 4509

USC Gould School of Law 2009 Tax Institute: Terence Floyd Cuff on The Use of Target Partnership Allocations: Wise Tax Planning or a Trap for the Unwary?

By Terence Cuff

November 2, 2009

SUMMARY: The use of target allocations is one way of allocating items of income, gain, loss and deduction from a partnership. Target allocations direct income and loss items to partners capital accounts so these accounts conform to the cash distribution scheme in liquidation. This model of allocations is not always superior or inferior to other models. Despite its appeal, such allocations may not comply with the economic effect test.

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ARTICLE: The use of target allocations is one method for allocating items of income, gain, loss, and deduction from a partnership. Target allocations specify how cash will be distributed from operations and in liquidation of the partnership. This model then allocates income and loss items to partners' capital accounts so that these capital accounts will conform to the cash distribution scheme in liquidation. This model of allocations of income, gain, loss, and deduction is not necessarily superior to or inferior to the other models. Despite the appeal of such an allocation strategy, target allocation provisions appear to fail to comply with the economic effect n1 test under the Allocation Regulations. n2 Additionally, target allocation provisions have substantial risk of not satisfying the alternate test of economic effect n3 ("alternate economic effect") or the economic effect equivalence test ("economic effect equivalence"). The matter is not resolved especially with respect to economic effect equivalence. n4

The partnership tax laws then would evaluate target allocation provisions under the ambiguous standard of partners' interests in the partnership. Target allocations of nonrecourse deductions are uncertain to meet requirements for nonrecourse deduction allocations under the Nonrecourse Deduction Regulations. The matter is not at all resolved.

Allocations under a target allocation provision apparently cannot satisfy the basic tests of economic effect

... throughout the full term of the partnership, the partnership agreement provides

(1) For the determination and maintenance of the partners' capital accounts in accordance with the rules of paragraph (b)(2)(iv) of this section,

(2) Upon liquidation of the partnership (or any partner's interest in the partnership), liquidating distributions

are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(b)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and

(3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(b)). n5

The partnership may maintain capital accounts in accordance with the Allocation Regulations. The target allocation provision has an uncertain claim to satisfying requirement (2) of economic effect liquidation in accordance with capital accounts. Advisors, however, may argue that requirement (2) of economic effect is *de facto* satisfied if the target allocation provision and distribution provisions are crafted properly. The target allocation provision has a particularly poor claim to satisfying requirement (3) of economic effect deficit capital account restoration.

The Allocation Regulations require that partnership allocations of income, gain, loss, and deduction have "substantiality" in order to have "substantial economic effect." n6 The test of "substantiality" is sufficiently complex, badly thought out, and badly written that few partnership advisors are much concerned with substantiality of allocations any more. n7 This Article will not discuss issues of substantiality in detail. Partnership tax laws test partnership allocations of income, gain, loss, and deduction with the test of substantiality in order for allocations to have "substantial economic effect." Failure to satisfy substantiality potentially can result in advisor penalties under IRC Section n8 6694 and possibly client penalties under Section 6662.

Alternate Test of Economic Effect

Advisors disagree on the issue of whether a target allocation provision can satisfy the alternate test of economic effect. The debate usually is conducted at a level of sufficient sophistication about partnership tax theory that most advisors will decline to participate.

The alternate test of economic effect provides:

If

(1) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and

(2) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and

(3) The partnership agreement contains a "qualified income offset,"

such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner's capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner's capital account also shall be reduced for

(4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner's capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and

(5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to IRC Section 704(e)(2), IRC Section 706(d), and paragraph (b)(2)(ii) of section 751-1, and

(6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner's capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made " (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under Reg. Section 1.704-2(f); however, increases to a partner's capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain)" under Reg. Section 1.704-2 (f). n9

A target allocation provision makes an uncertain case for satisfying the alternate test of economic effect. The case for satisfying requirement (1) of the alternate test of economic effect is uncertain. The partnership agreement using target allocation provisions will not explicitly liquidate in accordance with capital accounts, even though the agreement maintains capital accounts in accordance with the Allocation Regulations. The partnership agreement may be able to satisfy requirement (2) of the alternate test of economic effect. The partnership agreement can satisfy requirement (3) of the alternate test of economic effect if the partnership agreement contains an explicit qualified income offset. A target allocation provision operating by itself without a separately stated qualified income offset is unlikely to satisfy requirement (3) of the alternate test of economic effect. The target allocation provision by itself is unlikely to constitute a qualified income offset. The target allocation provision, however, may be drafted to work in tandem with a qualified income offset.

Economic Effect Equivalence Test

Many advisors are comfortable that target allocation provisions can satisfy the economic effect equivalence test and have deemed economic effect. The economic effect equivalence test is a results-oriented test.

A partnership may have considerably greater difficulty satisfying the economic effect equivalence test than is generally supposed. Economic effect equivalence may apply only to a very limited class of partnerships, which may exclude practically all limited liability companies. Economic effect equivalence may be of profoundly limited usefulness for a limited partnership or limited liability company. A partnership agreement may have to have a capital account deficit restoration obligation (or such an obligation may need to be supplied under state law) if allocations are to satisfy economic effect equivalence, but this matter is not unambiguously clear from the Allocation Regulations.

The economic effect equivalence test requires:

Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership. . . . n10

The economic effect equivalence test ties to the basic test of economic effect but does not appear to tie at all to the alternate test of economic effect. At least, the portion of the Allocation Regulations considering economic effect equivalence does not refer explicitly to the alternate test of economic effect. Economic effect equivalence must be satisfied at the end of the current year and at the end of any future year.

The economic effect equivalence test requires that "as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership." The meaning of this language is unclear. The partnership must satisfy economic effect equivalence "regardless of the economic performance of the partnership." What this means is not clear.

A partnership with target allocation provisions will not liquidate explicitly in accordance with capital accounts. Further, a partnership agreement with target allocation provisions typically will not provide for deficit capital account restoration. Whether these elements are required in order for a target allocation provision to produce economic effect equivalence is not entirely resolved. An example in the Allocation Regulations suggests that the regulations do have flexibility, at least with respect to requiring that the partnership liquidate in accordance with capital accounts.

Few limited liability company agreements or limited partnership agreements provide for deficit capital account restoration. Depending on the resolution of this issue, many or few partnership agreements will satisfy economic effect equivalence. Economic effect equivalence may be the minnow that swallows the whale if economic effect equivalence is applied as a more practical test that does not require deficit capital account restoration for limited liability companies. Economic effect equivalence might become the most common defense for partnership allocations.

Language of economic effect equivalence may require that the partnership satisfy deficit capital account restoration or, at least, produce the same economic results to the partners as would occur if the partnership agreement contained a qualifying capital account deficit restoration obligation. What this means, particularly in the case of a limited liability company, is not altogether clear. Limited liability companies rarely have deficit restoration obligations. These deficit restoration obligations may not be necessary for a limited liability company. Limited liability companies offer members the protection of a liability shield that usually (but not invariably) protects member assets from entity liabilities. Whether a limited liability company can satisfy economic effect equivalence in absence of an explicit capital account deficit restoration obligation unlikely to be found in a partnership agreement designed with target allocation provisions is a matter of conjecture. This matter would greatly benefit from clarification of the current Allocation Regulations.

Most limited liability companies may have difficulty satisfying requirement (3) of economic effect deficit restoration. Few limited liability company agreements have capital account deficit restoration obligations. A limited liability company may have difficulty satisfying requirement (3) of economic effect equivalence without a capital account deficit restoration obligation either explicitly set forth in the partnership agreement or imposed by state law.

Advisors of the limited liability company may suggest that requirement (3) is satisfied automatically the liability shield of the limited liability company will ensure that no member will have a deficit capital account at liquidation and therefore an explicit deficit restoration obligation is meaningless. n11 Treasury and Internal Revenue Service promulgated economic effect equivalence prior to widespread use of limited liability companies.

A court perhaps should look at economic effect equivalence more flexibly and in light of current prevalence of limited liability companies. No abuse is apparent in circumstances in which a limited liability company *de facto* liquidates in accordance with capital accounts but a member does not have a deficit capital account restoration obligation. The implicit purpose of the deficit capital account restoration obligation would seem to be merely to ensure that the partnership truly liquidate in accordance with positive capital account balances. A court perhaps could waive requirement (3) for a limited liability company where the court determines that risk is remote that a partner will have a deficit capital account in excess of the partner's share of minimum gain and partnership minimum gain. Protection afforded by the limited liability company's liability shield usually should protect members from having positive capital accounts when another partner has a negative capital account if allocations work properly.

We might be able to suggest economic circumstances in which one partner might be required to return a *pro rata* distribution and another would not. n12 Circumstances can exist in which distributions to partners can be clawed back

by the limited liability company. Circumstances exist in which the shield of limited liability can be pierced by creditors. Many limited liability company advisors might respond that it is nonsense to require a limited liability company to have a deficit restoration provision in its limited liability company agreement in order to meet economic effect equivalence. (Partnership and limited partnership advisors incidentally might make the same argument.) Skeptics might respond that regulations so punctilious as to require a qualified income offset under alternate economic effect should be interpreted to require deficit restoration in order to satisfy economic effect equivalence.

The economic effect equivalence test is illustrated by this example from the Allocation Regulations. The example unfortunately does not make economic effect equivalence much clearer.

Example (4). (i) *G and H contribute \$75,000 and \$25,000, respectively, in forming a general partnership. The partnership agreement provides that all income, gain, loss, and deduction will be allocated equally between the partners, that the partners' capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, but that all partnership distributions will, regardless of capital account balances, be made 75 percent to G and 25 percent to H. Following the liquidation of the partnership, neither partner is required to restore the deficit balance in his capital account to the partnership for distribution to partners with positive capital account balances. The allocations in the partnership agreement do not have economic effect. Since contributions were made in a 75/25 ratio and the partnership agreement indicates that all economic profits and losses of the partnership are to be shared in a 75/25 ratio, under paragraph (b)(3) of this section, partnership income, gain, loss, and deduction will be reallocated 75 percent to G and 25 percent to H.*

(ii) *Assume the same facts as in (i) except that the partnership maintains no capital accounts and the partnership agreement provides that all income, gain, loss, deduction, and credit will be allocated 75 percent to G and 25 percent to H. G and H are ultimately liable (under a State law right of contribution) for 75 percent and 25 percent, respectively, of any debts of the partnership. Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(b) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(i) of this section.*

(iii) *Assume the same facts as in (i) except that the partnership agreement provides that any partner with a deficit balance in his capital account must restore that deficit to the partnership (as set forth in paragraph (b)(2)(ii)(b)(2) of this section). Although the allocations do not satisfy the requirements of paragraph (b)(2)(ii)(b) of this section, the allocations have economic effect under the economic effect equivalence test of paragraph (b)(2)(ii)(i) of this section.* n13

Several features of this example are interesting.

The partnership agreement in the example does not liquidate explicitly in accordance with capital account balances. The partnership agreement in (i) contains allocation of tax items inconsistent with the distribution scheme in liquidation. The partnership agreement has partners making contributions in a 75:25 ratio, it provides that all income, gain, loss, and deduction will be allocated equally between the partners, and all distributions will be made in a 75:25 ratio. The allocations in the partnership agreement, of course, are nonsense allocations completely at variance with partnership economics. The allocations have no economic effect.

The partnership agreement in (ii) produces the same results as if the partnership did liquidate in accordance with capital account balances. The example indicates that producing the same results as liquidating in accordance with capital account balances is good enough to satisfy the economic effect equivalence test.

The partners in (ii) are ultimately liable under a state law right of contribution for debts of the partnership. This acts as a surrogate deficit capital account restoration obligation. This surrogate deficit restoration obligation apparently satisfies the deficit capital account restoration requirement. The economic effect equivalence test appears to ignore the subtleties of the definition of "liquidation" under the Allocation Regulations.

The example does not discuss the significance of the failure to meet the time periods for deficit restoration in the Allocation Regulations. The Allocation Regulations require restoration within a fixed period not discussed in the example: "If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(b))." n14

The example fails to note that the concept of "liquidation" in the Allocation Regulations is broader than the normal state law concept of liquidation. Deficit restoration is required on a constructive tax liquidation of the partnership. That aspect is not present in the example. The example does not capture the many nuances of "liquidation" in the Allocation Regulations. The Allocation Regulations provide:

For purposes of this paragraph, a liquidation of a partner's interest in the partnership occurs upon the earlier of (1) the date upon which there is a liquidation of the partnership, or (2) the date upon which there is a liquidation of the partner's interest in the partnership under paragraph (d) of Reg Section 1.761-1. For purposes of this paragraph, the liquidation of a partnership occurs upon the earlier of (3) the date upon which the partnership is terminated under IRC Section 708(b)(1), or (4) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners). Requirements (2) and (3) of paragraph (b)(2)(ii)(b) of this section will be considered unsatisfied if the liquidation of a partner's interest in the partnership is delayed after its primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity, if such actions themselves do not cause the partnership to terminate pursuant to IRC Section 708(b)(1)) for a principal purpose of deferring any distribution pursuant to requirement (2) of paragraph (b)(2)(ii)(b) of this section or deferring any partner's obligations under requirement (3) of paragraph (b)(2)(ii)(b) of this section. n15

Some advisors believe that a court would approve target allocation provisions under the economic effect equivalence since target allocation provisions are not abusive and should be encouraged. A court could use the economic effect equivalence test to justify approving allocations under a target allocation provision. Thus far, target allocation provisions have not been tested in tax litigation.

Other advisors believe that economic effect equivalence can be satisfied only if the partnership agreement has an explicit deficit restoration provision or a deficit restoration provision implied under state law. These advisors may believe that the partnership agreement must explicitly liquidate by capital accounts in all events in order to satisfy economic effect equivalence.

Some advisors believe that economic effect equivalence requires either an explicit or an implied capital account deficit restoration obligation. This view often is based on the example in the Allocation Regulations.

Some advisors argue that economic effect equivalence is a limited exception and that economic effect equivalence was not intended to undermine the extensive, precise tests of economic effect. Broad application of the economic effect equivalence test to limited liability companies would substantially restrict the importance of capital account deficit restoration. Some advisors argue that the precision with which the deficit restoration obligation requirement was drafted suggests that the Allocation Regulations did not intend that this requirement should be easily avoided or circumvented.

Partnerships using target allocations do not expressly allocate in accordance with capital accounts. They normally do not have any provision for deficit capital account restoration at any time. They may compute capital accounts in accordance with the Allocation Regulations or close to in accordance with the Allocation Regulations, but these capital accounts do not affect partnership economics. A partnership agreement containing a target allocation provision reads

differently from a partnership agreement seeking to satisfy the primary test of economic effect under the Allocation Regulations.

Advisers also should remember that, even if a target allocation provision satisfied the economic effect equivalence test, allocations also must satisfy the requirement of substantiality under the Allocation Regulations.

The tax law also has not clearly resolved whether satisfaction of the economic effect equivalence test will vest allocations with sufficient deemed economic effect so that allocations under a target allocation provision will satisfy *IRC Section 514(c)(9)(E)* or the nonrecourse deduction safe harbor under the Nonrecourse Deduction Regulations.

Part (iii) of the example is a situation in which the economic effect equivalence test is satisfied by a capital account deficit restoration obligation. This part uses the irregular allocations in part (i), except that economics are conformed to capital accounts by the deficit restoration obligation. The example concludes that the allocations have economic effect under the economic effect equivalence test.

A special class of economic cases particularly challenges target allocation provisions. The economic plan of a partnership agreement may return capital to partner A, pay a preferred return to partner A, and then return capital to and then profits to partner B. The subordination of return of capital distributions to partner B to both capital and profit distributions to partner A can create a situation in which capital accounts will not properly account for how the partnership would liquidate unless capital is shifted from one partner to another. Existing tax law on how to approach this situation is perilously thin. Some advisors believe that this situation requires a taxable capital shift between partners. Other advisors do not feel that a capital shift is necessary. The partnership agreement may violate the requirement of economic effect equivalence of equivalence that the partnership liquidate in accordance with capital accounts in these situations. The exercise of options to acquire partnership interests also may create situations in which the partnership may fail to liquidate in accordance with capital accounts, notwithstanding the application of a target allocation provision. This situation also provides challenges for satisfying the economic effect equivalence test with target allocations.

This Analysis will not resolve whether the target allocation provision will satisfy economic effect through either the economic effect test or the economic effect equivalence test. The resolution of this question is not clear.

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n1 [1] *Treas. Reg. § 1.704-1(b)(2)(ii)*. *Treasury Regulation § 1.704-1(b)(2)* shall hereafter be generally referred to as "the Allocation Regulations."

n2 [2] See discussion in Cuff, *Some Basic Issues in Drafting Real Estate Partnership and Limited Liability Company Agreements*, 65 NYU Instit. On Fed. Tax'n. § 18.84 (2007).

n3 [3] *Treas. Reg. § 1.704-1(b)(2)(ii)(d)*. Cuff, *Some Basic Issues in Drafting Real Estate Partnership and limited liability company agreements*, 65 NYU Instit. On Fed. Tax'n. § 18.84[7] (2007).

n4 [4] *Treas. Reg. § 1.704-1(b)(2)(ii)(i)*.

n5 [5] *Treas. Reg. § 1.704-1(b)(2)(ii)(b)*.

n6 [6] *Treas. Reg. § 1.704-1(b)(2)(i)*.

n7 [7] On substantiality, see *Treas. Reg. § 1.704-1(b)(2)(iii)(a)* ("Except as otherwise provided in this paragraph (b)(2)(iii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner's tax attributes that are unrelated to the partnership will be taken into account. . . ."). See, also, Cuff, *Some Basic Issues in Drafting Real Estate Partnership and limited liability company agreements*, 65 NYU Instit. On Fed. Tax'n. § 18.86 (2007).

n8 [8] All references to "Section" or "Code" are to the Internal Revenue Code of 1986, as amended.

n9 [9] *Treas. Reg. § 1.704-1(b)(2)(ii)(d)*.

n10 [10] *Treas. Reg. § 1.704-1(b)(2)(ii)(i)*.

n11 [11] *Treas. Reg. § 1.704-1(b)(2)(ii)(e)*.

n12 **[12]** For example, the distributions to partners could be set aside as fraudulent conveyances in appropriate circumstances, and a creditor might elect to pursue its remedies against only one partner.

n13 **[13]** *Treas. Reg. § 1.704-1(b)(5)*, Example (5).

n14 **[14]** *Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3)*.

n15 **[15]** *Treas. Reg. § 1.704-1(b)(2)(ii)(h)*.

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USC Gould School of Law 2009 Tax Institute: Nonrecourse Liabilities

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USC Gould School of Law 2009 Tax Institute: Terence Floyd Cuff on Drafting Target Partnership Allocations When Nonrecourse Liabilities Are Present

By Terence Cuff

November 2, 2009

SUMMARY: A challenge seen by practitioners when drafting target partnership allocations is how to deal with nonrecourse liabilities. The target allocation provision may satisfy the nonrecourse deduction safe harbor if allocations under the target allocation provision are deemed to have economic effect on account of economic effect equivalence. Explicit allocations of nonrecourse deductions are then respected. Whether this argument works is uncertain.

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ARTICLE: A challenge encountered by tax practitioners when attempting to draft target partnership allocations is how to deal with nonrecourse liabilities. The target allocation provision may satisfy the nonrecourse deduction safe harbor if allocations under the target allocation provision are deemed to have economic effect on account of economic effect equivalence. Explicit allocations of nonrecourse deductions then should be respected. Whether this argument works is a matter of conjecture.

The target allocation provision is unlikely to satisfy the nonrecourse deduction safe harbor if allocations under the target allocation provision do not satisfy the economic effect equivalence test. Failure to satisfy economic effect equivalence will create substantial doubt that explicit special allocations of nonrecourse deductions will be respected. Nonrecourse deductions then should be allocated in accordance with partners' interests in the partnership. What that means often is in doubt. Failure to satisfy the nonrecourse deduction safe harbor calls into question whether allocation of nonrecourse deductions under the target allocation provision -- or outside of the target allocation provision -- will be respected.

Many advisors will seek to specially allocate nonrecourse deductions in drafting a target allocation provision, despite the uncertainty over whether those special allocations of nonrecourse deductions will be respected for tax purposes. Doubts about the status of allocations of nonrecourse deductions complicate the use of target allocation provisions. The effectiveness of special allocations of nonrecourse deductions often will be in doubt. Advisors seeking certainty that allocations of nonrecourse deductions will be respected should consider the advisability of a target allocation provision.

IRC Section 752 regulations define a "nonrecourse liability":

A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under Reg Section 1.752-2. n1

By contrast,

A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under Reg Section 1.752-2. n2

This constitutes a logical partition. A partnership liability necessarily is either a recourse liability or nonrecourse liability under the *IRC Section 752* regulations.

Economic risk of loss is determined under *Treasury Regulations Section 1.752-2*. The general standard for measuring economic risk of loss is based on the extent that (if the partnership constructively liquidated) the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. n3

An obligation to make a payment is measured based on a facts and circumstances test. The analysis is based on all statutory and contractual obligations relating to the partnership liability. n4

Special rules apply where a partner or related person is a lender. Regulations provide generally that: "A partner bears the economic risk of loss for a partnership liability to the extent that the partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner." n5

A special rule can apply when a partner is a lender. The general rule that treats the lending partner as bearing the economic risk of loss of a nonrecourse loan that the partner lends to the partnership does not apply if -- (1) a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, (2) makes a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of *IRC Section 465(b)(6)* (determined without regard to the type of activity financed). n6

A parallel rule applies when a partner is a guarantor of partnership debt. The general rule concerning economic risk of loss does not apply if -- (1) a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees a loan that would otherwise be a nonrecourse loan of the partnership and (2) which would constitute qualified nonrecourse financing within the meaning of *IRC Section 465(b)(6)* (without regard to the type of activity financed) if the guarantor had made the loan to the partnership. n7

The Nonrecourse Deduction Regulations contain complex special rules for determining economic risk of loss with respect to a nonrecourse liability with interest guaranteed by a partner. n8

Contingent obligations to make payments are generally disregarded under the *IRC Section 752* regulations in determining economic risk of loss. n9

Reimbursement rights can cause a reallocation of economic risk of loss under *IRC Section 752*. n10

One of the controversial aspects of the *IRC Section 752* economic risk of loss rules is an unlimited presumption of solvency of the partner. A partner is deemed able to satisfy any obligation to make a payment to satisfy an obligation to a partnership, regardless of the partner's actual assets. n11

The Allocation Regulations contain two relevant definitions that operate for purposes of *IRC Section 704*:

Definition of nonrecourse liability. "Nonrecourse liability" means a nonrecourse liability as defined in Reg. Section 1.752-1(a)(2) or a Reg Section 1.752-7 liability (as defined in Reg. Section 1.752-7(b)(3)(i)) n12[12] assumed by the partnership from a partner on or after June 24, 2003.

Definition of partner nonrecourse debt. "Partner nonrecourse debt" or "partner nonrecourse liability" means any partnership liability to the extent the liability is nonrecourse for purposes of Reg Section 1.1001-2, and a partner or related person (within the meaning of Reg Section 1.752-4(b)) bears the economic risk of loss under Reg Section 1.752-2 because, for example, the partner or related person is the creditor or a guarantor. n13

The lack of parallelism between the definition of "nonrecourse liability" under the *Section 704* and the definition of "partner nonrecourse liability" under *Section 704* is interesting. The definition of "partner nonrecourse liability" depends on the liability being nonrecourse for purposes of the *IRC Section 1001* regulations. The definition of "nonrecourse liability" under the *IRC Section 704* regulations does not expressly reference *Section 1001* and depends exclusively on the *IRC Section 752* regulations. Whether this distinction was intended by the draftsmen is a matter that thoughtful advisors will debate.

Some target allocation provisions allocate nonrecourse deductions as part of Net Profits and Net Losses, even though chargeback allocations under the minimum gain chargeback are allocated separately from the target allocation provision. This scheme can result in different ratios of allocations of Net Income and Net Losses between partners from year to year. This can result in annually shifting allocations of nonrecourse deductions. Annually shifting allocations of nonrecourse deductions are not legally infirm, but this scheme shifting allocations of nonrecourse deductions may not make sense to the partners. Most advisors prefer a single ratio for allocating nonrecourse deductions that is invariable over time, if that single ratio is permitted.

Nonrecourse deductions perhaps can be addressed through a special allocation of nonrecourse deductions; nonrecourse deductions then are excluded from "Net Income" and "Net Loss." The exclusion provision might be: "For this purpose, Net Income and Net Loss shall be computed by excluding items allocated under *IRC Section 704(c)(1)(A)*, under the minimum gain chargeback, under the partner minimum gain chargeback, or under the qualified income offset, and also by excluding items allocated as nonrecourse deductions or as partner nonrecourse deductions."

Whether the Nonrecourse Deduction Regulations permit a special allocation of nonrecourse deductions when the partnership uses a target allocation provision is a matter of conjecture and some dispute. Some advisors are concerned that the target allocation provision will not satisfy the requirements of economic effect and the requirements of the Nonrecourse Deduction Regulations for allocations of nonrecourse deductions. This creates uncertainty concerning whether explicit special allocations of nonrecourse deductions outside of the target allocation provision will be respected for tax purposes. Whether allocations of nonrecourse deductions within the target allocation provision will be respected is uncertain.

Some advisors will avoid using a target allocation provision when they require certainty that allocations of nonrecourse deductions will be respected.

Many advisors are uncertain whether special allocations of nonrecourse deductions will be permitted when the partnership uses a target allocation provision, but a significant proportion of these advisors optimistically provide for special allocations of nonrecourse deductions.

The Nonrecourse Deduction Regulations provide:

Allocations of nonrecourse deductions are deemed to be in accordance with the partners' interests in the

partnership only if -

(1) Throughout the full term of the partnership requirements (1) and (2) of Reg. Section 1.704-1(b)(2)(ii)(b) are satisfied (i.e., capital accounts are maintained in accordance with Reg. Section 1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either Reg. Section 1.704-1(b)(2)(ii)(b) or Reg. Section 1.704-1(b)(2)(ii)(d) is satisfied (i.e., partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset);

(2) Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities;

(3) Beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of paragraph (f) of this section; and

(4) All other material allocations and capital account adjustments under the partnership agreement are recognized under Reg. Section 1.704-1(b) (without regard to whether allocations of adjusted tax basis and amount realized under IRC Section 613A(c)(7)(D) are recognized under Reg. Section 1.704-1(b)(4)(v)). n14

A target allocation provision may not meet the requirements of requirement (1). The heart of the target allocation provision is that distributions are made in accordance with specified tiers that do not reference capital accounts. Distributions are not required to be made in accordance with positive capital account balances. A target allocation provision usually is designed to produce consistency between specified distributions without referencing capital accounts and distributing liquidation proceeds in accordance with capital accounts.

Knowledgeable tax advisers will debate whether tax allocations can satisfy requirement (2) -- consistency with allocations that have substantial economic effect. This poses the question of whether allocations under the target allocation provision can have substantial economic effect or deemed economic effect.

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n1 *Treas. Reg. § 1.752-1(a)(2)*.

n2 *Treas. Reg. § 1.752-1(a)(1)*.

n3 *Treas. Reg. § 1.752-2(b)(1)*.

n4 *Treas. Reg. § 1.752-2(b)(3), (4), (5)*

n5 *Treas. Reg. § 1.752-2(c)(1).*

n6 *Treas. Reg. § 1.752-2(d)(1).* See *I.R.C. § 465(b)(6)* ("Qualified nonrecourse financing treated as amount at risk. For purposes of this section -- (A) In general. Notwithstanding any other provision of this subsection, in the case of an activity of holding real property, a taxpayer shall be considered at risk with respect to the taxpayer's share of any qualified nonrecourse financing which is secured by real property used in such activity. (B) Qualified nonrecourse financing. For purposes of this paragraph, the term 'qualified nonrecourse financing' means any financing -- (i) which is borrowed by the taxpayer with respect to the activity of holding real property, (ii) which is borrowed by the taxpayer from a qualified person or represents a loan from any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government, (iii) except to the extent provided in regulations, with respect to which no person is personally liable for repayment, and (iv) which is not convertible debt. (C) Special rule for partnerships. In the case of a partnership, a partner's share of any qualified nonrecourse financing of such partnership shall be determined on the basis of the partner's share of liabilities of such partnership incurred in connection with such financing (within the meaning of section 752). (D) Qualified person defined. For purposes of this paragraph -- (i) In general. The term 'qualified person' has the meaning given such term by section 49(a)(1)(D)(iv). (ii) Certain commercially reasonable financing from related persons For purposes of clause (i), section 49(a)(1)(D)(iv) shall be applied without regard to subclause (I) thereof (relating to financing from related persons) if the financing from the related person is commercially reasonable and on substantially the same terms as loans involving unrelated persons. (E) Activity of holding real property For purposes of this paragraph -- (i) Incidental personal property and services The activity of holding real property includes the holding of personal property and the providing of services which are incidental to making real property available as living accommodations. (ii) Mineral property The activity of holding real property shall not include the holding of mineral property."). See *I.R.C. § 49(a)(1)(D)(iv)* ("(iv) Qualified persons For purposes of this paragraph, the term 'qualified person' means any person which is actively and regularly engaged in the business of lending money and which is not -- (I) a related person with respect to the taxpayer, (II) a person from which the taxpayer acquired the property (or a related person to such person), or (III) a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).").

n7 *Treas. Reg. § 1.752-2(d)(2).*

n8 *Treas. Reg. § 1.752-2(e).*

n9 *Treas. Reg. § 1.752-2(d)(4)* ("(4) Contingent obligations. A payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs."). This may seem like an overly technical rule. This rule can affect how items are allocated under a sophisticated target allocation provision. Sophisticated target allocation provisions often provide for adjustments for capital contribution obligations and deemed capital contribution obligations.

n10 *Treas. Reg. § 1.752-2(d)(5)*.

n11 *Treas. Reg. § 1.752-2(d)(6)*.

n12 See *Treas. Reg. § 1.752-1(a)(4)* ("(4) Liability defined. (i) In general. An obligation is a liability for purposes of section 752 and the regulations thereunder (§ 1.752-1 liability), only if, when, and to the extent that incurring the obligation -- (A) Creates or increases the basis of any of the obligor's assets (including cash); (B) Gives rise to an immediate deduction to the obligor; or (C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital. (ii) Obligation. For purposes of this paragraph and § 1.752-7, an obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps."). See *Treas. Reg. § 1.752-7(b)(3)(i)* ("(3) § 1.752-7 liability. (i) In general. A § 1.752-7 liability is an obligation described in § 1.752-1(a)(4)(ii) to the extent that either -- (A) The obligation is not described in § 1.752-1(a)(4)(i); or (B) The amount of the obligation (under paragraph (b)(3)(ii) of this section) exceeds the amount taken into account under § 1.752-1(a)(4)(i). (ii) Amount and share of § 1.752-7 liability. The amount of a § 1.752-7 liability (or, for purposes of paragraph (b)(3)(i) of this section, the amount of an obligation) is the amount of cash that a willing assignor would pay to a willing assignee to assume the § 1.752-7 liability in an arm's-length transaction. If the obligation arose under a contract in exchange for rights granted to the obligor under that contract, and those contractual rights are contributed to the partnership in connection with the partnership's assumption of the contractual obligation, then the amount of the § 1.752-7 liability or obligation is the amount of cash, if any, that a willing assignor would pay to a willing assignee to assume the entire contract. A partner's share of a partnership's § 1.752-7 liability is the amount of deduction that would be allocated to the partner with respect to the § 1.752-7 liability if the partnership disposed of all of its assets, satisfied all of its liabilities (other than § 1.752-7 liabilities), and paid an unrelated person to assume all of its § 1.752-7 liabilities in a fully taxable arm's-length transaction (assuming such payment would give rise to an immediate deduction to the partnership). (iii) Example. In 2005, A, B, and C form partnership PRS. A contributes \$10,000,000 in exchange for a 25% interest in PRS and PRS's assumption of a debt obligation. The debt obligation was issued for cash and the issue price was equal to the stated redemption price at maturity (\$5,000,000). The debt obligation bears interest, payable quarterly, at a fixed rate of interest, which was a market rate of interest when the debt obligation was issued. At the time of the assumption, all accrued interest has been paid. Prior to the partnership assuming the obligation, interest rates decrease, resulting in the debt obligation bearing an above-market interest rate. Assume that, as a result of the decline in interest rates, A would have had to pay a willing assignee \$6,000,000 to assume

the debt obligation. The assumption of the debt obligation by PRS from A is treated as an assumption of a § 1.752-1(a)(4)(i) liability in the amount of \$5,000,000 (the portion of the total amount of the debt obligation that has created basis in A's assets, that is, the \$5,000,000 that was issued in exchange for the debt obligation) and an assumption of a § 1.752-7 liability in the amount of \$1,000,000 (the difference between the total obligation, \$6,000,000, and the § 1.752-1(a)(4)(i) liability, \$5,000,000).").

n13 *Treas. Reg. § 1.704-1(b)(3), (4).*

n14 *Treas. Reg. § 1.704-2(e).*

RELATED LINKS: For more information, see

- LexisNexis Tax Advisor -- Federal Topical 2D:4.09

For additional information, see

- 1-4 Tax Planning for Partners, Partnerships, and LLCs 4.09

For the text of the full conference paper, please see

- 61-11 USC Law School Institutes On Major Tax Planning P 1100,

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Economic Substance Doctrine Under Schering-Plough Corp. v. U.S.

2009 Emerging Issues 4524

Robert B. Jennings and Elizabeth Taishoff Sweigart on Why U.S. Multinationals Should Be Mindful of Economic Substance When Trying to Fully Reap Tax Benefits in Light of Schering-Plough Corp. v. U.S.

By Robert Jennings and Elizabeth Sweigart

October 30, 2009

SUMMARY: In *Schering-Plough Corporation v. United States*, the courts decision for the Government is a clarion call to taxpayers that even in cases when the taxpayer may be technically in compliance with relevant law, transactions -- particularly transfer pricing -- will be scrutinized for economic substance and tax benefits disallowed if a non-tax business purpose is found lacking.

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ARTICLE: Summary

A decision for the Government in the tax refund suit brought by Schering-Plough Corporation (Schering-Plough) is a wake-up call for U.S. taxpayers: Contemporaneous documentation in support of the economic substance of a transaction is critical. In *Schering-Plough Corporation v. United States*, 2009 U.S. Dist. LEXIS 77467 (August 28, 2009), Judge Katherine S. Hayden explicitly states that "the Court's decision requires an examination of the transactions for their 'economic reality' .. regardless of how a given transaction was characterized by the taxpayer." *Schering-Plough* is a significant case for tax practitioners and U.S. multinationals to note because it highlights the Government's continued focus on the economic substance doctrine as a means of combating structures it perceives as tax shelters, even in cases when the taxpayer may be technically in compliance with relevant law.

Case Summary

Overview. Schering-Plough brought a civil suit against the United States in New Jersey District Court seeking a tax refund of approximately \$473 million in Federal income taxes for taxable years 1989, 1991 and 1992. In 1991 and 1992, Schering-Plough assigned future income streams -- derived from interest rate swaps with a third party -- to related parties outside of the United States in exchange for lump-sum payments from those affiliates. The taxpayer represented that these "swap-and-assign" transactions were sales as opposed to loans and thus the income tax payment on the net proceeds of the sales could be deferred until later years. Essentially, Schering-Plough could gain access to its offshore cash immediately without a corresponding taxable event in the same year. The IRS concluded that the transactions were in fact intercompany loans and thus subject to tax under *Section 956 of the Internal Revenue Code of 1986* (I.R.C.) as the resultant loans were "investments in U.S. property." In rendering its opinion, the court noted the policy rationale

underlying the anti-deferral provisions enacted in the Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 1006, § 12(a) (1962) (commonly known as "Subpart F").

Corporate Structure. A New Jersey corporation, Schering-Plough operated as a global developer, manufacturer and seller of pharmaceuticals during the tax years in question. Through its wholly-owned New Jersey subsidiary, Schering Corporation, Schering-Plough was the majority owner of three Swiss corporations. During the tax years under consideration, Schering-Plough was a U.S. shareholder within the meaning of *I.R.C. §§ 951(b) and 958(b)* and the Swiss subsidiaries were Controlled Foreign Corporations within the meaning of *I.R.C. §§ 957 and 958*. (JTS 12, 94.)

The Transactions. As a means of bringing back its foreign affiliates' earnings into the United States, Schering-Plough entered into two 20-year interest rate swap transactions with Algemene Bank Nederland, N.V. (ABN), a Dutch investment bank, in 1991 and 1992. The transaction, as characterized by the court, required Schering-Plough and ABN to "exchange periodic interest payments based on a hypothetical amount (the 'notional principal') and two different interest rate indices. The swap agreements obligated Schering-Plough and ABN to make periodic payments to each other reflecting the movement of the particular interest rate assigned to their respective sides of the transaction."

Next, as permitted under the agreement, Schering-Plough assigned its right to receive interest payments from ABN ("receive legs") to two of its foreign subsidiaries for lump-sum payments of approximately \$690 million. The taxpayer did not report the lump sums as present income. Instead, relying on *IRS Notice 89-21*, it deferred reporting income until later years. Because Notice 89-21 required ratable taxation of payments received in exchange for the assignment of future income streams from notional principal contracts, the taxpayer reported income for the lump sums by amortizing them over the period in which the future income streams had been assigned. The transactions were structured under the guidance provided in *IRS Notice 89-21, 1989-1 C.B. 651, 1989 IRB LEXIS 91* (Deferred Recognition of Income from Lump-Sum Payments in Connection with Notional Principal Contracts), which stated the Commissioner's position that:

"in the case of lump-sum payments made or received with respect to notional principal contracts entered into, or assignments made, prior to the effective date of the regulations (including contracts entered into prior to the publication of this notice), a method of accounting used by a taxpayer is a method that clearly reflects income only if the payments are taken into account over the life of the contract using a reasonable method of amortization. . . . No inference should be drawn from this notice as to the proper treatment of transactions that are not properly characterized as notional principal contracts, for instance, to the extent that such transactions are in substance properly characterized as loans."

As long as the transactions could be properly characterized as sales, the taxpayer could achieve deferral of U.S. income tax. In creating and structuring the transactions, Schering-Plough relied on advice and opinions from its various third party advisors, including ABN, Merrill Lynch, Deloitte & Touche, and Skadden, Arps, Slate, Meagher & Flom.

Lessons for U.S. Multinationals and Their Advisors

Lesson 1: Documentation. Contemporaneous documentation is essential, not just for the form of the transaction (e.g., agreements, invoices), but also the economic substance and underlying non-tax business purpose of the transaction. Internal memoranda and e-mails must reflect the business purpose and projected bottom-line impact that the transaction is designed to further. Tailoring a transaction to fit a sentence or two in an IRS notice will not suffice.

Lesson 2: Related-Party Transactions Subject to Greater Scrutiny. The Government believes that transactions between affiliates offer more opportunities for improper revenue allocation than the same transactions involving third parties. Therefore, situations involving related parties (i.e., transfer pricing) will be subject to greater examination.

Even the presence of ABN -- a third party intermediary -- was insufficient to convince the court that Schering-Plough and its affiliates were operating at arm's length with respect to the transactions in question. Citing ABN's own internal documentation admitting that the transaction was solely based in avoiding U.S. federal income tax, the court concluded that the relationship between the controlled parties was not at arm's length.

Lesson 3: Do Not Work Backwards. When looking for a tax structuring solution the general tendency is to start with the desired answer (say, achieve deferral) and work backwards. Tax planning decisions should be based on facts and circumstances, not the latest tax guidance "flavor of the month" -- in the form of Notices, Revenue Procedures, etc. This approach is a recipe for disaster. Companies and their advisors must begin with a thorough development and understanding of the facts and circumstances and find the guidance that suits the taxpayer's specific situation. Although it may reduce short-term friction between the client and advisor, attempting to shoehorn a given set of facts and circumstances into the selected guidance and to rely on window-dressing to cover a position will put the taxpayer at risk.

The taxpayer in Schering-Plough summoned expert witnesses, yet their testimony was found wanting. None of the experts could show a bottom-line impact; they testified only to what the transaction looked like, not what it did. The court's suspicions were raised by "meticulously crafted, tax-motivated, related-party transactions between a parent corporation and its controlled subsidiaries." The taxpayer failed to put these suspicions to rest. It takes careful business and economic -- not pure tax -- planning, to do that.

Key Takeaways for Companies and Their Tax Advisors

Information is Power. Once confronted with an IRS deficiency notice, a company should review all documents with its internal and external counsel and advisors. It is critical for the company's management and its third-party advisors to talk with the personnel who devised and implemented the transaction and gather all of their notes and e-mails. There should be no surprises on examination, at appeal or at trial.

Plan Ahead. Taxpayers must anticipate that the IRS will scrutinize any related-party transaction that achieves tax savings. When the transaction is being considered, best practice dictates that the taxpayer and its advisors should document the non-tax business purpose, bottom-line economic impact, and full range of considerations in structuring and executing the transaction.

Nothing is "Off the Record." In many ways, Schering-Plough's in-the-trenches personnel did more damage than all the Government's witnesses and arguments.

In its decision, the court quoted extensively from the testimony of the taxpayer's accounting personnel and Schering-Plough's internal memoranda in its decision. Taxpayer's senior personnel put in writing that they thought the transaction was a loan and wanted to treat it as such, but as the Director of Financial Reporting and Compliance at the time wrote, "Tax could not have us record it as a loan." Personnel should be reminded that internal corporate memoranda and e-mails are readily discoverable.

Ultimately, proper planning is worth more than damage control. Schering-Plough provides a critical lesson for companies and their advisors: Start with substance.

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For further discussion, see

- 2-18 Rhoades & Langer, U.S. Int'l Tax'n & Tax Treaties 18.03

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Ohio CAT Factor Context Discussed, An Ohio Tax Practice Insight

2009 Emerging Issues 4490

Ohio CAT Factor Context Discussed, An Ohio Tax Practice Insight

By Sheldon Laskin

October 20, 2009

SUMMARY: In sustaining the constitutionality of Ohios Commercial Activity Tax (CAT) as applied to the gross receipts from the sale of food for human consumption, the Ohio Supreme Court has reaffirmed the principle that a tax measured by a factor is not legally equivalent to a tax imposed on that factor. *Ohio Grocers Ass'n v. Levin*, 2009 Ohio 4872 (Ohio Sept. 17, 2009).

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ARTICLE: In sustaining the constitutionality of Ohio's Commercial Activity Tax ("CAT") as applied to the gross receipts from the sale of food for human consumption, the Ohio Supreme Court has reaffirmed the principle that a tax measured by a factor is not legally equivalent to a tax imposed on that factor. *Ohio Grocers Ass'n v. Levin*, 2009 Ohio 4872 (Ohio Sept. 17, 2009).

The Ohio General Assembly imposed the Commercial Activity Tax (CAT) on gross receipts for the privilege of doing business in Ohio. In 2005, the Ohio General Assembly enacted the CAT, to be phased in beginning that year. 2005 Ohio H.B. 66. The CAT is imposed "on each person with taxable gross receipts for the privilege of doing business in [Ohio]." Ohio Rev. Code Ann. 5751.02(A). For many businesses, the CAT replaces the tax on personal property located and used in businesses in Ohio and the corporate franchise tax measured by net income.

Under the CAT, businesses with gross receipts less than \$150,000 in a calendar year are not required to register for or pay the tax. Businesses with gross receipts in excess of \$150,000 but not exceeding \$1,000,000 pay a flat tax of \$150. Businesses with gross receipts in excess of \$1,000,000 pay the \$150 tax plus a tax in the amount of two and six-tenth mills (0.0026) on the amount of gross receipts that exceeds \$1,000,000.

The Ohio Constitution permits laws that provide for excise and franchise taxes. However, the Constitution prohibits the imposition of an excise tax "upon the sale or purchase of food for human consumption off the premises where sold." Oh. Const. Art. XII, § 3(C). Furthermore, Oh. Const. Art. XII, § 13, similarly prohibits the imposition of a "sales or other excise tax" on the wholesale sale or purchase of food for human consumption, whether on or off the premises where sold.

The Ohio Grocers Association ("Grocers") brought a declaratory judgment action, alleging that the CAT violates

the provisions of Sections 3 (C) and 13 of Article XII, to the extent that the tax is imposed on gross receipts from the sale of food for human consumption. The Grocers asserted that the CAT, as applied to the sale of food for human consumption, is an excise tax on the sale or purchase of food for human consumption and is therefore prohibited by the Ohio Constitution.

In sustaining the constitutionality of the CAT, the Ohio Supreme Court initially noted that "it is permissible to tax the privilege of doing business, and to do so, the privilege must be valued." *Ohio Grocers Ass'n v. Levin*, 2009 Ohio 4872, P14 (Ohio Sept. 17, 2009). The Court cited several Ohio cases in support of the principle that an appropriate measure of the value of a business franchise is the gross income or receipts of the business.

Second, the Court pointed out that both Ohio and federal law make clear that there is a legal distinction between a tax levied on a factor and a tax on a privilege measured by that factor. 2009 Ohio Lexis 2531, **10. The courts have long ruled that the measure of a tax can include a factor even if it would be illegal for a state to impose a tax directly on that factor. See, e.g., *Werner Machine Co. v. Director, New Jersey Division of Taxation*, 350 U.S. 492, 1956 U.S. LEXIS 1203 (1956) (New Jersey's corporate franchise tax measured by net worth does not violate intergovernmental tax immunity notwithstanding that federal bonds exempt from state taxation were included in the measure of net worth).

Next, the Court ruled that a statute must be strictly construed in favor of its constitutionality and that the party challenging the statute bears the burden of proving the statute to be unconstitutional beyond a reasonable doubt. Based on a strict construction of the constitutional language, the Court concluded that neither provision prohibits a tax imposed on *sellers* of food as opposed to a tax imposed on the *sale* of food. The Grocers therefore failed to meet their burden of proof.

In any event, the Court found that the structure and history of the constitutional provisions support its finding that neither provision was intended to bar the state from imposing a franchise tax on the privilege of doing business measured by gross receipts including, as applied to grocers, gross receipts from the sale of food for human consumption. The structure and history make clear that the provisions were meant to bar only sales and similar taxes imposed on the sale of food, and not franchise taxes imposed on the owner of the business. The history of Section 3(C) shows that it was a response to the application of the sales tax to food sales at the time Ohio adopted its sales tax during the Great Depression. Similarly, the history of Section 13 demonstrates that it was enacted in response to a 1993 court ruling that the imposition of a beverage tax on soft drinks sold at wholesale did not violate Section 3(C). In contrast, the franchise tax on net income which the CAT replaces has long included net income from the sale of food for human consumption in the measure of the tax. Unlike the reaction to imposing the sales tax on food sales, no attempt was ever made to amend the Ohio Constitution to bar the imposition of the franchise tax on income derived from food sales.

Finally, the Court examined the structure of the CAT and determined that it is a franchise tax and not a sales tax. The General Assembly described the tax as being imposed for the privilege of doing business. The tax is imposed on the person with taxable gross receipts and not on the consumer of food. The statute prohibits the tax from being billed or invoiced to any person other than the holder of the privilege. Nor can the tax be collected from anyone else. Unlike a sales tax which is imposed and collected at the time of sale, the CAT is an annual tax based on the results of an entire year of doing business. It is computed on a cumulative basis either annually or quarterly and not on a transaction-by-transaction basis. The tax is calculated using a broad measure of market access gross receipts that is rationally related to the enjoyment of the privilege of doing business. The structure of the CAT demonstrates that it is a franchise tax on the privilege of doing business and not a sales tax.

The tax is not a sales tax because no tax is charged, collected or remitted on individual sales. Unlike a sales tax, no tax is due on the first \$150,000 of sales and only a minimum flat tax of \$150 is due on sales between \$150,000 and \$1,000,000. As a result, the Court concluded that it is unlikely that the tax would have any impact on the price of food to the consumer. Even if it did, it is not clear that grocers would pass the cost of the tax to their food customers. Instead, they might choose to pass the cost of the tax to their employees through lower wages, and/or absorb the cost through

lower profits. Alternatively, grocers could increase the price of non-food items in order to recover the cost of the tax as applied to the sale of food. For all these reasons, the CAT is not structured to have the same economic effect on consumers of food as does a sales tax. n1

As the caselaw cited in *Ohio Grocers* makes clear, the question of whether a tax is imposed on a factor or merely measured by the factor arises in varied and numerous contexts challenging the application of a tax to particular taxpayers, transactions or assets. Tax counsel would be well advised to study the opinion for a thorough survey of the law on this recurring issue.

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n1 Judge Pfeifer filed a dissent, both on the merits and in rejecting the principle that statutes are presumed to be constitutional.

RELATED LINKS: For a full discussion on the constitutional aspects of business activity taxes, see

■ 1-6 Bender's State Taxation: Principles and Practice § 6.04

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Sheldon Laskin is Counsel to the Multistate Tax Commission. Prior to joining the MTC staff in 1998, Mr. Laskin was an Assistant Attorney General for the Maryland Comptroller of the Treasury and litigated state tax cases in the Maryland court system for 8 years. Before joining the Attorney General's office, Mr. Laskin was in private practice, and argued and won a major employment discrimination case in the United States Supreme Court. *Burnett v. Grattan*, 468 U.S. 42 (1984). He also served on the staff of the U.S. Equal Employment Opportunity Commission and Florida Rural Legal Services. He received his BA and JD degrees from Rutgers University and his LL.M in Taxation from the University of Baltimore, where he currently teaches State and Local Taxation in the Graduate Tax Program. Mr. Laskin is a recipient of the University of Baltimore Graduate Tax Program's Excellence in Teaching Award. Also at the University of Baltimore, Mr. Laskin delivered a nine hour lecture series on state and local tax to officials from the Inner Mongolia Local Taxation Bureau of the People's Republic of China. Mr. Laskin has spoken on state and local tax issues at numerous forums, including annual symposia on state and local tax policy sponsored by the Taxation Section of the Maryland State Bar Association and the University of Baltimore Graduate Tax Program, the COST Sales Tax Conference, the CCH State Tax Advisory Board and the New Jersey Institute for Professionals in Taxation One-Day Tax Seminar. He is the author of a series of LexisNexis "Maryland State Tax Service Practice Insights." His law review article, "Only a Name? Trademark Royalties, Nexus and Taxing That Which Enriches" was published in the 2007 issue of the Akron Tax Journal. Mr. Laskin was the principal author of the Multistate Tax Commission's amicus brief in support of the Ohio Tax Commissioner in *Ohio Grocers Ass'n v. Levin*, 2009 Ohio 4872 (Ohio Sept. 17, 2009).

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USC Gould School of Law 2009 Tax Institute: Target Allocation & Service Partners

2009 Emerging Issues 4471

USC Gould School of Law 2009 Tax Institute: Terence Floyd Cuff on Target Allocation Agreements and the Service Partner

By Terence Cuff

October 15, 2009

SUMMARY: It is important to properly draft target allocation provisions, by examining a variety of such provisions. Certain partnership allocations concern income, gain, loss, and deductions, called target allocations. Target allocations specify how cash is distributed from operations and in liquidation of a partnership. A model then allocates income or loss items to partners capital accounts so that these accounts conform to a cash distribution scheme.

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ARTICLE: The task of drafting partnership agreements n1, and particularly target allocations, is to be as clear and understandable as possible. It is very common to encounter partnership agreements, especially target allocation clauses, which lack the requisite clarity. The consequence of such ambiguous drafting is that advisors must puzzle over the meaning and intention of the parties, which often results in matters going awry.

Many lawyers find drafting partnership allocations unappealing. The task can be complicated and time consuming. Opportunity abounds for making costly errors. Clients do not appreciate the delicacy of the drafting process. Clients do not understand why the work should be so expensive. Many lawyers look for ways to simplify the drafting. Shortcuts too often have inconvenient results. Several competing models of drafting partnership allocations of income, gain, loss, and deduction have evolved.

This analysis concerns the model of partnership allocations of income, gain, loss, and deduction commonly referred to as "target allocations." Target allocations specify how cash will be distributed from operations and in liquidation of the partnership. This model then allocates income and loss items to partners' capital accounts so that these capital accounts will conform to the cash distribution scheme in liquidation. This model of allocations of income, gain, loss, and deduction is not necessarily superior to or inferior to the other models. Target allocations currently are the rage with many draftsmen. Target allocations are the rage with draftsmen whether they much understand how their target allocation provisions work or not.

Key characteristics of "target allocations" are: (1) the partnership does not explicitly liquidate in accordance with capital accounts but rather liquidates in accordance with stated percentages, explicit tiers, *etc.*, that do not depend explicitly on capital account balances, and (2) allocations of income and loss items are made in such a manner that

capital accounts are adjusted to be consistent with the plan for liquidating distributions of cash.

A target allocation provision might (1) first, determine how the partnership would distribute cash on a hypothetical liquidation and (2) then, allocate income, gain, loss, and deduction (based on a hypothetical sale of all assets at "book" value) to adjust capital accounts so that they equal the amount of cash that the partnership would distribute to a partner on a hypothetical liquidation.

This analysis seeks to explore issues in drafting target allocation provisions by examining a variety of target allocation provisions. These target allocation provisions do not reflect an approved form. No format for partnership allocations of income, gain, loss, and deduction is "best" or "proper" or "right." n2

The function of this analysis is to help advisers better to understand some of the considerations in drafting a target allocation provision. Equipped with that understanding, advisors should be able to draft a better target allocation provision themselves.

Treasury and the Internal Revenue Service drafted Treasury Regulations concerning partnership allocations n3 ("Allocation Regulations") and regulations concerning allocations of deductions attributable to nonrecourse debt n4 ("Nonrecourse Deduction Regulations") prior to prevalence of target allocation provisions. This time was prior to prevalence of limited liability companies. Neither the Allocation Regulations nor the Nonrecourse Deduction Regulations expressly address target allocation provisions.

The failure of the Allocation Regulations and Nonrecourse Deduction Regulations expressly to consider the tax effects of limited liability companies leaves considerable doubt concerning the status of target allocation provisions under these two regulations. Nonrecourse deductions create special issues (discussed below) when a partnership uses a target allocation provision. A special allocation of nonrecourse deductions outside of the target allocation provision may not qualify under the Nonrecourse Deduction Regulations. An allocation of nonrecourse deductions under the target allocation provision may not qualify under the Nonrecourse Deduction Regulations.

Priority of Target Allocation Provisions. The prevalence of target allocation provisions and their tax uncertainty suggests that the Internal Revenue Service should make advice on target allocation provisions a high priority. A good case can be made that target allocation provisions generally should be approved for tax purposes, provided that anyone can decide how properly to draft target allocation provisions.

Service Partner. One particular issue which the Treasury Regulations fail to adequately consider is the situation of a service partner. Consider the following example:

Alvin, Simon, and Ted form Acorn Ventures, LLC. The purpose of Acorn Ventures is to grow and to market acorns to a growing commercial purpose. Alvin makes a capital contribution of \$10 million in cash. Simon makes a capital contribution of \$1 million in cash. Ted makes no capital contributions. This is the initial balance sheet of Acorn Ventures immediately after the capital contributions:

AB

FMV

Assets

Cash

\$11,000,000

\$11,000,000

Total

\$11,000,000

\$11,000,000

Liabilities and Capital

Nonrecourse Liabilities

\$0

\$0

Capital Alvin

\$10,000,000

\$10,000,000

Capital Simon

\$1,000,000

\$1,000,000

Capital Ted

\$0

\$0

Total

\$11,000,000

\$11,000,000

Acorn Ventures soon acquires a significant acorn farming property. This is the balance sheet of Acorn Ventures after this acquisition:

AB

FMV

Assets

Cash

\$1,000,000

\$1,000,000

Trees

\$17,000,000

\$17,000,000

Land

\$2,000,000

\$2,000,000

Equipment

\$1,500,000

\$1,500,000

Irrigation Systems

\$2,500,000

\$2,500,000

Total

\$24,000,000

\$24,000,000

Liabilities and Capital

Nonrecourse Liabilities

\$13,000,000

\$13,000,000

Capital Alvin

\$10,000,000

\$10,000,000

Capital Simon

\$1,000,000

\$1,000,000

Capital Ted

\$0

\$0

Total

\$24,000,000

\$24,000,000

The Acorn Ventures limited liability company agreement provides that Acorn Ventures LLC will make all distributions, whether from day-to-day operations, sale of capital assets, distributions in liquidation, or otherwise: (a) First, to Alvin until Alvin has received a 14% internal rate of return (based on a discount rate exponentially converted to a daily rate and compounded daily) on his capital investment. (b) Second, to Simon until Simon has received a 14% internal rate of return (based on a discount rate exponentially converted to a daily rate and compounded daily) on his capital investment. (c) Third, 75% to Alvin, 5% to Simon, and 20% to Ted.

We might draft the target allocation provision like this:

Clause 12. Section x.x. The Company shall allocate Net Profits or Net Losses (as the case may be) among the Members in such a manner as to produce this result (to the extent possible): after the allocation of Net Profits and Net Losses, the Capital Account of each Member (after hypothetical adjustment for the items that the Company would recognize on a Hypothetical Liquidation) shall equal the hypothetical amount that the Company would distribute to the Member pursuant to Section y.y upon a Hypothetical Liquidation.

For this purpose,

(a) "Hypothetical Sale and Liquidation" means a hypothetical transaction in which the Company

(i) sells all of its assets for their "book" values (or, for the amount of nonrecourse liabilities or partner nonrecourse liabilities secured by these assets, if nonrecourse liabilities or partner nonrecourse liabilities exceed "book" values),

(ii) first applies the proceeds to discharge Company liabilities at face amount (including repayment of interest that has accrued and has been deducted under the Company's method of accounting), and then

(iii) distributes the remaining net proceeds of this sale in accordance with Section y.y [the liquidating distribution provision].

(b) "Net Profits" means the net amount of all items (other than Contributions and liabilities) that increase or decrease capital accounts under *Treasury Regulations Section 1.704-1(b)(2)(iv)* if that net amount produces a net increase to capital accounts, and "Net Losses" means the net amount of all items (other than Distributions and liabilities) that increase or decrease capital accounts under *Treasury Regulations Section 1.704-1(b)(2)(iv)* if that net amount produces a decrease to capital accounts; provided, however, that all items allocated under the minimum gain chargeback, the partner nonrecourse debt minimum gain chargeback, and the qualified income offset, and nonrecourse deductions and partner nonrecourse deductions shall be excluded in computing Net Profits and Net Losses for this purpose.

(c) "Book value" means "book value" as used in *Treasury Regulations Section 1.704-1(b)(2)(iv)*.

(d) "Book" income and "book" loss of the Company shall be computed based on the principles for computing "book" items under *Treasury Regulations Section 1.704-1(b)(2)(iv)*.

(e) All items that adjust capital accounts pursuant to *Treasury Regulations Section 1.704-1(b)(2)(iv)* (other than assumptions of liabilities, distributions and contributions) shall be considered items of income, gain, loss, and deduction of the Company that are included in the computation of Net Profits or Net Losses (except as expressly

excluded from this computation by this Section x.x).

(f) Nonrecourse liabilities and partner nonrecourse liabilities shall be determined under Treasury Regulations Section 1.704-2, but shall be limited to liabilities that create minimum gain or partner minimum gain.

(g) Capital Accounts shall be determined for this purpose

(i) after adjustments for any specially allocated items, contributions, or distributions and

(ii) as if any net "book" income or net "book" loss that the Company would have recognized on this hypothetical sale (such as under the minimum gain chargeback or partner minimum gain chargeback) has been recognized and (other than items allocated under this Section y.y) credited to or debited from (as the case may be) the Members' Capital Accounts, and

(iii) by increasing the Capital Account of each Member on account of the amount that the Member would be required to pay or to contribute on account of the Members' obligations to make payments or contributions to the Company that would fall due on account of the liquidation of the Company or that would be treated as obligations to restore the Member's deficit Capital Account under *Treasury Regulations 1.704-1(b)(2)(ii)(b)(3)* (net of the amount of these payments or contributions that the Company would return to the Member on the Hypothetical Sale and Liquidation) (but not including a deemed deficit restoration obligation on account of minimum gain or partner minimum gain [which is already treated as fully recognized for this purpose under paragraph (e)(ii)]).

Acorn Ventures limited liability company agreement will contain separate provisions for allocating nonrecourse deductions and partner nonrecourse deductions, and separate provisions for the minimum gain chargeback, partner minimum gain chargeback, and qualified income offset. The Acorn Ventures limited liability company agreement allocates nonrecourse deductions 75% to Alvin, 5% to Simon, and 20% to Ted. The Acorn Ventures limited liability company agreement allocates partner nonrecourse deductions to the member who bears the economic risk of loss in accordance with the Nonrecourse Deduction Regulations. n5 Acorn Ventures elects the accrual method of accounting.

This chart summarizes the first year of operations of Acorn Ventures:

Year

Receipts/ Gross Income

Operating Expenses (exclusive of interest)

Interest Expense

Total Cash Expenses

"Book" Depreciation

Gross "Book" Deductions

Net "Book" Income (Loss)

Cash Distributions to the Members

1

\$1,800,000

\$1,680,000

\$1,040,000

\$2,720,000

\$1,850,000

\$4,570,000

(\$2,770,000)

\$0

The net "book" loss of \$2,770,000 for the year reduces the net asset value of Acorn Ventures LLC (on a "book" basis). The net proceeds would be $\$11,000,000 - \$2,770,000 = \$8,230,000$ if Acorn Ventures LLC were to sell all of its assets at the end of year 1 for "book" value. Acorn Ventures LLC would distribute proceeds of this hypothetical sale: (a) First, to Alvin until Alvin has received a 14% internal rate of return (based on a discount rate exponentially converted to a daily rate and compounded daily) on his capital investment. (b) Second, to Simon until Simon has receives a 14% internal rate of return (based on a discount rate exponentially converted to a daily rate and compounded daily) on his capital investment. (c) Third, 75% to Alvin, 5% to Simon, and 20% to Ted.

Assume that an \$11,400,000 payment on the last day of year 1 would be necessary to give Alvin a 14% internal rate of return. These are the members' capital accounts before allocations and distributions:

Capital -- Alvin

\$10,000,000

Capital -- Simon

\$1,000,000

Capital -- Ted

\$0

Total

\$11,000,000

The target allocation provision should allocate to Alvin, to the extent possible, net profits so that Alvin's capital account will be equal to the amount that Alvin would receive on liquidation. After \$2,770,000 in "book" losses in year 1, Acorn Ventures LLC will have \$8,230,000 in assets. Acorn Ventures LLC would distribute all of these assets to Alvin on a constructive liquidation.

This seems to be the most reasonable allocation of net profits and net losses if we respect the target allocation provision:

Alvin

Simon

Ted

Beginning Capital

\$10,000,000

\$1,000,000

\$0

Net Loss

\$1,770,000

\$1,000,000

\$0

Ending Capital

\$8,230,000

\$0

\$0

The Acorn Ventures limited liability company agreement allocates its first \$1,000,000 of net loss to Simon. Simon effectively bears first losses through subordination of return of his capital investment to the 14% internal rate of return distribution to Alvin (which includes return of Alvin's capital contribution). Alvin bears the next \$1,770,000 of losses. This conclusion is based on liquidation at an \$8,230,000 value of Acorn Ventures LLC.

We will leave it to the future to explore the nuances of whether the target allocation provision will yield results that accord with partners' interests in the partnership. This can involve a difficult analysis. Partners may not have the benefit of a presumption of unlimited solvency.

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n1 **[1]** This article arbitrarily will mix the terms "partnership", "limited liability company", and "LLC". It also will mix the terms "partner" and "member." A limited liability company normally is taxed as a partnership unless the entity elects to be taxed as a corporation.

n2 **[2]** The tax laws will not respect some ways to draft partnership allocations of income, gain, loss, and deduction. The tax laws will not respect allocations of income, gain, loss, and deduction if the allocations fail to have substantial economic effect, do not satisfy the alternate test of economic effect, do not satisfy the economic effect equivalence test, and are not in accordance with partners' interests in the partnership.

n3 [3] *Treas. Reg. § 1.704-1.*

n4 [4] *Treas. Reg. § 1.704-2.*

n5 [5] A well-drafted partnership agreement also should clarify the ordering of application of these provisions. Other allocation provisions should apply prior to the target allocation provision.

RELATED LINKS: for more information, see

- LexisNexis Tax Advisor -- Federal Topical § 11:15.11

For further information, see

- 1-4 Tax Planning for Partners, Partnerships, and LLCs § 4.02

For the full text of the author's article, see

- 61-11 USC Law School Institutes On Major Tax Planning P 1100

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Is New York's Amazon Tax Law the First of Many? A New York Tax Practice Insight

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Is New York's Amazon Tax Law the First of Many? A New York Tax Practice Insight

By Andrew Swain

October 15, 2009

SUMMARY: In 2008, NY enacted the Amazon Tax Law, requiring certain e-tailers to collect and remit tax on sales to NY residents. The law has created controversy as to whether the relationship between the e-tailers and the in-state businesses creates sufficient nexus for imposition of this requirement. The law, which is currently being litigated, may have set a trend as other states have proposed or enacted similar measures emulating the NY Amazon Law.

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ARTICLE: SUMMARY

Since April 2008, when New York enacted its controversial "Amazon Tax Law," several other states have considered or are considering enacting similar legislation. The New York law, which in effect requires certain out-of-state retailers making sales to in-state customers via the internet with established business affiliate relationships to in-state retailers to collect and remit state and local sales taxes on sales made to New York residents, looks not only at whether an out-of-state retailer has a physical presence in the state, but whether its affiliation with entities in the state creates the substantial nexus required by the Commerce Clause of the U.S. Constitution for a state to impose its sales tax on out-of-state sellers. As a result of lawsuits brought by Amazon.com and Overstock.com, the state's law has already survived its first significant challenge--but only at the trial level. The case is currently on appeal in the New York Supreme Court, Appellate Division.

Other states have either proposed or enacted similar measures that emulate New York's Amazon Law. The language and structure of the bills that have been drafted in most of those states closely follow that of the New York law. This insight discusses New York's Amazon Law, adoption or prospective adoption of similar laws by other states, the Amazon Law's compliance with the Streamlined Sales Tax Project, and the potential ramifications of adoption of the Amazon Law by other states.

ANALYSIS

By way of background, Amazon.com is an online retailer headquartered in Seattle, Washington, which makes online sales throughout the world. n1 Amazon.com does not own property, maintain offices, or retain any employees in New York. n2 The company does, however, maintain an affiliate marketing program, known as its Associates Program,

which allows participants to link to Amazon and receive up to 15% in fees on products Amazon sells as a result of the referrals. n3 While Amazon does not have a physical location based in New York, many of its affiliates are residents of New York that clearly have nexus with the state. Thus, a question arises as to whether Amazon's relationship with its New York participants creates nexus between the state and Amazon. In essence, the law as enacted by New York State states that this is exactly what happens.

New York started a sales and use tax affiliate nexus trend by enacting the Amazon tax law.

NY CLS Tax § 1101(b)(8) as amended by Chapter 57 of the Laws of 2008(the Amazon Tax Law) provides that "certain sellers of taxable, tangible personal property or services are sales tax vendors that are required to register for sales tax purposes and collect state and local sales taxes." n4 The "certain sellers," as defined in a Technical Services Memorandum Bulletin, which was issued by the New York State Department of Taxation and Finance to clarify the amended Section 1101(b)(8), are out-of-state vendors who work with independent contractors or other representatives that are residents of the state of New York. Under the law as amended, an out-of-state vendor, such as an online retailer operating outside of New York, is presumed to be soliciting business through an independent contractor, agent, or other representative if two conditions are met:

- First, the vendor or seller enters into an agreement with a New York resident according to which the resident receives a commission or other consideration for referring potential customers to the vendor. n5
- Second, as a result of these referrals, the vendor makes at least \$10,000 in sales to customers in New York during four consecutive quarters. n6 So long as he or she meets both conditions, the out-of-state vendor is subject to New York's sales tax collection duty whether he or she makes 10,000 sales of a dollar each or a single sale of \$10,000. n7

The law creates a rebuttable presumption that the online retailer is subject to the state's tax jurisdiction. The presumption can be rebutted "by proof that the resident with whom the seller has an agreement did not engage in any solicitation in the state on behalf of the seller that would satisfy the nexus requirement of the U.S. Constitution during the four quarterly periods in question." n8 New York deems "solicitation on behalf of the seller" to be activity on the part of the resident that refers potential customers to the out-of-state vendor "including, but not limited to: distributing flyers, coupons, newsletters and other printed promotional material or electronic equivalents; verbal solicitations []; initiating phone calls; and sending e-mails." n9 Advertising done by an out-of-state vendor on a New York resident's web site does not constitute solicitation and will not, therefore, give rise to the provision's presumption. Consequently, an out-of-state vendor can pay for an advertisement on a New York resident's web site via either a flat fee or commission and not be subject to New York's Amazon Law as long as it can demonstrate that the New York resident did not do any solicitation activity on its behalf as defined by the Section. n10

An out-of-state seller that meets the definition of a vendor under the amended law can rebut the presumption only if it meets two conditions:

- First, the seller must have a written contract or agreement with the New York resident that prohibits the resident from soliciting potential customers in the state and referring them to the seller. n11
- Second, the seller must demonstrate compliance with the Amazon law. It does this by having each of its in-state resident representatives annually sign and submit to it a certification that the representative has not engaged in prohibited solicitation in New York at any time in the previous year. n12

In the short period of time since its enactment, the New York State Amazon Tax Law has faced significant challenges.

Even though the New York law only took effect in 2008, it has already faced significant constitutional challenges in the courts. These challenges, the first of which has come from Amazon.com, are anticipated to continue for some

time to come. On April 25, 2008, only 16 days after New York amended § 1101(b)(8) to include the new nexus tax provision, Amazon.com filed suit, alleging that the statute violated the commerce, due process, and equal protection clauses of the United States Constitution and the constitution of New York. n13 Overstock.com, another online retailer with sales throughout the United States, filed a similar suit one month later. n14 The cases were consolidated and, on January 12, 2009, in *Amazon.com LLC v. N.Y. State Dep't of Taxation and Fin.*, n15 the New York Supreme Court, Manhattan Division, ruled in New York's favor.

Although the court addressed all three constitutional issues, the principal one in the case was what constituted nexus between New York and Amazon; that is, whether a substantial nexus existed between New York and the out-of-state Amazon that satisfied the U.S. Supreme Court's holding in *Quill* and the requirements of the Commerce Clause. If such nexus existed, New York could require Amazon to collect and remit state and local sales taxes. Amazon argued that it did not have a physical presence in New York, and that the statute unconstitutionally creates a presumption that the company has the necessary contacts with the state to create sales-tax nexus. n16 New York defended its Amazon tax provision by arguing that Amazon's participants have a physical presence in the state and that, citing *Scripto v. Carson* and *Tyler Pipe Indus. v. Dep't of Rev.*, the use of representatives in the state established an attributional link between Amazon and New York sufficient enough to create sales-tax nexus between the state and an out-of-state seller. n17

The New York Supreme Court, the trial court in which the case was brought, agreed with the state and followed the U.S. Supreme Court's holding in *Quill v. North Dakota*. The court concluded that to "establish substantial nexus, with the taxing State, physical presence of the vendor is required [but] it need not be substantial. Rather, it must be demonstrably more than a slightest presence." n18 In rejecting Amazon's facial challenge and granting the state's motion to dismiss, the court proclaimed:

Amazon should not be permitted to escape tax collection indirectly, through use of an incentivized New York sales force to generate revenue, when it would not be able to achieve tax avoidance directly through use of New York employees engaged in the very same activities. n19

In the realm of transactional taxes (*e.g.*, sales taxes), the traditional Commerce Clause nexus analysis requires determining whether an out-of-state retailer's contacts with a taxing jurisdiction (*e.g.*, the presence there of the retailer's employees or property) rise to the level of a physical presence. In the context of attributional nexus, the Commerce Clause analysis does not focus on a physical presence. It is presumed that an entity affiliated with the remote retailer has an in-state physical presence that satisfies *Quill*'s substantial-nexus mandate. The Commerce Clause analysis focuses on whether the in-state entity performs activities inside the taxing jurisdiction that are significantly associated with the out-of-state retailer's ability to establish and maintain a market there. n20 If so, the attribution of the in-state entity's physical presence to the out-of-state retailer satisfies the Commerce Clause.

Amazon.com has appealed the New York Supreme Court's decision. The state will most likely succeed in defending its Amazon Tax law against the due process and more restrictive Commerce Clause challenges if the state's higher courts agree with the proposition that the use of in-state residents by Amazon is sufficient to create attributional nexus with the state of New York. The state should be able to show that Amazon purposefully availed itself of New York's economic market when Amazon contracted with the New York participants of its Associates Program, and that both Amazon and the in-state associate financially benefited from the contractual arrangement. The state should also succeed in defending its tax law provision against Amazon's equal protection challenge. The burden will be on Amazon to demonstrate that it has been treated differently than similarly situated businesses, and this should prove difficult "since the statute was drafted to apply to all retailers that use affiliate marketing programs." n21

Since the New York law was enacted, other states have considered similar provisions.

Since New York enacted its Amazon Tax Law, other states (including California, Colorado, Connecticut, Hawaii, Illinois, Maryland, Minnesota, Mississippi, New Mexico, North Carolina, Rhode Island, Tennessee, Vermont, Virginia,

and Wisconsin) have either considered or are currently considering enacting a similar law. n22 Of these states, some of the states have failed to pass their versions of the Amazon Law n23 while others have succeeded in passage, but failed to enact the law. (E.g., legislation proposed in California and Hawaii were later the subject of gubernatorial veto, which the legislature chose not to override. n24)

California's version of the Amazon Law was introduced as part of Assembly Bill 27 in late January of 2009. n25 The legislation proposed establishing a definition of a "retailer engaging in business in [the] state" in its tax code. The definition would have included "a retailer entering into an agreement with a resident of [California] under which the resident, for a commission or other consideration" would refer potential customers to the retailer. n26 Like New York's Amazon Law, California's stipulated a \$10,000 threshold under which retailers would escape the definition and the tax obligation. n27 Unlike New York's provision, California's provision would not have created a rebuttable presumption, but would have provided an exception for out-of-state sellers who demonstrate that their in-state affiliates did not engage in referral activity on the seller's behalf. n28[28] Although the California measure was not enacted in the state's special session, many observers expect that the provision will be enacted in the near future. n29

Maryland introduced its version of the Amazon Tax Law in House Bill 337 in early February of last year, but failed to pass it by the time the General Assembly adjourned on April 13, 2009. n30 Like California's failed provision, Maryland's proposal closely followed the structure and language of New York's Amazon Law.

Hawaii's Legislature passed House Bill 1405 in March of 2009, which would have provided the state with its version of the Amazon Law. Like New York's provision, Hawaii's law would have expanded the definition of a phrase, "engaging in business," already present in its tax code. n31 The rest of Hawaii's measure, from describing the presumption and establishing a \$10,000 monetary threshold to detailing the process of rebutting the presumption, read very much like New York's Amazon Law. Although the legislature passed the provision, the Governor vetoed it on July 1, and so Hawaii remains without such a provision. n32

Rhode Island and North Carolina have been the most recent states to enact an Amazon Tax Law. In enacting its measure on March 12, 2009, Rhode Island amended § 44-18-15 of its tax code, and expanded the definition of "retailer" in much the same way as New York. did. n33 As with other states that have considered an Amazon provision, Rhode Island modeled its measure closely after New York's Amazon law, including an exception from the provision for any out-of-state retailer that only advertises on a server or other computer equipment located in Rhode Island, or disseminates or displays advertisements on the internet. n34 Out-of-state retailers who merely advertise on an in-state resident's website and are thus excepted from the Amazon Tax Law do not contract with or otherwise engage in-state residents to actively solicit or refer business to the out-of-state retailer. The in-state residents, in turn, do not operate as representatives or agents for the out-of-state retailer by conducting activities that would actively refer potential customers to the out-of-state retailer's web site. The in-state resident serves only as a host for the out-of-state retailer's advertisement and is usually compensated based on a flat-rate fee structure versus on a per-purchase commission structure.

Effective Mar. 1, 2010, Colorado has enacted legislation that is basically intended to accomplish the same goal as the other laws, but differs in some significant aspects. Like the New York, Rhode Island, and North Carolina laws, the Colorado law addresses the affiliate nexus issue with respect to electronic retailers. Unlike the other laws, however, the Colorado law does not create a sales tax collection obligation; instead, it creates an obligation on the part of the retailer to notify residents of their use tax obligation and contains provisions as to the specific details of the retailer's obligation.

The provisions that states such as Connecticut, Illinois, Minnesota, Mississippi, New Mexico, Tennessee, Vermont, Virginia, and Wisconsin have introduced are substantially similar to those enacted by New York.

State Amazon laws must be evaluated for compliance with the Streamlined Sales and Use Tax Agreement.

In 2001, members of four groups the National Conference of State Legislatures, the Federation of Tax

Administrators, the Multistate Tax Commission and the National Governors Association-- initiated the Streamlined Sales Tax Project (SSTP) in part to: (1) override the physical presence requirement mandated in *Quill*, (2) improve tax administration through the adoption of uniform sales and use tax laws that decrease complexity and administrative burdens, and (3) promote fairness in the tax system. n35 Under the SSTP's Streamlined Sales and Use Tax Agreement (SSUTA), remote vendors without nexus in a market state register with the market state, agreeing to collect and remit sales tax on sales sourced to the state. n36 This registration, however, is voluntary and falls woefully short of SSTP's goal of overriding *Quill*. This goal can be met only by the passage of federal legislation that allows states that have adopted the SSUTA and satisfy its requirements to require remote sellers to collect transaction taxes on the states' behalf.

Of the states that have enacted or considered an Amazon Tax Law, Minnesota, North Carolina, and Tennessee are implementing states that have enacted legislation to conform their sales and use tax laws to provisions of the SSTP.. n37 The remaining states are participating states that have yet to enact legislation that conforms to the SSTP. n38 The Amazon Tax Law as enacted by New York and other states does not establish new state or local sales tax rates or modify existing ones. The tax provision requires only that out-of-state sellers collect and remit state and local sales taxes at the rates that exist within each state. Consequently, a state's compliance with the SSTP will depend on whether the state is a party to the SSTP and, if so, whether it has established state and local sales tax rates (regardless of any effort to enact an Amazon Tax Law) that conform to the language of the SSUTA.

With over 7,500 state and local taxing jurisdictions throughout the United States, states have an interest in being a party to and complying with the SSTP. If not, they risk presenting to multi-state businesses an overly complex taxing system that might invite the federal government to step in and remove the complexities in the interest of freeing interstate commerce of undue burdens. n39 Congress has acted in the past to restrict the states' activities with regard to taxes and the Internet in passing the Internet Tax Freedom Act (IFTA). n40 The IFTA prohibits taxes imposed by state and local jurisdictions on "Internet access, multiple taxes on electronic commerce, and discriminatory taxes on electronic commerce." n41 Uniform state participation in and compliance with the SSTP and SSUTA should reduce the risk that the U.S. Congress or the federal courts will decide for the states if states can put Amazon Laws to use.

State Amazon laws may have long-term implications for electronic retailers.

The long-term implications of Amazon Tax Laws are uncertain. Proponents of the Amazon provisions present them as a means of leveling the playing field between in-state retailers, usually brick-and-mortar sellers, who have had to collect state and local sales taxes, and out-of-state sellers, who can often avoid those collection responsibilities. In truth, though, the main reason that states consider the provisions is the millions of dollars in sales tax revenue that the provisions allow the states to collect. It is estimated that state and local taxing authorities lost \$16 billion in taxes in 2004, for example, and that, based on current rates, losses for 2008 are probably between \$21.5 billion and \$33.7 billion. n42

Estimates as to how much revenue would be raised as a result of enacting an Amazon Tax Law vary by state. They include estimates of \$13.2 million in 2009 and \$17.8 million in 2010 for North Carolina, n43 and \$73 million for New York in 2009 alone. n44 For states with deepening budget deficits, this additional revenue can prove critical. Rhode Island, for instance, according to one estimate, stands to raise \$17.7 million in sales tax revenue this year from its Amazon Tax Law and nearly \$30 million a year by 2012. n45 This is revenue the state cannot afford to ignore given an operating deficit of \$590 million for its 2010 fiscal year, which began on July 1, 2009. n46

A negative implication for states that enact an Amazon tax provision is a probable decline in state income taxes as out-of-state, online retailers sever their ties with their in-state affiliates. Online retailers such as Amazon, Overstock, and Blueline have already severed ties with thousands of in-state affiliates in New York and Rhode Island n47 and have threatened to do the same in states where similar provisions are pending. The impact on individual businesses ranges from a loss of only hundreds of dollars per year to tens of thousands, driving some out of business. Of course, any decline in state income tax as a result of a state's enacting an Amazon Tax Law would subtract from the usefulness of

the provision.

It is not clear whether severing ties with affiliates is a sustainable response by the online sellers to the enactment of Amazon tax provisions, particularly with more states considering enactment of similar provisions. Not all online retailers have severed ties with their affiliates, and collecting and remitting state and local taxes does not appear to be burdensome enough to outweigh the financial benefits of such affiliate relationships. Online retailers such as J.Crew, Walmart.com and Target.com currently collect and remit state and local sales tax to states in which they make sales. These retailers, however, are extensions of multistate, brick-and-mortar corporations with operating budgets much larger than most online retailers and a physical presence in nearly all states. For those retailers, compliance, while somewhat burdensome, does not seem prohibitive. This might not be true for their smaller online competitors.

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n1 *Amazon.com LLC v. N.Y. State Dep't of Taxation and Fin.* 877 N.Y.S.2d 842, at 844.

n2 *Id.* at 845.

n3 See also Jennifer Carr & Cara Griffith, *Battle of the Giants Amazon v. New York*, 49 *State Tax Notes* 407 (August 11, 2008).

n4 See N.Y.S. Department of Taxation and Finance, Office of Tax Policy Analysis Taxpayer Guidance Div., TSB-M-08(3)S, *New Presumption Applicable to Definition of Sales Tax Vendor* (2008).

n5 See NY CLS Tax § 1101(b)(8)(vi).

n6 *Id.*

n7 Robert T. Szybka, *New York Physically Presents the Amazon Tax*, 51 *State Tax Notes* 847 (March 16, 2009), 2009 STT 49-1.

n8 See NY CLS Tax § 1101(b)(8)(vi).

n9 See New York State Department of Taxation and Finance, Office of Tax Policy Analysis Taxpayer Guidance Division, TSB-M-08(3.1)S, *Additional Information on How Sellers May Rebut the New Presumption Applicable to the Definition of Sales Tax Vendor as Described in TSB-M-08(3)S* (2008),.

n10 See Szyba, *supra*, at 849; Timothy P. Noonan & Joshua K. Lawrence, *Merchants and Affiliates Struggle to Navigate New York's Amazon Law*, 52 *State Tax Notes* 73, 74 (April 6, 2009), 2009 STT 64-6.

n11 See TSB-M-08(3.1)S, *supra* note 9.

n12 *Id.*

n13 *Amazon.com LLC v. N.Y. State Dep't of Taxation and Fin.*, 877 N.Y.S.2d 842, 846 (N.Y. Sup. Ct. 2009).

n14 See Carr & Griffith, *supra* note 3, at 407.

n15 877 N.Y.S.2d 842, 846 (N.Y. Sup. Ct. 2009).

n16 See Carr & Griffith, *supra* note 3, at 408.

n17 *Id.*

n18 *Amazon.com. LLC*, 877 N.Y.S.2d at 847.

n19 *Id.* at 849.

n20 See *Tyler Pipe Indus. v. Dep't of Rev.*, 483 U.S. 232, 250 (1987). See also, e.g., *Borders Online, LLC v. State Bd. of Equalization*, 129 Cal. App. 4th 1179, 1196 (1st Dist. 2005); Andrew W. Swain *et al.*, "Borders Online, Barnesandnoble.Com, and Beyond: The Two Faces of Attributional Nexus," 45 *St. Tax Notes (TA)* 691 (Sept. 10, 2007) (discussing *Tyler Pipe Indus.*).

n21 See Carr & Griffith, *supra* note 3, at 410.

n22 See John Buhl, *Eight States Considering New York-Style Amazon Law*, '52 *State Tax Notes* 100 (April 13, 2009); *Maryland Sales and Use Tax: SST and Nexus Presumption Bills Died in Committees*, CCH Tax Group (2009), available at <http://tax.cchgroup.com/news/headlines/2009/nws41709.htm#5>.

n23 See Karen Setze, *PwC Director: State May Copy New York's Amazon Law*, '52 *State Tax Notes* 17 (April 6, 2009); *Maryland Sales and Use Tax*, *supra* note 65.

n24 See *State Tax Notes, Hawaii Governor Vetoes 'Amazon' Tax Legislation*, 2009 STT 126-11; State of Rhode Island and Providence Plantations, Department of Revenue, Division of Taxation, *Definition of Sales Tax "Retailer" Amended* (2009), available at http://www.tax.state.ri.us/notice/Retailer_definition_NoticeC.pdf.

n25 See Assem. B. 27, 2009 Leg., 3d Extraordinary Sess. (Cal. 2009) [hereinafter "AB X3 27"].

n26 *Id.* at 3.

n27 *Id.*

n28 *Id.*

n29 See Setze, *supra* note 23.

n30 See *Maryland Sales and Use Tax*, *supra* note 22.

n31 See H. B.1405, 25th Leg. (Haw. 2009).

n32 *Id.* at 1-2.

n33 See H. B. 5983, 2009 Gen. Assem., Jan. Sess. (R.I. 2009).

n34 See *State of Rhode Island and Providence Plantations*, *supra* note 24.

n35 See the SSTP web page at <http://www.streamlinedsalestax.org/index.html>.

n36 SSUTA § 401(B).

n37 See Sales Tax Institute, *Streamlined Sales Tax Status*, available at <http://www.salestaxinstitute.com/streamlined-sales-tax-status.php>.

n38 *Id.*

n39 See Streamlined Sales Tax Governing Board, Inc., *See About the Project, White Paper on Streamlined Sales Tax Project*, available at <http://www.streamlinedsalestax.org/oprules.html>.

n40 See Szyba, *supra* note 7, at 851 (citing 47 U.S.C. § 151 (2003)).

n41 *Id.* at 851 (citing Bennett Kelley, *Congress Debates Internet Freedom: From Tax to Censorship*, 11 *J. Internet L.* 21 (2007)).

n42 See Donald Bruce & William F. Fox, *State and Local Sales Tax Revenue Losses from E Commerce: Estimates as of July 2004* (Univ. of Tenn., July 2004), available at <http://www.nga.org/cda/files/0407ecommerce.pdf>.

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n44 See Szyba, *supra* note 7, at 848.

n45 See *Moneyline: Rhode Island Considers an "Amazon" Law to Tax Online Purchases*, *The Providence Journal*, May 24, 2009 (citing a study conducted by the University of Tennessee at Knoxville), available at http://www.projo.com/generalassembly/BZ_MoneyLine_Amazon_05-25-09_05-24-09_9LEEVJG_v9.1c408b0.html.

n46 *Id.*

n47 See Neil Downing, *R.I. Advises Web Retailers of Tax*, *The Providence Journal* (July 4, 2009), available at http://www.projo.com/news/stategovernment/content/BZ_Amazon_07-04-09_N4EUI98_v10.2f3bb43.html.

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USC Gould School of Law 2009 Tax Institute: Tax Issues and Troubled Companies

2009 Emerging Issues 4433

USC Gould School of Law 2009 Tax Institute: Silverman on Taxation of Liquidations, Corporate Formations, and Reorganizations of Troubled Companies

By Mark Silverman

October 8, 2009

SUMMARY: Under IRC Sec. 332, a liquidation is not taxable to a corporate shareholder if the corporate shareholder owns at least 80 percent (by vote and value) of the stock of the liquidating subsidiary. IRC Sec. 337 shields the liquidating company from tax. If the requirements of IRC Sec. 332 are not satisfied, a liquidation is taxable to the liquidating corporation and its shareholders under IRC Sec. 331 and IRC Sec. 336.

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ARTICLE: Liquidations: In General -- Under *IRC Sec. 332*, a liquidation is not taxable to a corporate shareholder if the corporate shareholder owns at least 80 percent (by vote and value) of the stock of the liquidating subsidiary. *IRC Sec. 337* shields the liquidating company from tax. If the requirements of *IRC Sec. 332* are not satisfied, a liquidation is taxable to the liquidating corporation and its shareholders under *IRC Sec. 331* and *IRC Sec. 336*. Pursuant to *Treas. Reg. §1.332-2(b)*, *IRC Sec. 332* applies only where the parent receives at least partial payment for its stock. This requirement has been held to apply to *IRC Sec. 331* liquidations as well. See *Braddock Land Co. v. Commissioner*, 75 T.C. 324 (1980); *Jordan v. Commissioner*, 11 T.C. 914 (1948). *Treas. Reg. §1.332-2(b)* also provides that *IRC Sec. 332* requires a distribution in cancellation or redemption of all of the stock of the liquidating company. Thus, a distribution that is sufficient to redeem only the company's preferred stock is not a liquidation. See *Commissioner v. Spaulding Bakeries, Inc.*, 252 F.2d 693 (2d Cir. 1958); *H.K. Porter Co. v. Commissioner*, 87 T.C. 689 (1986). Therefore, *IRC Sec. 332* does not apply when a parent liquidates an insolvent subsidiary, and the parent can recognize loss on its sub stock under *IRC Sec. 165(g)*. *Iron Fireman Mfg. Co. v. Commissioner*, 5 T.C. 452 (1945); *H.G. Hill Stores, Inc. v. Commissioner*, 44 B.T.A. 1182 (1941); *Rev. Rul. 70-489*, 1970-2 C.B. 53, amplifying, *Rev. Rul. 59-296*, 1959-2 C.B. 87.

Proposed No Net Value Regulations -- The proposed regulations retain the partial payment rule of the current regulations and provide new rules with respect to liquidations involving multiple classes of stock. *Prop. Treas. Reg. §1.332-2(b)*. If partial payment is not received for every class of stock but is received for at least one class, the proposed regulations look separately to each class of stock to determine the tax consequences. With respect to those classes of stock for which no payment is received, the proposed regulations refer to *IRC Sec. 165(g)* worthless stock deductions. With respect to those classes of stock for which payment is received, the proposed regulations refer to *IRC Sec. 368(a)(1)* regarding a potential reorganization or to *IRC Sec. 331* if the distribution does not qualify as a reorganization.

The Service also takes the position that an upstream merger cannot qualify as a tax-free A reorganization. *Rev. Rul. 70-489*. But see *Norman Scott, Inc.*, 48 T.C. 598 (1967) (noting that unlike the requirement for a liquidation that there be a payment in cancellation or redemption of stock, there is no such requirement for a statutory merger to qualify under IRC Sec. 368(a)(1)(A)).

Section 351: In General -- No gain or loss is recognized if property is transferred to a corporation solely in exchange for stock of such corporation. Where the transferor of property is the sole shareholder of the transferee corporation, issuance of new stock is not necessary, because it would be a meaningless gesture. See *Lessinger v. Commissioner*, 85 T.C. 824 (1985), aff'd, 872 F.2d 519 (2d Cir. 1989); *Rev. Rul. 64-155*, 1964-1 CB 138. In *Rosen v. Commissioner*, 62 T.C. 11 (1974), the taxpayer transferred the assets and liabilities of a sole proprietorship to a newly formed corporation. At the time of the transfer, the liabilities exceeded the value of the assets, and the corporation was insolvent. The court held that the taxpayer realized gain under section 357(c) to the extent the liabilities assumed exceeded the adjusted basis of the assets transferred. See also *Focht v. Commissioner*, 68 T.C. 223 (1977); *G.C.M. 33,915* (Aug. 26, 1968). But see *DeFelice v. Commissioner*, 386 F.2d 704 (10th Cir. 1967) (rejecting the taxpayer's argument that section 357(c) did not apply, because he was insolvent; the court found that the taxpayer failed to prove he was insolvent).

Proposed No Net Value Regulations -- The proposed regulations provide that stock will not be treated as issued for property if either: (i) the fair market value of the transferred property does not exceed the sum of the amount of liabilities of the transferor that are assumed by the transferee in connection with the transfer and the amount of money and fair market value of any other property received by the transferor in connection with the transfer (i.e., the transferor does not transfer net value); or (ii) the fair market value of the assets of the transferee does not exceed the amount of its liabilities immediately after the transfer (i.e., the transferee is insolvent). *Prop. Treas. Reg. §1.351-1(a)(1)(iii)*. For purposes of (i), any liability of the transferor to the transferee that is extinguished in connection with the transfer is treated as a liability assumed by the transferee.

Tax-Free Reorganizations: In General

Debtor Consequences -- If the debtor issues stock or securities to a creditor, it will not recognize gain or loss. Section 1032(a). If a debtor corporation transfers its assets to another corporation in an asset reorganization, including an A, C, D, or G reorganization, solely in exchange for stock or securities of the acquiring corporation, the debtor will not recognize gain or loss. Section 361(a). Where property other than stock or securities (i.e., 'boot') is received, gain must be recognized, unless the debtor distributes the boot to its shareholders or creditors. Section 361(b)(1), (3). In general, the assumption of a liability of the debtor corporation by the acquiror will not be treated as boot. Section 357(a). However, in the case of a divisive D reorganization or section 351 transaction, the debtor must recognize gain to the extent the liabilities assumed exceed the debtor's basis in the transferred assets. Section 357(c)(1). The acquiror succeeds to the tax attributes enumerated in section 381(c), although section 382 may apply to limit the use of the corporation's NOLs after the acquisition.

Creditor Consequences -- If the creditor is a security holder, it will not recognize gain or loss when it exchanges its securities for stock or securities of the debtor corporation pursuant to a recapitalization under section 368(a)(1)(E) or for stock or securities of the acquiror pursuant to a reorganization under section 368. Section 354(a)(1). However, the creditor recognizes gain currently with respect to any property other than stock or securities (i.e., boot) received in the exchange. Section 356(a), (c). In addition, if the principal amount of the security received in the exchange exceeds the principal amount of the security surrendered, then gain will be recognized to the extent of the excess. Sections 354(a)(2)(A); 356(d)(2)(B). The creditor's basis in the new security will equal its basis in the old security, increased by any gain recognized and reduced by the FMV of any boot received. Section 358. The creditor's holding period in the new security will include its holding period in the old security. Section 1223(1).

Norman Scott, Inc., 48 T.C. 598 (1967), acq. in result only, AOD 1967-104 (Dec. 7, 1967).

In the *Norman Scott* decision, two insolvent corporations merged under state law into the taxpayer, which was owned by the same shareholders of the two insolvent corporations. The Tax Court held that the merger was a tax-free reorganization under section 368(a)(1)(A).

IRS Argument: Because the target was insolvent, any stock that the shareholder exchanged was worthless; therefore, the shareholder could not obtain a proprietary interest in the acquiror. The Tax Court rejected this argument, concluding that the COI requirement was satisfied because the shareholders received a proprietary interest in the acquiror either as a shareholder or as a creditor. In G.C.M. 33,859 (June 25, 1968), the IRS analyzed the Tax Court's decision. The IRS disagreed with the court's broad conclusion, taking the position that unless affirmative steps are taken by the creditors to assert their proprietary interest, the shareholders remain the equity holders of the corporation. Nonetheless, the IRS concluded that because of the significant overlap between the shareholders and creditors, the shareholders satisfied the COI requirement in their capacity as shareholders, and their status as creditors did not affect that proprietary interest. See *Seiberling Rubber Co. v. Commissioner*, 169 F.2d 595 (6th Cir. 1948), and *Rev. Rul. 54-610*.

Alternative IRS Argument: Since the acquiror was also a substantial creditor of the target, the merger was in reality a satisfaction of indebtedness (citing *Rev. Rul. 59-296*, 1959-2 C.B. 87). The Tax Court disagreed, distinguishing *Hill Stores, Inc. v. Commissioner*, 44 B.T.A. 1182 (1941), on which *Rev. Rul. 59-296* relied. *Hill Stores* held that section 332 did not apply to the liquidation of an insolvent corporation, because there could be no distribution of assets in cancellation or redemption of the parent's stock. By contrast, there is no specific requirement in section 368(a)(1)(A) that there must be a cancellation or redemption of stock to qualify for a statutory merger. The IRS also disagreed with this holding, arguing that sections 354 and 361, the operative reorganization provisions, require that there be an exchange of property solely for stock or securities of the transferee corporation. A discharge of debt is insufficient to satisfy this standard. However, the IRS conceded that the upstream merger involved in *Rev. Rul. 59-296* was distinguishable from a brother-sister merger.

Proposed No Net Value Regulations

On March 10, 2005, Treasury and the IRS issued proposed regulations regarding corporate formations, reorganizations, and liquidations of insolvent corporations. The proposed regulations generally require the exchange (or, in the case of a section 332 liquidation, the distribution) of net value for the nonrecognition rules of sections 332, 351, and 368 to apply. Thus, the proposed regulations would reverse the result in *Norman Scott, Inc.*, 48 T.C. 598. For tax-free reorganizations under section 368, the proposed regulations require that there be both a surrender and a receipt of net value. *Prop. Treas. Reg. §1.368-1(f)(1)*. Whether net value is surrendered is determined by reference to the assets and liabilities of the target corporation. Whether net value is received is determined by reference to the assets and liabilities of the issuing corporation.

Asset Reorganizations -- There is a surrender of net value if the FMV of the property transferred by the target exceeds the sum of (i) the target liabilities assumed by the acquiror in connection with the exchange and (ii) the amount of money and the FMV of any other property received by the target in connection with the exchange. *Prop. Treas. Reg. §1.368-1(f)(2)(i)*. Any liability that the target owes the acquiror that is extinguished in the exchange is treated as assumed in connection with the exchange. There is a receipt of net value if the FMV of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange. *Prop. Treas. Reg. §1.368-1(f)(2)(ii)*.

Stock Reorganizations -- There is a surrender of net value if the FMV of the assets of the target exceeds the sum of (i) the amount of the target liabilities immediately prior to the exchange and (ii) the amount of money and the FMV of any other property received by the target shareholders in connection with the exchange. *Prop. Treas. Reg. §1.368-1(f)(3)(i)*. Assets of the target that are not held immediately after the exchange and liabilities of the target that are extinguished in the exchange are disregarded. There is a receipt of net value if the FMV of the assets of the issuing corporation exceeds the amount of its liabilities immediately after the exchange. *Prop. Treas. Reg. §1.368-1(f)(3)(ii)*.

Exceptions -- The net value requirement does not apply to E and F reorganizations. *Prop. Treas. Reg. §1.368-1(b)(1)*.

The net value requirement does not apply to acquisitive D reorganizations, provided the FMV of the property transferred to the acquiror by the target exceeds the amount of target liabilities immediately before the exchange (including any liabilities cancelled, extinguished, or assumed in connection with the exchange), and the FMV of the assets of the acquiror equals or exceeds the amount of its liabilities immediately after the exchange. *Prop. Treas. Reg. §1.368-1(f)(4)*; see also *Rev. Rul. 70-240*.

Final Regulations on Creditor Continuity of Interest (COI)

On December 11, 2008, the IRS issued final regulations on creditor continuity of interest ('COI') (TD 9434). These rules were originally proposed in connection with the no net value regulations on March 10, 2005. The final regulations are similar in substance to the earlier proposed regulations, but add minor modifications and clarifications. The COI requirement requires that in substance a substantial value of the proprietary interests in the target corporation be preserved in the reorganization. The final regulations provide when and to what extent creditors of a bankrupt or insolvent corporation will be treated as proprietors of the corporation for purposes of determining whether COI is preserved in a potential reorganization. The final regulations apply to transactions occurring after December 12, 2008.

The regulations treat a creditor's claim against a target corporation as a proprietary interest if (i) the target is in a title 11 or similar case, or (ii) the target is insolvent immediately before the reorganization. In such cases, if any creditor receives a proprietary interest in the issuing corporation in exchange for its claim, then every claim of that class of creditors and every claim of all equal and junior classes of creditors is a proprietary interest in the target corporation. *Treas. Reg. §1.368-1(e)(6)(i)*. Shareholders retain their proprietary interest in the target corporation notwithstanding that creditors are treated as having a proprietary interest. *Treas. Reg. §1.368-1(e)(6)(iv)*.

Measuring COI

Senior Creditors -- The claims of the most senior class of creditors to receive a proprietary interest and all other equal creditors (together the "senior creditors") represent, in part, a creditor claim and, in part, a proprietary interest. The portion of the claim treated as a proprietary interest is equal to: FMV of creditor's claim x FMV of proprietary interests issued to senior creditors / Total consideration paid to senior creditors. *Treas. Reg. §1.368-1(e)(6)(ii)(A)*.

Junior Creditors -- The claims of the junior creditors are treated as a proprietary interest in full (i.e., the proprietary interest is equal to the FMV of the creditor's claim). *Treas. Reg. §1.368-1(e)(6)(ii)(B)*. The final COI regulations add a new rule which requires that where only one class of creditors receives stock, more than a de minimis amount of acquiring corporation stock must be exchanged for the creditors' proprietary interest relative to the total consideration received by the insolvent target corporation, its shareholders, and its creditors, before the stock will be counted for purposes of COI. *Treas. Reg. §1.368-1(e)(6)(ii)(A)*. The final COI regulations also add an example to demonstrate the bifurcation of senior claims when the creditors of that class receive disproportionate amounts of acquiring corporation stock and other property. *Treas. Reg. §1.368-1(e)(8)*, Ex. 10(ii).

RELATED LINKS: For the author's full discussion on the tax issues of troubled companies, see

- 61-1 USC Law School Institutes On Major Tax Planning P 111

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USC Gould School of Law 2009 Tax Institute: Section 338 and Step Transactions

2009 Emerging Issues 4407

USC Gould School of Law 2009 Tax Institute: Stephen L. Tolles on Section 338 Reorganizations and the Step Transaction Doctrine

By Stephen L. Tolles

October 8, 2009

SUMMARY: IRC Section 338 creates a confrontation with traditional step transaction doctrine in reorganizations. Section 338 provides that, when a corporation makes a "qualified stock purchase," and timely election under Section 338(g), the acquired corporation is treated as having sold assets to a "new corporation." But, if a transaction's steps are integrated into a tax-free reorganization, that applies and no Section 338(g) election is permitted.

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ARTICLE: With the passage of *IRC Section 338* in 1982, Congress set up a confrontation between that section and traditional step transaction doctrine, as it had been applied in the reorganization arena. Currently, *IRC Section 338* is the only method for a stock acquisition to result in asset sale treatment. Hence, the *Kimbell-Diamond Milling Company v. Commissioner*, n1 doctrine no longer applies.

In addition, any two-step transaction must be tested under the step transaction doctrine, as well as analyzed under *IRC Section 338*. If the steps can be integrated into a tax-free reorganization, then that characterization applies and no *IRC Section 338(g)* election is permitted. However, the special exception in *Treasury Regulation Section 1.338(h)(10)-1(c)(2)* allows an *IRC Section 338(h)(10)* election if the first step constitutes a qualified stock purchase (QSP). If the steps when integrated fail to constitute a reorganization, then the first step will permit a regular *IRC Section 338* election if it is a QSP. If no *IRC Section 338* election is made, the two steps cannot be integrated in such a way as to result in a taxable asset purchase. The reasoning is interesting: the step transaction doctrine is applied to test for reorganization status, but if a reorganization does not result, then the step transaction doctrine cannot be applied to cause asset purchase treatment. This conclusion ought to apply regardless of whether the first step is a QSP, although the IRS has not specifically so stated in published guidance.

Background

In *Kimbell-Diamond*, the tax court held that a taxable stock purchase followed immediately by a liquidation should be treated, from the purchaser's perspective, as an asset purchase. In the wake of this decision, Congress codified the *Kimbell-Diamond* doctrine in 1954 with passage of *IRC Section 334(b)(2)*. By the terms of that provision, a liquidation within two years of the stock purchase resulted in asset purchase treatment for the buyer. n2 The weight of

subsequent judicial authority interpreted the new section as having replaced the *Kimbell-Diamond* standard with an objective statutory test. n3 As was the case under *Kimbell-Diamond*, a liquidation within the two-year period impacted the purchasing corporation, only. The seller's treatment was not affected by the liquidation. The apparent disparate treatment of the sellers and the purchasing corporation was consistent with the then prevalent *General Utilities* doctrine, which generally allowed a corporation to sell all its assets and liquidate without generating any corporate level tax. n4

IRC Section 338 Doctrine

A. The Statutory Framework

In 1982, Congress replaced *IRC Section 334(b)(2)* with *IRC Section 338*, and, in so doing, set up a confrontation between that section and traditional step transaction doctrine, as applied in the reorganization arena. According to the legislative history, Congress, with the promulgation of *IRC Section 338*, 'intended to replace any non-statutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine.' n5 *IRC Section 338* accordingly provides that, where a purchasing corporation makes a 'qualified stock purchase,' and also makes a timely election under *IRC Section 338(g)*, the acquired corporation is treated as having sold its assets to a 'new corporation.' n6 The 'new corporation' takes a purchase price basis in the assets, while the 'old' target is taxed on the gain in the hypothetical asset sale that occurs after the purchasing corporation acquires the stock. n7 The hypothetical sale, gain recognition, and basis adjustment affect the purchaser only.

The repeal of the *General Utilities* doctrine in 1986 greatly reduced the usefulness of the basic *IRC Section 338(g)* election, however, since it meant that a buyer seeking a step-up in basis would also realize an immediate gain in an amount equal to the step-up. n8 Elections under *IRC Section 338(h)(10)*, on the other hand, remain quite common because they result in only one level of taxation. Under *IRC Section 338(h)(10)*, a corporate purchaser, and targets that are members of a consolidated or affiliated group, or are S corporations, can achieve asset sale treatment, if the purchaser and the seller, or sellers, make a timely joint election. n9 The purchaser then takes a cost basis in the target's assets, and tax is paid by the seller only on the deemed asset sale, as a result.

Any election under *IRC Section 338* requires a 'qualified stock purchase' (QSP), defined as any transaction, or series of transactions, in which stock consisting of 80 percent of the voting power, and 80 percent of the value, of a corporation is acquired by another corporation by purchase during a 12-month period. n10 Purchase means an acquisition of stock only where:

(i) the basis of the purchasing corporation in the acquired stock is not determined, in whole or in part, by reference to the adjusted basis in the hands of the seller;

(ii) the stock is not acquired in an exchange to which *IRC Sections 351, 354, 355 or 356* applies; and

(iii) the stock is not acquired from a related person as determined under *IRC Section 318(a)* (other than attribution via options). n11

The existence of a QSP in the first step of a two-step acquisition plays an important role in current IRS analysis of such transactions.

Revenue Ruling 90-95

The IRS addressed a *Kimbell-Diamond* type fact pattern in *Revenue Ruling 90-95*. n12 There, P acquired T via an all cash, reverse subsidiary merger in which S, a transitory subsidiary of P, merged into T with T surviving. The ruling addressed two questions. The first involved whether the use of a transitory merger subsidiary, in a reverse subsidiary cash merger, could result in a qualified stock purchase, under *IRC Section 338*. The Service answered this question in the affirmative, since a transitory merger subsidiary formed solely for the purpose of acquiring the stock of the target company, and not conducting any other activities, is disregarded. n13

The second question raised in the ruling asked whether the post-QSP liquidation should result in asset acquisition treatment for P, pursuant to *Kimbell-Diamond* doctrine. The Service, in resolving the issue, noted that *IRC Section 338* replaced the *Kimbell-Diamond* doctrine, and, in so doing, became the sole source of authority for causing a taxable stock purchase to be treated as an asset acquisition. Therefore, any liquidation of T, absent an *IRC Section 338* election, would not be integrated with the stock purchase, under the step transaction rationale adopted by the court in *Kimbell-Diamond*. Rather, the sole path to asset purchase treatment, following a QSP, is via an election under *IRC Section 338*.

Regardless whether such an election is made, if a subsequent liquidation occurs after a QSP, that liquidation will bear independent significance. Indeed, the liquidation will be a tax-free event under *IRC Section 332*, n14 and P will take a carryover basis in the T assets. n15 If no election is made, P's basis in the T assets would be same as it was in T's hands. If the election is made, on the other hand, the 'new T,' under *IRC Section 338*, takes a purchase price basis, computed in accord with the *IRC Section 338* regulations, n16 and P inherits that new basis in the *IRC Section 332* liquidation.

Treasury Regulations Under *IRC Section 338*

The Treasury Regulations incorporate the approach of *Revenue Ruling 90-95* by requiring the purchasing corporation (or a member of its affiliated group) to treat certain asset transfers following a QSP (where no *IRC Section 338* election is made) independently of the QSP. n17 The regulations provide special reorganization rules that apply only to a purchasing corporation that fails to make a *IRC Section 338* election with respect to a QSP. n18 Such a corporation is treated as an owner of the target for purposes of the continuity of interest test, as a controlling person for purposes of the 'D' reorganization rules, and is not prevented from qualifying a subsequent reorganization of the target as a 'C' reorganization. n19

The regulations provide an example in which P purchases, for cash, 85% of the target stock in a QSP, with 15% of the stock remaining in the hands of a non-selling shareholder. n20 P does not make an *IRC Section 338* election with respect to its acquisition of the target stock. Shortly thereafter, and as part of the same plan, the target merges into X, a wholly-owned subsidiary of P, in a transaction in which all the target's assets are transferred to X, with P, and the 15% shareholder of the target, receiving X stock in exchange for its target stock.

The QSP first step in the example effectively results in the 85% block of stock in the hands of P being deemed an interest by a person who was an owner of the target's business prior to the transfer. n21 Hence, the continuity of interest test is satisfied with respect to P, and the merger of the target into X qualifies as an 'A' reorganization, n22 as well as a 'D' reorganization. n23 However, the 15% shareholder of the target who receives stock in the second step merger does not receive reorganization treatment, since general principles of tax law are applied, as opposed to the special rule for purchasing corporations under the *IRC Section 338* regulations. Under these general principles, the continuity of interest test is not satisfied because P's stock purchase, and the merger of the target into X, are deemed made pursuant to an integrated transaction in which the owner of the 85% block of target stock received solely cash in the stock purchase. n24 Thus, where the first step in a two-step acquisition constitutes a QSP, integration of that first step with a variety of second step transactions is prevented under the regulations, as well as *Revenue Ruling 90-95*.

B. *IRC Section 338*, Reorganizations, and the Step Transaction Doctrine

With the passage of *IRC Section 338* in 1982, Congress set up a confrontation between that section and traditional step transaction doctrine, as it had been applied in the reorganization arena.

1. *Revenue Ruling 2001-46*

The IRS first examined the interplay between *IRC Section 338* and the step transaction doctrine in *Revenue Ruling 2001-46*. n25 This ruling considered two very similar fact patterns. In Situation (1), Corp X acquired all the stock of Corp T, by means of a merger of a transitory merger subsidiary of X into T (the 'Acquisition Merger'). In the

Acquisition Merger, the T shareholders received 70% X voting stock and 30% cash. Thereafter, and as part of a plan, T merged upstream into X (the 'Upstream Merger'). In Situation (2), the facts are the same, except the T shareholders received stock alone in the Acquisition Merger so that, if viewed independently, the Acquisition Merger would qualify as a *IRC Section 368(a)(2)(E)* reorganization.

The Service began its analysis of Situation (1) by examining the tension between *Revenue Ruling 67-274*, n26 and *Revenue Ruling 90-95*. Noting that the Acquisition Merger could not qualify as a reorganization under *IRC Section 368(a)(2)(E)*, because the amount of cash consideration paid to the T shareholders prevented the merger from meeting the 80% voting stock test, n27 the Service stated that, were the Acquisition Merger and the Upstream Merger in Situation (1) treated separately (as was the case in *Revenue Ruling 90-95*), the Acquisition Merger would be treated as a qualified stock purchase, and the Upstream Merger as a liquidation under *IRC Section 332*. The Service contrasted that outcome with the approach reflected in *Revenue Ruling 67-274*, in which the Situation (1) transaction would be treated as an integrated acquisition of T's assets by X in a single, statutory merger (without a preliminary stock acquisition).

The Service then concluded that, unless the policies underlying *IRC Section 338* dictate otherwise, the integrated asset acquisition in Situation (1) was properly treated as a statutory merger of T into X that qualified as an 'A' reorganization, citing *King Enterprises* and *Seagram*. n28 The policy underlying *IRC Section 338* is expressed in several sources: (i) the Congressional intent that *IRC Section 338* 'replace any nonstatutory treatment of a stock purchase as an asset purchase under the *Kimbell-Diamond* doctrine;' n29 (ii) *Revenue Ruling 90-95* and *Treasury Regulation 1.338-3(d)*, which reject the approach reflected in *Revenue Ruling 67-274* to the extent it gives the purchaser of a target corporation's stock a cost basis in target's assets in the absence of an *IRC Section 338* election. The policy of *IRC Section 338*, as expressed in the foregoing, precludes any non-statutory treatment of the two steps as an integrated asset purchase where such treatment would yield something other than a carryover basis.

Accordingly, the Service, relying on *King Enterprises*, *Seagram*, and *Revenue Ruling 67-274*, concluded that the acquisition and liquidation mergers should be viewed as one, integrated transaction, since so doing did not conflict with *IRC Section 338* policies. Because Congress intended *IRC Section 338* to replace any non-statutory treatment of a stock purchase as an asset purchase, the step transaction doctrine cannot apply if its application would result in a purchase price basis, as opposed to a carryover basis. The fact patterns in the ruling yield a carryover basis, *IRC Section 338* policy is not contradicted, and application of the step transaction doctrine is warranted. Accordingly, the Acquisition and Upstream mergers were integrated, and both Situations (1) and (2) qualify as reorganizations. Furthermore, no *IRC Section 338(g)* election could be made for either situation, since a stock acquisition that is part of a reorganization is not a QSP.

If, however, applying the step transaction doctrine would result in a cost basis in the acquired assets, under a *Kimbell-Diamond* theory, *Revenue Ruling 90-95* and *Treasury Regulation Section 1.338-3(d)* would apply and the two transactions viewed independently, the Service noted. Thus, the IRS confirmed, once again, that *Kimbell-Diamond* represents an obsolete application of the step transaction doctrine.

2. Treasury Regulation Section 1.338(h)(10)-1(c)(2)

Revenue Ruling 2001-46 solicited comments regarding whether taxpayers should be permitted to make *IRC Section 338(h)(10)* elections with respect to QSPs in fact patterns similar to those addressed in the ruling. Subsequently, regulations were issued allowing a *338(h)(10)* election so long as P's acquisition of T's stock, when viewed independently, constituted a QSP, even where a merger or liquidation of T into P after the initial acquisition would cause the two steps to be a reorganization if integrated. Therefore, in Situation (1) of *Revenue Ruling 2001-46*, had T been a member of an affiliated group or an S corporation, the parties could have made an *IRC Section 338(h)(10)* election, since, viewed independently, the acquisition was a QSP. This outcome could not occur in Situation (2), because, when viewed independently, the initial step qualified as a reorganization under *IRC Section 368(a)(2)(E)*.

The approach of *Treasury Regulation Section 1.338(h)(10)-1(c)(2)* is illustrated in several examples:

(i) Example 11: P owns all the stock of Y, a newly formed subsidiary. S owns all the stock of T. P acquires all the T stock in a merger of Y into T with T surviving. S receives 50% P voting stock and 50% cash. Thereafter, T merges upstream into P. No *IRC Section 338(h)(10)* election is made. Therefore, the two transactions are integrated and treated as a reorganization.

(ii) Example 12: Same facts as Example 11, except an *IRC Section 338(h)(10)* election is made. The acquisition merger is treated as a QSP and not part of a reorganization.

(iii) Example 13: Same facts as Example 12 except that following P's acquisition of T, T merges into a first tier subsidiary of P. Because an *IRC Section 338(h)(10)* election is made, the acquisition merger is treated as a QSP and not part of a reorganization.

(iv) Example 14: Same facts as Example 11, except that in the acquisition merger, S receives only P voting stock. An *IRC Section 338(h)(10)* election cannot be made because the acquisition merger viewed independently constitutes a reorganization. n30

3. Revenue Ruling 2008-25

The government took the next step in the elaboration of its position in *Revenue Ruling 2008-25*. n31 There, individual A owned all the stock of Corp T, which had assets of \$150x and liabilities of \$50x. Corp P formed transitory merger subsidiary X to acquire T by causing X to merge into T (the 'Acquisition Merger'). In the Acquisition Merger, A received \$10x cash and \$90x of P voting stock. Following the Acquisition Merger, and as part of an integrated plan, T completely liquidated into P (the 'Liquidation'). Note that the Liquidation was not accomplished via a merger. After the Liquidation, P continued the business previously conducted by T.

Assessing the transactions separately, the Acquisition Merger qualified as an *IRC Section 368(a)(2)(E)* reorganization, and the Liquidation qualified under *IRC Section 332*. However, the step transaction doctrine required that the two steps be analyzed as a single, integrated transaction in which P acquired the assets of T in exchange for \$10x cash, \$90x of P voting stock, and the assumption of T's liabilities. The Service then proceeded to examine whether any of the provisions of Section 368 might apply to the transaction considered as a whole.

The IRS first concluded that the transaction failed to meet the requirement that the surviving corporation in an *IRC Section 368(a)(2)(E)* merger hold substantially all of its assets, as well as those of the merged subsidiary, because T no longer existed and, thus, could not hold any, let alone substantially all its, assets. In addition, the Service noted that the liquidating distribution of T's assets was not within the purview of *Treasury Regulation Section 1.368-2(k)*, which generally allows the transfer of assets or stock following a reorganization, but specifically states that such transfers cannot result in a liquidation of that corporation. n32

As in *Revenue Ruling 67-274*, the Service tested the integrated transaction to see if it qualified as a any other type of reorganization. Thus, the IRS held that the transaction was not a 'C' reorganization, because the \$10x of cash and the \$50x of liabilities assumed exceeded the 20% threshold allowed in *IRC Section 368(a)(2)(B)*. It ruled further that the transaction was not a 'D' reorganization because neither T nor A was in control of P after the transaction. And, finally, it was not an 'A' reorganization because T did not merge into P. Thus, the integrated transaction as a whole was neither a reorganization at all, nor governed by *IRC Section 351*, since A did not satisfy the control requirement of that section. n33

Because integrating the steps did not result in a reorganization, and would result in P taking a cost basis in T's assets if a *Kimbell-Diamond* theory applied, the Service held that the step transaction could not apply. *Revenue Ruling 90-95* and *Section 1.338-3(d)* of the *Treasury Regulations* instead treat the acquisition of the stock of the target corporation as a QSP, followed by a separate, carryover basis transaction to preclude any nonstatutory treatment of the steps as an integrated asset purchase. This conclusion confirms the analysis in *Revenue Ruling 2001-46*. Accordingly, the transaction described in *Revenue Ruling 2008-25* is treated as having two separate, independent steps: a QSP,

followed by the liquidation of T into P under *IRC Section 332*.

4. Neither Reorganization nor QSP

A fact pattern yet to be addressed by a Revenue Ruling is one in which the first step is neither a reorganization, nor a QSP, and the integration of the second step with the first also does not produce a reorganization.

Example 1

Suppose the first step is a purchase, by P, for cash of 70% of T stock, and the second step is a merger of T into P in which the remaining T stockholders receive only P stock. The two steps together do not constitute a reorganization of any type because there is not sufficient continuity of interest. In addition, the first step is not a QSP because P did not purchase 80% or more of the stock of T. If the two steps are integrated, the result looks a failed forward merger.

In Revenue Ruling 69-6, the Service dealt with a forward merger between two domestic building and loan associations. n34 X was a state chartered savings and loan association having permanent shares of stock outstanding. It proposed to merge into Y, a federally chartered, nonstock membership savings and loan association owned entirely by its share account holders, which were evidenced by passbooks in the association. Each consenting X shareholder exchanged his stock for a voting membership in the form of a voting share account of Y evidenced by a passbook in an amount equal to the value of his shares in X. Following the merger, X was dissolved.

The IRS analyzed the characteristics of the interest of members in a federal, nonstock mutual association, and concluded that only minimal value could be assigned to the proprietary interests in Y received by the X shareholders inasmuch as the principal property received by them consisted of withdrawable cash deposits, as reflected by their passbook balances. Therefore, the passbooks distributed to them did not constitute solely 'stock' within the meaning of the reorganization provisions, and there was not a sufficient continuity of interest. Accordingly, the Service ruled that the transfer, by X, of all of its assets to Y constituted a sale in which gain or loss was recognized to X, measured by the difference between the basis of the property transferred, and the amount received from Y.

The tax consequences of a failed forward merger can be harsh. First, there is a taxable sale of assets by the target to the acquiring corporation that can generate a corporate level tax. Second, the shareholders of the target will have a taxable event on receipt of the merger consideration in exchange for their shares in the target. Thus, the effect of integrating the two steps, in the example of a purchase of 70% of target stock followed by a forward merger, is two levels of tax, and a costly way to obtain a purchase price basis in the assets of a target.

There does not appear to be a conflict with *IRC Section 338*, or its underlying principles, because there is no QSP in the transaction.

Example 2

A more interesting fact pattern than the failed forward merger example is the following. Suppose P has owned 21% of T for many years. T redeems some of the non-P shareholders for 40% of its assets. P then acquires the remaining 79% of T stock solely in return for P voting stock in a reverse subsidiary merger, and immediately liquidates T. The merger is not a reorganization since it is tested as a 'C' reorganization under *Revenue Ruling 67-274* but fails the substantially all requirement. The acquisition is also not a QSP because the 80% requirement is not satisfied. The result appears to be a fully taxable transaction for both T and P, thus leading to a corporate level gain for T, and a purchase price basis for P in the T assets. The question arises whether the two steps should be accorded independent significance with the result that the liquidation is tax-free under *IRC Section 332*. Such a result would be consistent with *Revenue Ruling 90-95*. The result should be the same as in the next example.

Example 3

Suppose P has owned 21% of T for many years. P then purchases, for cash, the remaining 79% of T stock, and immediately liquidates T. The acquisition is not a QSP because the 80% requirement is not satisfied. It could be argued that the purchase and liquidation should be integrated, and treated as an asset purchase, causing a corporate level tax on T. However, applying the step transaction doctrine in this case would involve treating the transaction as an asset purchase, followed by the liquidation of T by T's shareholders, steps that did not happen. If the step transaction doctrine is not allowed to create fictitious steps, then the two steps in this fact pattern should be given independent significance so that the liquidation is tax-free under *IRC Section 332*. n35

Conclusion

Thus, where there is a stock purchase followed by a non-merger liquidation, the two steps should not be integrated to produce asset sale treatment regardless whether the initial first step is a QSP. The only time asset purchase treatment is applied to a stock purchase is where an *IRC Section 338* election is made. n36 This conclusion seems to flow from the various authorities discussed in this article but has not been clearly set forth in IRS guidance.

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n1 14 T.C. 74 (1950) , *aff'd per curiam*, 187 F.2d 718 (5th Cir. 1951), *cert. denied*, 342 U.S. 827 (1951).

n2 I.R.C. § 334(b)(2)(1954). The legislative history of the 1954 Code stated that Section 334(b)(2) contained rules 'effectuating principles derived from the *Kimbell-Diamond* (Doctrine),' S. Rep. No. 1622, 83rd Cong., 2d Sess. 1954.

n3 See, e.g., *Broadview Lumber Co. v. United States*, 561 F.2d 698 (7th Cir. 1977); *International State Bank v. Commissioner*, 70 T.C. 173 (1978) ; *Chrome Plate, Inc. v. United States*, 614 F.2d 990 (5th Cir. 1980). But, c.f., *American Potash & Chemical Corp. v. United States*, 399 F.2d 194 (Ct. Cl. 1968) .

n4 *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935); I.R.C. § 337(a) (1954) (providing for nonrecognition of corporate level tax where a corporation adopted a plan of liquidation, sold its assets and then distributed the proceeds in a 12-month period).

n5 H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982), 1982-2 C.B. 600, 632.

n6 I.R.C. § 338(a).

n7 *I.R.C. § 338(b)(1)*.

n8 Tax Reform Act of 1986, P.L. No. 99-514, §§ 631-33, *100 Stat. 2085 (1986)*. The legislation contained several provisions designed to overturn the principle of *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

n9 *I.R.C. § 338(h)(10)*; *Treas. Reg. § 1.338(h)(10)-1*.

n10 *I.R.C. § 338(d)(3)*.

n11 *I.R.C. § 338(d)(3)*.

n12 1990-2 C.B. 67.

n13 See *Rev. Rul. 79-273*, 1979-2 C.B. 125; *Rev. Rul. 73-427*, 1973-2 C.B. 301

n14 *I.R.C. § 332(a)* provides that no gain or loss shall be recognized on the receipt by a corporation of property distributed in complete liquidation of another corporation provided that the corporation receiving the property owns at least 80% of the total voting power and at least 80% of the total value of the stock of the liquidating corporation and provided that certain other requirements are met. See *I.R.C. § 332(b)*.

n15 *I.R.C. § 334(b)(1)*.

n16 See *Treas. Reg. § 1.338-5*.

n17 *Treas. Reg. § 1.338-3(d)*.

n18 *Treas. Reg. § 1.338-3(d)(1)*.

n19 *Treas. Reg. § 1.338-3(d)(2)-(4)*. A 'D' reorganization occurs where there is a transfer of assets to another corporation if immediately after the transfer, the transferor or one or more of its shareholders is in control of the transferee, but only if as part of the plan stock or securities of the transferee are distributed in a transaction under Section 354, 355 or 356. *I.R.C. § 368(a)(1)(D)*. A 'C' reorganization occurs where there is an acquisition by one corporation in exchange solely for its voting stock of substantially all of the properties of another corporation, provided that the transferor corporation distributes the stock and all its other properties in pursuance of the plan of reorganization. *I.R.C. §§ 368(a)(1)(C) and (a)(2)(G)*.

n20 *Treas. Reg. § 1.338-3(d)(5)*.

n21 *Treas. Reg. § 1.338-3(d)(2)*.

n22 'A' reorganization is defined as a statutory merger or consolidation. *I.R.C. § 368(a)(1)(A)*.

n23 *See, supra*, note 21.

n24 *Treas. Reg. § 1.338-3(d)(5)(v)*.

n25 2001-2 C.B. 321

n26 *Rev. Rul. 67-274, 1967-2 C.B. 141*

n27 *I.R.C. § 368(a)(2)(E)(ii)* requires that an acquiring corporation must obtain control (i.e., 80% of the stock where there is one class of stock) of the target corporation in exchange for voting stock of the acquiror.

n28 *King Enterprises, Inc. v. United States*, 418 F. 2d 511 (Ct. Cl. 1969), and *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995), respectively. For an introductory look at these cases, see, Tolles on Stock Purchases Followed by Back End Merger, 2009 Emerging Issues XXXX.

n29 H.R. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982), 1982-2 C.B. 600, 632.

n30 *Treas. Reg. § 1.338(h)(10)-1(e)*.

n31 2008-21 IRB 986.

n32 *Treas. Reg. § 1.368-2(k)(1)(i)(B)(1)*.

n33 Section 351 control would require that A receive stock of P possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock. *I.R.C. §§ 351(a) and 368(c)*.

n34 1969-1 C.B. 104.

n35 *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), *aff'd*, 886 F.2d 1318 (7th Cir. 1989).

n36 In an intermediary transaction (also called midco deals) where a corporation whose stock is sold to an intermediary that then sells the corporation's assets, the IRS may seek to tax the corporation as though it sold its assets or treat the buyer as having bought stock. *IRS Notice 2001-16*, 2001 C.B. 730 , as clarified by *IRS Notice 2008-111*, 2008-51 IRB 1299 . These tax shelter transactions are outside the scope of this article.

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Economic Turbulence Spurs Transfer Pricing Analysis

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By Robert Feinschreiber and Margaret Kent

October 7, 2009

SUMMARY: The interface between the downward economic turbulence and governments' transfer pricing objectives became an important facet of the OECD's Global Forum on Tax Treaties and Transfer Pricing, held September 21-22, 2009 in Paris. Among attendees there were common understandings of many of the transfer pricing economic turbulence issues. Nevertheless, there were few agreements about solutions to the transfer pricing economic turbulence interface.

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ARTICLE: The interface between the downward economic turbulence and governments' transfer pricing objectives became an important facet of the OECD's Global Forum on Tax Treaties and Transfer Pricing, held September 21-22, 2009 in Paris. More than 600 people, both within the private sector and within the governmental sector, attended the OECD conference. Among those attendees there were common understandings of many of the transfer pricing economic turbulence issues facing multinational businesses. Nevertheless, there were few agreements as to the solutions to the transfer pricing -- economic turbulence interface. This Emerging Issue addresses the transfer pricing issues a business is likely to face because of the economic turbulence.

Transfer Pricing Economic Turbulence Issues

A multinational taxpayer facing economic turbulence might have a number of diverse options in addressing current transfer pricing concerns. n1 Such a range of options might include one of the following eight possibilities, among others:

- Increasing reliance on in-house data rather than relying on external data sources.
- Modifying the arm's length range of results.
- Fine-tuning and adjusting comparable data through regression analysis or otherwise.
- Restructuring applicable related-party commercial and financial relationships to reflect new economic realities.
- Renegotiating and restructuring transfer pricing relationships, including advance pricing agreements.
- Selecting transfer pricing measures less vulnerable to profit sensitivity. Changing the time period for assessing comparability.
- Changing the time period for assessing comparability.
- Modifying central entrepreneur structures.

Transfer Pricing as a Profession

Transfer pricing as an area of specialization has become undeniably complex as the U.S. government, foreign governments, and state governments all wanted to collect their perceived share of "the tax take." Many corporate taxpayers and their advisors, faced with their need to acquire economic, legal, and accounting expertise applicable to the company's business, retreated from the scene, often undertaking the minimum transfer pricing analysis in each applicable jurisdiction. The present economic turbulence complicates the taxpayer's goal to undertake the minimum necessary transfer pricing analysis. The economic turbulence, in and of itself, requires taxpayers and their advisors to undertake more complex strategies unneeded in prior time periods.

As a general matter, transfer pricing regimes provide taxpayers with a number of transfer pricing options, often permitting the taxpayer to select the best [transfer pricing] method. Prior to the onset of the 2007-2009 economic turbulence, a significant number of taxpayers and their advisors almost automatically select the comparable profits method (CPM) or the transactional net margin method (TNMM) as the transfer pricing method of choice. The present economic conditions change the parameters, making that almost automatic approach no longer viable.

The advisors treat the company's transfer pricing method as being the company's "best" transfer pricing method, making that determination almost as a knee-jerk reaction. These advisors quickly select a SIC or NAICS code, often doing so without really understanding how a particular business operates. The taxpayer and its advisors may spend significant sums to acquire a database from which they will perform number-crunching operations to select the taxpayer's CPM or TNMM.

The database providers become stakeholders in the transfer pricing process. The advisors are often able to provide voluminous materials, incurring limited analytical thought. The advisors, regrettably, are often MBA-trained workers unfamiliar with the economics of the business under review, on one hand, and also unfamiliar with corollary related international tax issues, contractual issues, and cost accounting concerns on the other hand.

Incredulously, even in this day, even major businesses undertake a transfer pricing study without the input of economists, lawyers, and cost accountants, all of whom are necessary to the transfer pricing practice. n2

General Considerations

The current economic downturn, because of its sharp economic severity and the gradual improvement in economic conditions, continues to impact transfer pricing analysis. Transfer pricing analysis, by its very nature, looks to comparative data to set or test transfer prices. These economic factors might test the arm's length range or put the company's results beyond this arm's length range. Changes in the economy might cause comparables to shift rapidly, especially as to profit ratios.

These preceding factors, i.e., the presence or absence of fixed costs, contact manufacture relationships, and distributor relationships can be significant factors in determining profit comparability. The taxpayer, then, in determining apples-to-apples comparability, needs to screen out companies that differ sharply from the company's risk profile, measured by fixed costs, contact manufacture relationships, and distributor relationships.

The manner in which a business operates determines the sharpness of an economic decline. This sharpness impacts both the extent of the economic decline and the time during which the decline happens. The factors that impact the sharpness of the economic decline include the following:

- the extent to which the assets of the business constitute fixed costs as opposed to variable costs
- the extent to which the company as a manufacturer operates on a contract manufacture basis
- the extent to which the company as a distributor incurs limited risk

The manner in which a business operates determines the time at which a decline can happen. Such a taxpayer might measure its activities by sales volume or by capacity utilization.

A factor of primary importance for the company to respond to the economic decline is the agility of this company to respond to adverse economic conditions. This agility requires the company to undertake a cohesive but rapid review of the manner in which the company does business, including contractual structures. Thus, the business would be reviewing the operations of the business the company can change, including from a legal perspective, employment contracts, distribution contracts, and the like.

From a governmental perspective, the transfer pricing often becomes the ascertaining of which party should bear the cost of downsizing -- based on downsizing of its manufacturing capacity or otherwise to limit overcapacity. ⁿ³ The cost of economic turbulence becomes cost indemnification, including any transfer of assets, and reversals of business restructuring from full-fledged distributors to low-risk distributors. The question should be raised as to whether tax administrations will permit taxpayers to have full reign, to win both ways, in periods of economic success and in economic decline.

1. Increasing Reliance on In-house Data Rather than Relying on External Data Sources

A better transfer pricing approach for the taxpayer is often to rely on in-house comparables. In other words, the taxpayer would compare the business' performance measured by transactions with related parties, on one hand, to the business' performance measured by transactions with unrelated parties. Prior to the onset of the economic turbulence, a significant number of companies retreated from the in-house comparable approach because in-house comparables are rarely available. The current economic situation is modifying these parameters, however.

The economic turbulence brings with it low levels of demand, and with these lower levels of demand, excess capacity for production and sales. The prudent business is often likely to fill this otherwise unused capacity by using its inputs into the productive process to provide goods and services originated by other company's product lines. That fact alone -- the utilization of excess capacity standing alone causes the company to use other companies' goods and services to produce goods, or to sell goods, in and of itself creates in-house transfer pricing comparables.

An additional benefit to using in-house comparables rather than relying on external data sources is that the company may be able to cut or perhaps eliminate the charges it would otherwise incur to database providers.

2. Modifying the Arm's Length Range of Results

Taxpayers might find that it is necessary to expand its arm's length range of results because of the economic turbulence. The taxpayer may need to consider developing new parameters to reflect the economic downturn, including changes to screen that the taxpayer might use. This rescreening process is more complex than it appears. The business' competitors might not be affected in the same way as the business itself, or at the same time. Two important variables are the extent of excess capacity and the ratio of fixed costs to total costs.

A business might find that the screening process might cause the company to eliminate too many erstwhile competitors in making the comparability analysis. In that case, the company should consider revising the screening criteria to broaden the applicable geographic area, to broaden the applicable product lines, and to broaden the applicable years at issue. ⁿ⁴

3. Fine-tuning and Adjusting Comparable Data through Regression Analysis or Otherwise

A taxpayer might be able to obtain better transfer pricing data by calibrating present results to reflect current economic turbulent conditions. The taxpayer, for example, could adjust for median differentials, make adjustments using regression analysis, adjust for business volume, or adjust for differences in cost structure, inventory levels, accounts payable and accounts receivable, or for foreign exchange effects. ⁿ⁵ Such a taxpayer, in seeking to apply the CPM/TNMM, would most typically seek to adjust profit-level indicators to reflect the extent of the economic turbulence. Such a taxpayer, for example, could:

- reduce the percentage return on assets of its comparables to reflect the new economic reality.
- undertake a regression analysis to reflect operating profit using a PLI base.
- perform regression-based analysis to establish the systematic relationship between changes in sales and profitability.
- make adjustments to account for such factors as differences in the ratio of fixed costs to total costs between the taxpayer and the comparables.

4. Restructuring Applicable Related-party Commercial and Financial Relationships to Reflect New Economic Realities

A company might seek to restructure its commercial relationships, including its related-party commercial relationships, based on the new economic realities. Similarly, a company might seek to restructure its financial relationships, including its related-party financial relationships, based on the new economic realities. The company, at the outset, needs to consider its legal structure and documentation it might need to make these changes, and to consider the extent to which the company would make these changes in a related-party context. In this regard, the taxpayer should consider the impact of these modifications on the stakeholders and the extent to which the company would find it necessary or appropriate to justify these changes to the stakeholders.

An issue of increasing importance during a period of economic turbulence is the ability of the taxpayer to incur losses. As such, players in the transfer pricing arena might be engaged in loss-shifting opportunities. The tax administrations, then, may find it opportune to access whether such loss-shifting is real. Alternatively, the tax administration might accept the reality of the transfer but then preclude the taxpayer from making further changes on a cost free basis.

5. Renegotiating and Restructuring Transfer Pricing Relationships, including Advance Pricing Agreements

A number of multinational businesses have assumed stable-state conditions in applying advance pricing agreements (APAs), both unilateral and bilateral. These businesses did not carefully consider the economic impact as a whole, nor did these businesses consider the risk profile of the business as whole, nor its components. As a practical matter, each business component is likely to have a risk profile that differs sharply from those of other components.

An APA is a long-term contract between taxpayers and the tax authority, designed to provide certainty or to manage risk. ⁿ⁶ But APAs are multiyear binding contracts, and taxpayers might find that their APA failed to take into account the present economic turbulence, causing unintended consequences to the taxpayer or the tax authority. Bilateral or multilateral APA may compound the problem, especially because the time period for the economic turbulence differs across jurisdictional lines.

Taxpayers are quite reluctant to break the APA, in large measure because breaking the APA almost certainly brings with it an aggressive audit approach. The APA typically brings with it various "economic conditions" that are part and parcel of the APA process. A number of companies undertaking the APA process had made short shrift of the economic conditions clause. The present economic turbulence shows us that companies that ignore these economic conditions issues did so at their peril. As Mr. Foley and Mr. Vincent point out, "The tax authority agrees not to seek higher levels of income in good times, but it also expects to receive the agreed return in bad times." ⁿ⁷

These economic conditions might lead to "special adjustments" that impact the APA's critical adjustments. The term "extraordinary event" is narrow, and taxpayers should not assume that the current economic turbulence is within the confines of these special adjustments. Most taxpayers, in reaching APA agreements, do not limit critical assumptions in terms of capacity utilization, sales volume, labor unrest, natural resource prices, currency fluctuations, bankruptcy of major suppliers or major creditors, or the like. As transfer pricing tax practitioners, we suspect that companies will pay more attention to these economic conditions going forward. We recommend that the company contemplating an APA provide input from economists and transfer pricing attorneys into this process.

6. Selecting Transfer Pricing Measures less Vulnerable to Profit Sensitivity

Certain profit sensitivity measures are more sensitive than are others. Such profit sensitivity measures can occur within the comparable profits method (CPM) or within the transactional net margin method (TNMM). Alternatively, these profit sensitivity measures can occur through other applicable transfer pricing measures. Depending on the applicable circumstances, a taxpayer should consider CPM/TNMM ratios based on gross assets or based on gross receipts rather than ratios based on profitability. Reliance on gross receipts ratios or gross asset ratios increases the year-to-year comparability that otherwise might not be available.

7. Changing Time Periods for Assessing Comparability

A number of jurisdictions look to comparability based on a one-year time period; other jurisdictions look to a three-year time period. In addition, taxpayers have to face timing issues; that comparable data will necessarily lag the company's own data. This comparability issue becomes more complex because the depth of economic turbulence and the time period for economic turbulence differs country by country. The issue then becomes the extent to which the comparative analysis should take into account the comparative depth of the economic turbulence or the time period for this economic turbulence.

8. Modifying Centralized Entrepreneurial Structures

A significant number of multinational businesses employ centralized entrepreneurial structures in which the centralized decision-making structure takes place in a relatively low-taxed country and distribution operations take place in high tax countries. One well-known country known for centralized entrepreneurship is Singapore. The centralized decision-making structure, in normal times, would seek to minimize profits in the high-taxed distribution operations by locking in the distribution activities, providing the distributor with a steady -- but low -- stream of income.

The economic turbulence is likely to provide adverse results to such centralized entrepreneurial structures. ⁿ⁸ The centralized entrepreneur might suffer losses because of the economic turbulence; in contrast, the distribution functions in high tax countries might remain profitable just because these limited entities provide limited risk. ⁿ⁹ The cumulative effective tax rate increases dramatically because of losses in the centralized entrepreneurial structure, coupled with continued high-taxed profitability of distribution functions.

The typical centralized entrepreneur acts as a hub of the business' operating functions. This centralized entrepreneur might be the owner of the intangible the business utilizes to make the product or to distribute the product. However, the centralized entrepreneur might make use of a tax haven structure to hold the intangibles if there is a sufficient disparity between the effective tax rate for the centralized entrepreneur in contrast to the effective tax rate in the tax haven.

The centralized entrepreneur most typically sells its products in a variety of countries to local affiliates. These affiliates are most typically limited-risk buy-sell distributors, commissionaires, or commission agents. The centralized entrepreneur might make use of independent third-party distributors. The centralized entrepreneur most typically makes use of limited risk distributors in companies with large sales volumes, relying on independent third-party distributors in countries with smaller volumes.

The centralized entrepreneur facing its own loss, coupled with having to pay tax for its high-tax distribution functions, might be tempted to review and recast its overall tax structure. The company's decision depends significantly on the company's time horizon, the time period for which the centralized entrepreneur continues to have losses and the distribution company continues to be taxable. Centralized entrepreneurs should be cautious in making these structural changes, in large measure because it will be difficult to reverse the process when the centralized entrepreneur becomes profitable.

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n1 See, Robert Feinschreiber, Business Facets of Transfer Pricing, Transfer Pricing Handbook, Third Edition Chapter 1, John Wiley & Sons, Inc., 2001.

n2 Robert Feinschreiber, Practical Aspects of Transfer Pricing, Transfer Pricing Handbook, Third Edition, Chapter 2, John Wiley & Sons, Inc., 2001

n3 David Ernick, Steef Huibregtse, Jean-Vincent Massoni, and Roberto Schatan, Transfer Pricing in a Downturn Economy, OECD Global Forum on Tax Treaties and Transfer Pricing, 2009 p. 142

n4 Nobuo Mori, Nihan Mert Beydilli, and Graham Poole, Transfer Pricing International -- Transfer Pricing, Volume 10, Number 8, August 2009 pp. 21, 23.

n5 Nobuo Mori, Nihan Mert Beydilli, and Graham Poole, Transfer Pricing International -- Transfer Pricing, Volume 10, Number 8, August 2009 pp. 21, 24.

n6 Sean Foley and Francois Vincent, Advance Pricing Agreements Under Pressure, Planning for the Recovery, KPMG 2009, p.54

n7 Sean Foley and Francois Vincent, Advance Pricing Agreements Under Pressure, Planning for the Recovery, KPMG 2009, p.55.

n8 Thomas Herr, Geoffrey Soh, Markus Wyss, and Thomas Zollo, Bringing Centralized Entrepreneur Structures Successfully Out the Crisis, Planning for the Recovery, KPMG 2009, p.6

n9 Jenny Buchan, Square Pegs in Round Holes: Franchisees of Insolvent Franchisors, Business Law International, May 2008, 114-144, addressees similar risk issues in a non-tax context.

RELATED LINKS: For more information on transfer pricing practice and theory, see analysis by Robert T. Cole in
 ■ Practical Guide to U.S. Transfer Pricing

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USC Gould School of Law 2009 Tax Institute: Stock Purchases and Back-End Mergers

2009 Emerging Issues 4382

USC Gould School of Law 2009 Tax Institute: Tolles on Stock Purchases Followed by Back-End Merger

By Stephen L. Tolles

October 2, 2009

SUMMARY: A tender offer followed by a back-end merger can be structured as an integrated transaction. Where such structure is agreed to by acquiror and the target, it is easy to establish that the parties intended an integrated transaction qualifying for reorganization treatment under the step transaction doctrine. Even in a hostile tender offer, the step transaction ought to allow reorganization status if Section 368 is satisfied on an integrated basis.

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ARTICLE: A tender offer followed by a back-end merger can clearly be structured as an integrated transaction under the authority of *King Enterprises, Seagram* and Revenue Ruling 2001-26, discussed below. Where such a structure is agreed to by the acquiror and the target, it should be easy to establish that the parties intended an integrated transaction qualifying for reorganization treatment under the step transaction doctrine. Recitals as to the overall intent set forth in the parties' agreements should provide further comfort that the transaction is one covered by *Revenue Ruling 2001-26*. Even in a hostile tender offer where the offeror makes it clear that it intends to proceed with a back-end merger if a sufficient percentage of the target stock is obtained in the tender, the step transaction ought to allow reorganization status provided the requirements of *IRC Section 368* are met on an integrated basis.

King Enterprises, Inc. v. United States

In the controversial *King Enterprises, Inc. v. United States*,ⁿ¹ the court confronted the following facts. King Enterprises, along with ten others, was a shareholder of Tenco, Inc. The Tenco shareholders entered into a purchase and sale agreement with Minute Maid Corporation under which the shareholders agreed to sell their Tenco stock in exchange for a combination of cash, notes, and Minute Maid stock in a transaction that closed on September 18, 1959. The value of the stock component of the consideration comprised more than 50% of the value of the total consideration paid in the deal.

On December 10, 1959, the Minute Maid board approved a plan to merge Tenco upstream. On January 5, 1960, Minute Maid requested a private letter ruling from the IRS applying former IRC Section 334(b)(2) to the transaction, and a favorable ruling issued on February 25, 1960.ⁿ² At the end of April 1960, Tenco merged into Minute Maid,

pursuant to a state law merger statute. Minute Maid treated the transaction as a asset purchase under former IRC Section 334(b)(2), receiving an increase in the basis of the Tenco assets to reflect the purchase price paid for the stock in the process.

King Enterprises, however, took a different view of the transaction. It argued the transaction as a whole qualified as an 'A' reorganization through the integration of the stock purchase with the merger (continuity of interest was preserved since more than half of the consideration was stock of Minute Maid).ⁿ³ The court agreed with this view and held that, under the step transaction doctrine, the 1959 stock purchase and 1960 upstream merger, constituted an integrated transaction qualifying as an 'A' reorganization.

The court rejected the government's argument that a binding commitment must be found before the two steps may be integrated, asking instead whether the ultimate result was intended from the outset.ⁿ⁴ Finding sufficient evidence in the record to support the conclusion, the court held that the upstream merger was the intended result of the transaction all along. However, no hard evidence of intent to follow the purchase with a merger existed. Rather, the court assumed a merger was intended, at least by Minute Maid, and seemed to think all parties probably could be deemed to have such intent because the tax benefits should have been obvious to 'sophisticated businessmen.'ⁿ⁵

J.E. Seagram Corp. v. Commissioner

A fascinating case from the wild takeover days of the 1980s is *J.E. Seagram Corp. v. Commissioner*, in which multiple bidders participated, during the summer of 1981, in takeover battle for Conoco, Inc.ⁿ⁶ Seagram made a cash tender offer for Conoco shares, initially seeking 51% of the target. DuPont, however, signed an agreement with Conoco under which DuPont would initiate a tender offer in exchange for Conoco stock, followed by a back-end merger. DuPont would pay a combination of cash and stock in the tender. The agreement also gave DuPont an option to buy a certain number of Conoco shares directly from Conoco in return for cash and a note. At the end of the bidding, Seagram owned 32% of Conoco, but DuPont held a majority (including the shares acquired by exercising its option). Shortly thereafter, Seagram tendered its Conoco shares in return for DuPont shares. The final step qualified as a forward subsidiary merger in which Conoco merged into a DuPont subsidiary.ⁿ⁷

DuPont treated the tender offer, and back-end merger, as an integrated transaction qualifying as a reorganization under *IRC Section 368(a)(2)(D)*.ⁿ⁸ Seagram, however, took the position that a reorganization did not occur, and that it could therefore claim a loss on its Conoco stock.ⁿ⁹ The court held that DuPont had a binding commitment to complete the merger once the tender offer ended and the tender and the merger were an integrated transaction, as a result.ⁿ¹⁰ The fact that some contingencies existed did not change the fact that the merger, in fact, occurred. The court also rejected Seagram's argument that continuity failed on the grounds it was not an historic shareholder.

Revenue Ruling 2001-26

The IRS addressed a fact pattern broadly similar to *King Enterprises* and *Seagram* in *Revenue Ruling 2001-26*.ⁿ¹¹ There, Corp P desiring to acquire Corp T and for 'valid business reasons,' decided to employ a two-step process. In situation (1), P first made a tender offer for stock of T, acquiring 51% of the T stock in exchange solely for P voting stock. P then formed transitory subsidiary, S, which merged into T with T surviving. The remaining 49% of T's shareholders received consideration consisting of 2/3 P voting stock and 1/3 cash pursuant to the back-end merger. The ruling assumed that, under general principles of tax law, including the step transaction doctrine, the tender offer, and back-end merger, were treated as an integrated acquisition by P of all of the T stock. The ruling also considered a slight variation in facts in situation (2) where the only difference was that S, as opposed to P, initiated the tender offer for T stock.

The Service noted that, since the two steps were part of an integrated acquisition by P of all of the T stock, it could rely on *King Enterprises* to conclude that the tender offer be treated as part of the statutory merger. Since the two steps were viewed together to determine the tax consequences of the deal, and since P acquired in excess of 80% of the voting

stock of T in exchange for P voting stock, in both situations (1) and (2), the transaction as a whole qualified as a reverse subsidiary merger under *IRC Section 368(a)(2)(E)*. n12

The ruling concluded that all of the T shareholders that exchanged their T stock for P stock in the transaction would be treated as having exchanged their T stock in return for P stock pursuant to a plan of reorganization. Therefore, T shareholders that exchanged their T stock solely for P stock in the transaction recognized no gain or loss under *IRC Section 354*. T shareholders that exchanged their T stock for P stock, and cash, in the transaction recognized gain to the extent provided in *IRC Section 356*. In both Situations (1) and (2), neither P, nor S, nor T recognized any gain or loss in the transaction, and P's basis in the T stock was determined by treating P as having acquired all of the T stock in the transaction and not before.

Some Variations on Revenue Ruling 2001-26

A. Second Step Forward Subsidiary Merger

If one alters the second step transaction in the fact pattern of *Revenue Ruling 2001-26*, a number of possibilities arise. For example, assume that instead of a merger of a transitory merger subsidiary into T, with T surviving, the merger went the other way. In such a case, T would merge with, and into, the subsidiary of P, T would disappear, and the merger subsidiary would be the surviving corporation. That fact pattern is precisely what the court faced in *Seagram*, holding the transaction a valid reorganization. That result should continue to be valid today.

B. Second Step Upstream Merger

Another variation would find a merger of T into P after the tender offer. A tender offer followed by an upstream merger is a *King Enterprises* fact pattern. Hence, where the two steps are part of an integrated plan, the result should be an 'A' reorganization, just as was the case in *King Enterprises*.

C. Second Step Liquidation and Revenue Ruling 67-274

If P liquidates T (rather than executing an upstream merger) after P acquires 51% of the stock of T, a host of potential problems for achieving reorganization status arise. First, since neither step involves a merger, the only candidates for a reorganization status are a 'B' reorganization, or a 'C' reorganization. A 'B' reorganization requires that P issue solely voting stock for stock constituting control of T. However, in the *Revenue Ruling 2001-26* fact pattern, P did not acquire control of T in the first step, since control here means 80 percent of the stock of T. Can the second step liquidation of T bring the overall transaction under Section 368?

The Service addressed this question in *Revenue Ruling 67-274*, where Corp Y acquired all of the stock of Corp X in exchange for voting stock of Y in a transaction having the form of a 'B' reorganization. n13 Y, however, then liquidated X as part of the same plan. The IRS ruled that, because the two steps were part of an overall plan of reorganization, they could not be considered independently of each other. The integrated steps resulted in Y having acquired all of X's assets, rather than its stock. Hence, the transaction did not qualify as a 'B' reorganization.

The Service then tested the integrated, two-step transaction for qualification under the other provisions of Section 368. A likely candidate was a 'C' reorganization, which occurs when one corporation acquires substantially all of the properties of another corporation in exchange solely for its voting stock. In the ruling, the requirements of *IRC Section 368(a)(1)(C)* were in fact satisfied so that, although the transaction as a whole failed to constitute a 'B' reorganization, it still qualified as a 'C' reorganization.

Revenue Ruling 2001-26, however, differs from the *Revenue Ruling 67-274* in that cash represented a portion of the consideration in the second step in the former. Under *IRC Section 368(a)(2)(B)*, a portion of the consideration in a 'C' reorganization can consist of property other than voting stock but the limit is only 20%, and for purposes of applying the 20% limit, one must count any liabilities assumed by the acquiring corporation. In *Revenue Ruling 2001-26* roughly

84% of the total consideration consisted of voting stock of the acquiring corporation. Therefore, it is theoretically possible for the combined tender offer back-end liquidation to qualify as a 'C' reorganization, but any significant amount of liabilities of the target would prevent such result.

D. Liquidation Versus Upstream Merger

A comparison of *Revenue Ruling 67-274* and *Revenue Ruling 2001-26* highlights the extremely important difference between a second-step liquidation, and a second-step upstream merger. The liquidation throws the transaction onto the dangerous shoals of the 'C' reorganization rules, while an upstream merger directs the transaction towards the relative safety of the 'A' reorganization rules. The distinction can cause dramatically different outcomes.

When to Test for Continuity

Where a reorganization is accomplished by means of a tender offer, followed by a back-end merger, one wonders when to measure value for purposes of the continuity of interest test. At the time of the *King Enterprises* and *Seagram* transactions, the continuity test required that the historic shareholders of an acquired corporation retain a substantial continuing interest in the acquiring corporation if reorganization treatment was to be afforded. Although no definitive authority regarding the date for testing whether continuity was satisfied under this test then existed, but the general view was to use the effective date of the reorganization.

The question, then, is when effective date occurred in a two-step transaction like *King Enterprises* or *Seagram*. In *King Enterprises*, for example, had the upstream merger never happened, there could have been no reorganization. Hence, it seems the reorganization was 'effective' in April of 1960. The court, however, appears to have measured continuity by looking at the value of the Minute Maid stock on the closing date of the stock purchase, that is, on September 18, 1959. Using the earlier date seems appropriate from the Tenco shareholders' perspective, since that is the date on which they actually received the consideration. Since the Minute Maid stock value in September 1959 was more than 50% of the value of the total consideration, continuity of interest would be satisfied if that was the proper time frame for the measurement.

Seagram and *Revenue Ruling 2001-26* raise an additional complication. In those fact patterns, acquiring company stock was issued on two different dates: the date on which the tender offer closed, and the date on which the back-end merger closed. In effect, there are two potential effective dates. The reorganization presumably could only be 'effective' on the second closing. If the stock values change significantly between the two closings, the transaction as a whole might or might not satisfy continuity depending on what prices were used to value the stock portion of the consideration. The conservative approach, of course, would be to take the lower stock price on the two dates and apply it to all the stock consideration, and in the absence of any authority on point that is probably the prudent thing to do.

The recent signing date regulations have changed the date for measuring continuity where there is fixed consideration pursuant to a binding contract.⁶¹ If these requirements (as defined in the regulations) are met, the date for measuring continuity is the day before the parties enter into such binding contract. A tender offer subject to 14(d) of the Securities and Exchange Act of 1934 and Regulation 14D is treated as a binding contract made on the date of its announcement. Although the regulations do not specifically address a tender offer followed by a back-end merger, the signing date rule ought to apply to such fact pattern. Virtually no tender offer ever receives a 100% tender and thus some sort of back-end transaction (typically, a merger) necessarily must occur where (as is usually the case) the acquisition seeks complete ownership of the target. So in a fact pattern like *Seagram* where the acquiring corporation commenced a tender offer under SEC rules, there is a definite testing date for continuity if the signing date regulations are satisfied.

But what if the signing date rule does not apply? For example, the terms of a tender offer or an agreement might not meet the fixed consideration test of the current regulations. In such case, the parties may be forced to evaluate continuity on the 'effective' date and, as discussed above, there is considerable uncertainty as to how to value stock if

there are multiple steps.

REORGANIZATION RULINGS

There are several rulings in which the Service has analyzed the tax treatment of two-step (or even multi-step) transactions to determine whether a reorganization occurred under one of the provisions of *IRC Section 368*. One of the most important of these rulings is *Revenue Ruling 67-274*, discussed above. *Revenue Ruling 67-274* plays an important role in the recent rulings that address the interaction of Section 338 and the application of the step transaction doctrine to two-step transactions.

Revenue Ruling 70-240

In *Revenue Ruling 70-240*,ⁿ¹⁴ Individual B owned all the outstanding stock of Corp X and Corp Y. X sold its operating assets to Y for cash and used its remaining assets to pay its debts. X then liquidated and B received a liquidating distribution. The Service concluded that the transaction was a 'D' reorganization, even though there was not an actual distribution of Y stock to B. Thus, B was treated as having received Y stock in exchange for his X stock, plus a cash distribution taxable under *IRC Section 356(a)(1)*.

Revenue Ruling 72-405

In *Revenue Ruling 72-405*,ⁿ¹⁵ Corp P formed subsidiary S and then acquired Corp T by a merger of T into S, via forward triangular merger under *IRC Section 368(a)(2)(D)*, in which the T shareholders received only P voting stock. Immediately after the merger, S was completely liquidated into P. The Service ruled that, since the two steps were part of one overall plan, the transaction was not a merger reorganization under *IRC Section 368(a)(2)(D)*, followed by a liquidation, but rather was a 'C' reorganization. This ruling was a variation of *Revenue Ruling 67-274* and underscores the important difference between a second-step liquidation and a second-step upstream merger.

Revenue Ruling 2004-83

The facts in *Revenue Ruling 2004-83*ⁿ¹⁶ involve three members of a consolidated group: Corp P was the parent, owning all of the stock of Corps S and T. As part of an integrated plan, S bought all the stock of T from P for cash and then S caused T to completely liquidate into S. Citing the step transaction doctrine, and *Revenue Rulings 67-274*, *70-240* and *72-405*, the Service ruled that the transaction qualified as a 'D' reorganization. The IRS also ruled that if P, S, and T were not members of a consolidated group, the result would be the same. This ruling is another example of the approach to two-step reorganizations found in *Revenue Ruling 67-274*.

Summary

The cited rulings, and cases such as *King Enterprises* and *Seagram*, demonstrate that the step transaction doctrine is firmly entrenched in the reorganization arena. Where two (or more) steps are part of an integrated plan, those steps are viewed as a single transaction for purposes of determining whether a reorganization under *IRC Section 368* has occurred. However, application of the step transaction doctrine in the reorganization context may be limited by *IRC Section 338* and its underlying policy.

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ⁿ¹ 418 F. 2d 511 (Ct. Cl. 1969).

n2 By the terms of that provision, a liquidation within two years of the stock purchase resulted in asset purchase treatment for the buyer.

n3 An 'A' reorganization is defined as a statutory merger or consolidation. *I.R.C. § 368(a)(1)(A)*.

n4 *King Enterprises*, 418 F. 2d at 519.

n5 *Id.* The court's reasoning has been roundly criticized over the years. *See, e.g.*, Jeffrey Kwall & Kristina Maynard, *Dethroning King Enterprises*, 58 Tax Lawyer 1 (2004).

n6 104 T.C. 75 (1995). The facts are lengthy and are discussed here only insofar as they relate to the tax treatment of a two-step transaction.

n7 A forward subsidiary merger under Section 368(a)(2)(D) qualifies as a reorganization under Section 368(a)(1)(A) where stock of the parent of the merger subsidiary is used in the transaction and (i) the merger subsidiary acquires substantially all of properties of the target corporation, (ii) no stock of the merger subsidiary is used in the transaction and (iii) the transaction would otherwise have qualified under Section 368(a)(1)(A). *I.R.C. § 368(a)(2)(D)*.

n8 26 U.S.C. § 368(a)(2)(D).

n9 Its basis was \$92 per share and its amount received was \$73 per share.

n10 104 T.C. at 99.

n11 *Rev. Rul. 2001-26; 2001-1 C.B. 1297.*

n12 26 U.S.C. § 368(a)(2)(E).

n13 Rev. Rul 67-274, 1967-2 C.B. 141

n14 Rev. Rul. 70-240, 1970-1 C.B. 81.

n15 Rev. Rul. 72-405, 1972-2 C.B. 217

n16 Rev. Rul. 2004-83, 2004-2 C.B. 157.

RELATED LINKS: For more information, see

■ LexisNexis Tax Advisor -- Federal Topical 1J:10.07

and

■ 1-10 Tax Planning for Corporations and Shareholders 10.04.

For the full text of the article, please see

■ 61-3 USC Law School Institutes On Major Tax Planning P 303.

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2009: The Year of Enforcement Action Against Offshore Bank Accounts

2009 Emerging Issues 4388

2009: The Year of Enforcement Action Against Offshore Bank Accounts

By Fran Obeid Esq.

October 2, 2009

SUMMARY: There are a number of reporting obligations that must be complied with to avoid criminal and civil penalties in connection with foreign bank accounts. This year, the IRS, Department of Justice, President Obama and Congress have prioritized enforcement action against those with undisclosed foreign bank accounts to generate revenue and to bring those with such accounts into compliance with federal tax laws.

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ARTICLE: I. Accelerated Enforcement Against Those with Undisclosed Offshore Bank Accounts

This year, the Internal Revenue Service ("IRS"), Department of Justice ("DOJ"), President Barack Obama and Congress have prioritized enforcement action against those with undisclosed foreign bank accounts to generate revenue for the United States and to bring those with such accounts into compliance with federal tax laws. This initiative quickly accelerated last year after the Senate Permanent Subcommittee on Investigations ("Subcommittee") held hearings and reported that the United States loses an estimated \$100 billion in tax revenue per year due to offshore tax abuses taking place in countries such as Switzerland and Liechtenstein. n1

While there is nothing wrong about having an interest in an offshore account, there are a number of reporting obligations that must be complied with to avoid criminal and civil penalties. In the event that a taxpayer has not timely reported an offshore account, criminal prosecution may be avoided and civil penalties reduced by participating in a voluntary disclosure. Any taxpayer who wishes to participate in a voluntary disclosure, should engage a tax representative as soon as possible to assist the taxpayer with the disclosure because the IRS has warned that after October 15, 2009, "taxpayers who do not voluntarily disclose their hidden accounts. . . face much harsher civil penalties, where applicable, and possible criminal prosecution." n2

II. Reporting Obligations

Federal tax returns require the taxpayer to report interest and ordinary dividends on Schedule B and capital gains on Schedule C of the taxpayer's return. Part III of Schedule B requires the taxpayer to (i) disclose *any interest*, or signatory, or other authority in a foreign financial account; and (ii) state the country where the account is held. Schedule B also places taxpayers on notice that if they such an interest or authority over a foreign account, they may be required

to file a Foreign Bank Account Report ("FBAR" or Form TDF 90-22.1).

The FBAR must be filed by all U.S. persons who have an interest, signatory or other authority over foreign accounts that have a combined value of more than \$10,000 at any time during the course of the year. n3 The FBAR requires filers to report their name, address and taxpayer identification number and disclose the type, location and account number of the foreign bank accounts and the maximum amount held in the accounts during the calendar year. However, if the filer has a financial interest in 25 or more foreign financial accounts, the filer is not obligated to disclose the type, location and maximum value of the amounts held in the accounts but must retain records of this information for five years and produce it upon request. The filer must also disclose if the account is owned separately or jointly and, if jointly, the filer must report the taxpayer identification number of the principal joint owner. The FBAR is separate from a taxpayer's regular income tax return and must be filed with the Treasury Department on or before June 30th of the calendar year following the year in which the taxpayer had the account at issue. n4

In October 2008, the IRS revised the FBAR instructions to (i) clarify and expand the definition of who must file an FBAR and (ii) require additional disclosures of foreign persons who have an interest in the accounts of U.S. persons. The revised BAR instructions explicitly state that U.S. persons with a foreign debit or a foreign prepaid credit card must file an FBAR. These instructions also clarify that an FBAR must be filed by a U.S. person who has a financial interest in a foreign account for which the record holder "is a trust or a person acting on behalf of a trust, that was established by such United States person and for which a trust protector has been appointed." n5

Additionally, for the first time, the revised FBAR form requires a filer to (i) list the exact maximum value of the account during the calendar year; and (ii) identify by name and passport number all non-U.S. persons with a financial interest in the filer's foreign accounts. Another change concerns the filing of an amended FBAR, requiring the filer to attach a separate statement explaining the changes to the form.

III. The Criminal and Civil Risks of Not Disclosing an Offshore Account

A taxpayer who does not timely report income held offshore and neglects to participate in a voluntary disclosure risks prosecution for tax evasion, filing a false return, the failure to file a tax return and an FBAR, as well as conspiracy.

The crime of tax evasion requires (1) a deficiency in tax; (2) an affirmative or attempted act of evasion; and (3) willfulness. The violation carries with it an imprisonment term of up to five years and a fine of up to \$250,000. n6 Taxpayers who have undeclared offshore accounts may also be prosecuted for filing a false return, since Part III of Schedule B requires the disclosure of a financial interest in an offshore account. The elements of this crime are willfully making a false statement on any tax return, statement or other document, under the penalties of perjury, that is false as to a material matter. The government need not prove that the false statement resulted in a tax deficiency. This violation carries with it a term of imprisonment for up to three years and a fine of up to \$250,000. n7 The failure to file a tax return is punishable by imprisonment for up to one year and a fine of up to \$100,000. n8 Perhaps the harshest criminal penalty that may be imposed is for the willful failure to file an FBAR. This violation carries with it an imprisonment term for up to ten years and a fine for up to \$500,000.

In addition to these traditional criminal penalties, it is likely that the Department of Justice may prosecute taxpayers who hold offshore accounts with conspiring with their offshore bank. The crime of conspiracy requires (i) an agreement to commit the elements of an offense or defraud the United States; (ii) specific intent to achieve that objective; and (iii) an overt act by one of the conspirators in furtherance of the conspiracy. To be guilty of conspiracy, the conspirators must have at least the same degree of criminal intent required for the underlying offense which is the object of the conspiracy. The crime carries with it an imprisonment term for up to five years and a fine for up to \$250,000. n9

A taxpayer who fails to timely disclose an interest in an offshore account or participate in a voluntary disclosure risks civil penalties as well. The penalty for failing to timely file a tax return is 5% of the net tax amount required to be

shown on the tax return for each month that the return is late. The maximum penalty is 25% per month but is increased to a maximum of 75% per month if the taxpayer's failure to file is fraudulent. n10 An accuracy-related penalty of 20% may be imposed on any portion of an underpayment of tax due to negligence, substantial understatement, overvaluation or undervaluation on a tax return. In cases of a substantial valuation misstatement, the accuracy-related penalty may be as high as 40%. n11

A taxpayer with an undisclosed foreign account may also face a fraud penalty of 75% of the portion of the underpayment. n12 In order for this penalty to be imposed, the Service must prove by clear and convincing evidence that there was actual intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owed. n13 The accuracy-related penalty and the fraud penalty are coordinated with each other so that the accuracy-related penalty is inapplicable to that portion of the underpayment that is subject to the fraud penalty. n14

Although the accuracy-related and the fraud penalties are coordinated with each other, the FBAR penalty is not. Therefore, a taxpayer who fails to file an FBAR may also face an FBAR penalty in addition to other civil penalties. For a non-willful failure to file, a penalty up to \$10,000 may be imposed for each year of non-filing. In the case of a willful failure to file, the penalty may be as high as the greater of \$100,000 or 50% of the value of the account for each non-filed year. n15

IV. Swiss Bank Secrecy Laws

Bank secrecy has long been a source of national pride and considerable revenue in Switzerland, resulting in several Swiss laws that vigorously protect accountholders' privacy and information. Article 47 of the Federal Act on Banks and Savings Banks prohibits bank employees and former employees, of intentionally divulging "a secret entrusted" to them in their professional capacity, or inducing others to violate a professional secret. n16 Similarly, Article 273 of the Swiss Criminal Code prohibits one from making (or seeking to make) a business secret available to a foreign agency. n17 Article 271 of the Swiss Criminal Code also prohibits taking evidence on Swiss territory for use by a foreign government, without prior proper authorization. Violations of any of these crimes are punishable by a fine and up to three years of imprisonment. n18

Since 1996, a tax treaty between the United States and Switzerland has provided for the exchange of information between the two countries, for the prevention of tax fraud but not tax evasion, which is considered an administrative matter in Switzerland and may be resolved by no more than a fine. n19 In mid-March, the Swiss agreed to alter its treaty with the United States as a result of international pressure to adopt the Organization for Economic Cooperation and Development's ("OECD") standard concerning the exchange of information with other countries, thereby agreeing to eliminate the restriction of assistance only in matters involving tax fraud. n20 In announcing the decision to revise its tax information exchange agreements, the Federal Council of Switzerland stated that assistance will be given "in individual cases where a specific and justified request has been made," and not for general "fishing expeditions." n21 The Federal Council further affirmed Switzerland's commitment to bank secrecy but noted that such secrecy "does not protect any form of tax offence." n22

On September 23, 2009, the United States and Switzerland signed a protocol revising the existing income tax treaty between the two countries. The protocol provides for the "exchange of information in tax matters to the widest possible extent without allowing the Contracting States to engage in 'fishing expeditions' or to request information that is unlikely to be relevant to the tax affairs of a given taxpayer." n23 The State seeking the information must submit a request containing (i) information identifying the person under investigation; (ii) the time period for which the information is requested; (iii) a description of the information sought and the tax purpose for seeking the information; and (iv) information identifying the person thought to be in possession of the requested information. n24 If the United States and Switzerland are unable to agree about a particular case governed by the treaty, the protocol provides for a mandatory arbitration proceeding to resolve the dispute. n25 The revised treaty is likely to ease the IRS' ability to obtain information concerning U.S. persons with Swiss bank accounts. The IRS, however, has not been waiting in the wings for a revised treaty but has obtained, and continues to obtain, information from Switzerland concerning U.S.

persons with Swiss accounts.

V. The Deferred Prosecution Agreement with UBS and Summons Enforcement Action

Over the last two years, the Senate Permanent Subcommittee on Investigations has held hearings which focused on UBS AG's Swiss offices practices concerning its U.S. clients. n26 The investigation of those practices led to a Deferred Prosecution Agreement ("DPA") between the DOJ and UBS, requiring UBS to (i) pay a settlement amount of \$780,000,000; (ii) exit the cross-border business with the United States by closing accounts held by U.S. persons or by entities that benefit U.S. persons; and (iii) disclose to the DOJ identities and account information of certain U.S. clients where tax fraud is suspected. n27 The Information and Statement of Facts of the DPA charge UBS AG with conspiracy to defraud the IRS by providing unlicensed and unregistered banking services for clients in the U.S. by having Swiss-based UBS bankers travel to the United States with encrypted laptops and using other counter-surveillance techniques to avoid detection by authorities. These documents also charge that UBS AG represented to the IRS that it was in compliance with its "Qualified Intermediary Agreement" ("QIA") with the IRS when it knew it was not. n28

The Information further charges that UBS AG bankers circumvented the QIA's requirements by referring U.S. clients to advisors who created sham offshore companies in Panama, Hong Kong and the British Virgin Islands. These sham companies would be the alleged UBS AG accountholder of the U.S. clients' assets and UBS would thereby avoid disclosing information required by the QIA about its U.S. client to the IRS. n29 UBS AG's unlicensed banking services and the offshore companies scheme were, according to the Information, intended to conceal the identities of UBS AG's U.S. clients, "who willfully evaded their income tax obligations by, among other things, filing false income tax returns and failing to disclose their UBS accounts to the IRS." n30 The announcement of the DPA prompted IRS Commissioner Doug Shulman to once again urge those with offshore accounts to make a voluntary disclosure with the IRS. "People who have hidden unreported income offshore need to get right with their government. They should come forward and take advantage of our voluntary disclosure process." n31

On February 19, 2009 -- one day after the filing of the DPA -- the IRS and DOJ filed a petition seeking to enforce the court-ordered "John Doe" summons served on the Miami branch of UBS in July 2008, demanding the identities of U.S. taxpayers who had signing or other authority over billions of dollars held in accounts managed through UBS AG's Switzerland offices or its affiliates. n32 The petition, brought by order to show cause, sought the names of 52,000 U.S. clients of UBS AG containing about \$14.8 billion in assets (as opposed to the 19,000 originally sought by the summons). n33

UBS AG argued that its compliance with the summons would violate Swiss law because without the authorization from Swiss authorities pursuant to standards set forth in the then unrevised Swiss-U.S. treaties (allowing for disclosure where tax fraud is suspected), Swiss law prohibited UBSAG from disclosing account information located in Switzerland. n34 The Swiss government filed an *amicus* brief, supporting UBS' position and noted that the Swiss government expressed its objections to the summons to State Department officials. n35

The summons case was resolved on August 19, 2009 by a settlement agreement between the United States and Switzerland whereby Switzerland agreed to release information concerning approximately 4,450 UBS accountholders to the United States through a treaty request pursuant to the countries' then unrevised tax treaty. n36 The settlement agreement provides that Switzerland will process the United States' treaty request in an expedited fashion but that UBS will give notice to the accountholders prior to the disclosure of their bank information so that the accountholders may have an opportunity to fight the disclosure in Swiss courts. n37 In declarations to the settlement agreement, the Swiss further agreed to process additional requests for information pursuant to its treaty with the United States "if [those requests] are based on a pattern of facts and circumstances that are equivalent to those of the UBS AG case." n38 There can be no doubt that the IRS will, pursuant to this settlement agreement, seek information from the Swiss government concerning U.S. accountholders taking advantage of Switzerland's bank secrecy laws within major financial institutions.

VI. The Initiative for Voluntary Disclosures by the IRS

On March 23, 2009, the IRS issued to its directors a series of memoranda centralizing the processing of voluntary disclosures concerning offshore bank accounts in its Philadelphia office, and providing for penalty guidelines for taxpayers who make their voluntary disclosure by September 23, 2009. n39 On September 21, 2009, the IRS announced that the penalty guidelines concerning the voluntary disclosure of offshore accounts would be in place until October 15, 2009 to allow representatives additional time to assist taxpayers. The IRS warned that there would be no further extension and that those "who do not voluntarily disclose their hidden accounts by the new deadline face much harsher civil penalties, where applicable and possible criminal prosecution." n40

The penalty guidelines in effect until October 15, 2009, provide that a taxpayer who makes a voluntary disclosure will be assessed (i) taxes and interest due for the past six years and will be required to file and amend all returns including FBARs for those years; (ii) either an accuracy-related or delinquency penalty of 20% on the tax for the last six years; and (iii) in lieu of other penalties that may apply, a 20% penalty of the amount in the foreign bank accounts in the year with the highest aggregate value. If, however, the taxpayer did not cause any foreign bank accounts to be opened and there has been no activity in the account and all taxes have been paid on the funds excluding the account earnings, then the penalty on the aggregate value of the account is reduced from 20% to 5%. n41

Subsequent to the IRS' internal memoranda, the IRS posted on its website answers to "Frequently Asked Questions" ("FAQs") concerning voluntary disclosures and the penalties that one may expect when making a voluntary disclosure. By posting these FAQs, the IRS intended to eliminate uncertainty about penalties that may be imposed in connection with a voluntary disclosure and thereby encourage more taxpayers to participate in the practice.

The FAQs warn about the potential penalties a taxpayer faces if the taxpayer does not participate in a voluntary disclosure and the IRS discovers the undisclosed account. These penalties include a 75% fraud penalty on the amount of tax owed; an FBAR of 20% on the amount in the offshore account *for each of the past six years*; and additional penalties if the foreign account was held through a trust or corporation and the required information returns were not filed disclosing the account. The FAQs also caution that without a voluntary disclosure, a taxpayer has criminal exposure and may be prosecuted for tax evasion; filing a false tax return or no return and the failure to file an FBAR. These crimes carry prison terms from one to ten years and fines of up to \$500,000, as explained above.

If, however, a taxpayer has reported all taxable income but only recently learned about the FBAR requirement, the FAQs advise the taxpayer to file the delinquent FBAR forms and copies of the relevant tax returns at a specified address by October 15, 2009. If this procedure is followed and the taxpayer comes into compliance, "[t]he IRS will not impose a penalty for the failure to file the FBARs." n42

In a recent update to the FAQs, the IRS explained that all persons are eligible for a voluntary disclosure, including UBS accountholders, up until the IRS receives specific information from any source, that the taxpayer has an undisclosed offshore account. n43

VII. The IRS' Voluntary Disclosure Practice for Undisclosed Income

For more than 50 years, the IRS has had a voluntary disclosure initiative to allow those with undisclosed income to come forward and report that income in exchange for reduced civil penalties and to avoid criminal prosecution. Although the IRS is now publically encouraging those with undisclosed offshore accounts to utilize its voluntary disclosure practice, the practice is also used in other circumstances where the taxpayer wishes to come forward to correct a false or improper tax return.

To participate in a voluntary disclosure, the taxpayer's undisclosed income must originate from a legal source and the taxpayer's disclosure to the IRS must be timely, truthful and complete. A disclosure will be considered timely by the IRS if it is received before (i) the IRS has initiated a civil examination or a criminal investigation of the taxpayer or related to the specific liability of the taxpayer; or (ii) the IRS has received information from a third party alerting the IRS to the specific taxpayer's noncompliance. n44 The disclosure will be considered truthful and complete when the

taxpayer demonstrates a willingness to cooperate and does cooperate with the IRS in determining the taxpayer's correct tax liability and by making good faith arrangements to pay in full, the tax, interest and penalties determined to be due.
n45

The voluntary disclosure practice requires elements of trust by both the taxpayer and the IRS: the taxpayer relies on the IRS not to prosecute and the IRS relies on the taxpayer to disclose previously undisclosed income. Although a voluntary disclosure does not officially immunize the taxpayer from criminal prosecution, it has been the long term experience of tax practitioners that the IRS' practice of accepting voluntary disclosures is as effective as a grant of immunity. Such disclosures are now more important than ever since (i) the IRS and DOJ are aggressively working in tandem on criminal prosecutions concerning those who have undisclosed foreign accounts; and (ii) recently, the IRS acknowledged that it has created a new group within its Large and Midsize Business Division to examine wealthy taxpayers who use offshore arrangements for tax evasion. By making a voluntary disclosure, a taxpayer may avoid criminal prosecution and limit the assessment of civil penalties.

CONCLUSION

A taxpayer with an undisclosed offshore account would be well-advised to promptly retain a representative to assist the taxpayer through the voluntary disclosure process and with the repatriation of offshore monies.

The IRS should also coordinate with other government agencies to ensure the uninhibited repatriation of monies from offshore accounts by those who have come forward and made voluntary disclosures. Such coordination would achieve the government's goals of (i) the disclosure of offshore accounts and payment of taxes to the U.S. Treasury; and (ii) the generation of revenue for the U.S. economy, as well as allow the taxpayer access to monies previously held offshore.

These materials are published solely as reference materials for use by attorneys and other tax professionals. They do not constitute legal advice, or an opinion or written advice concerning federal or state tax issues and are not written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or other applicable tax laws.

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n1 U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, "Tax Haven Banks and U.S. Tax Compliance" at 1 (July 17, 2008) (hereinafter, "Tax Haven Banks").

n2 IR-2009-84 (Sept. 21, 2009).

n3 31 CFR §§ 103.24; 103.27(c); 31 U.S.C. § 5314.

n4 Form TD F 90-22., General Instructions, General Definitions (Rev. 10-2008).

n5 *Id.*

n6 26 USC § 7201.

n7 26 USC § 7206(1).

n8 26 USC § 7203.

n9 18 USC § 371.

n10 26 USC § 6651.

n11 26 USC § 6662.

n12 26 USC § 6663.

n13 1 Robert S. Fink, Tax Controversies- Audits, Investigations, Trials at 15-51 (May 2008).

n14 IRC § 6662(b).

n15 31 U.S.C. § 5322.

n16 *United States v. UBS AG*, Case No. 09-20423-mc-Gold, *Amicus Brief of Government of Switzerland*, at 3 (S.D.Fl. 2009); (Swiss) Federal Law on Banks and Savings Banks, Article 47.

n17 *Id.*; Swiss Criminal Code, Article 273.

n18 *Id.*; Swiss Criminal Code, Article 271.

n19 See Articles 175 and 186 of Switzerland's Federal Direct Tax Law.

n20 David Jessop, *Caribbean has exposure in tax-haven crackdown*, Jamaica Gleaner News (April 5, 2009); David Crawford, *Tax Havens Pledge to Ease Secrecy Laws*, The Wall Street Journal (March 13, 2009).

n21 The Federal Authorities of the Swiss Confederation, *Switzerland to adopt OECD standard on administrative assistance in fiscal matters* (Bern, Switz. 13.03.2009).

n22 *Id.*

n23 *Protocol Amending the Convention Between the Swiss Confederation and the United States of America for the Avoidance of Double Taxation with Respect to Taxes on Income, Signed at Washington on October 2, 1996* ("Protocol"), Article 4 10(b).

n24 Protocol, Article 4 10(a).

n25 Protocol, Article 2.

n26 Tax Haven Banks at 8-15.

n27 *United States v. UBS AG*, Case No. 09-60033-cr-Cohn (S.D.Fl. 2009), *Deferred Prosecution Agreement*.

n28 *Id.*

n29 *United States v. UBS AG*, 09-60033-CR-Cohn (S.D.Fl. 2009), Information at 4.

n30 *Id.*

n31 *Statement of IRS Commissioner Doug Shulman on the Deferred Prosecution Agreement*, IRS News Release (Feb. 18, 2009).

n32 *United States v. UBS AG*, Case No. 09-20423-cv-Gold, *Petition to Enforce John Doe Summons* (S.D.Fl. 2009).

n33 *Id.*

n34 *United States v. UBS AG*, Case No. 09-20423-cv-Gold, *Statement of Background Information for the Court's Consideration Prior to the Scheduled Court Conference* at 3 (S.D.Fl. 2009).

n35 *United States v. UBS AG*, Case No. 09-20423-cv-Gold, *Brief of the Amicus Curiae Government of Switzerland* (S.D.Fl. 2009).

n36 Agreement Between the United States of America and the Swiss Confederation on the request for

information from the Internal Revenue Service of the United States of America regarding UBS AG, a corporation established under the laws of the Swiss Federation.

n37 *Id.* at Article 1.1 n. 1.

n38 Declarations to the Agreement Between the United States of America and the Swiss Confederation on the request for information from the Internal Revenue Service of the United States of America regarding UBS AG, a corporation established under the laws of the Swiss Federation.

n39 *Memorandum for SBSE Examination Area Directors, LMSB Industry Directors, CI Directors Field Operations* (March 23, 2009) available at www.irs.gov.

n40 *IR 2009-84* (Sept. 21, 2009).

n41 *Memorandum for SBSE Examination Area Directors, LMSB Industry Directors, CI Directors Field Operations: Authorization to Apply Penalty Framework to Voluntary Disclosure Requests Regarding Unreported Offshore Accounts and Entities* (March 23, 2009).

n42 *Voluntary Disclosure: Questions and Answers* (last updated Sept. 21, 2009), available at www.irs.gov.

n43 *Id.*

n44 *IRM 9.5.11.9(4)*(09-09-2004).

n45 *IRM 9.5.11.9(3)*(09-09-2004).

RELATED LINKS: For more information, see

■ LexisNexis Tax Advisor -- Federal Topical 4A:7.02

and

■ 1-6 FEDERAL TAX GUIDEBOOK 6.01.

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USC Gould School of Law 2009 Tax Institute: Acquisitions Using Tax Partnerships

2009 Emerging Issues 4332

USC Gould School of Law 2009 Tax Institute: Tanden, Villmow & Sergi on Advantages and Disadvantages of Acquisitions Using Tax Partnerships

By Raj Tanden, Keith Villmow and LD Sergi

September 28, 2009

SUMMARY: A common transaction involves acquiring a business conducted by an S corporation or member of a consolidated group where the selling shareholder keeps an equity interest in the business. The buyer wants the transaction to produce amortizable step-up in assets of the acquired business, the selling shareholders want to maximize deferral of taxable gain. Achieving those objectives is best accomplished using a partnership acquisition vehicle.

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ARTICLE: Introduction

A common transactional pattern involves the acquisition of a business conducted by an S corporation or member of a consolidated group in which the selling shareholder(s) will retain an equity interest in the business (often referred to as "rollover" equity). In such cases, the buyer typically wants the transaction to be structured to produce amortizable step-up in the assets of the acquired business, while the selling shareholders typically want to maximize the deferral of taxable gain recognition.

Achieving both of those objectives is often best accomplished by using a partnership n1 acquisition vehicle. However, planning this type of transaction often requires addressing difficult issues arising under the partnership disguised sale, debt allocation, and built-in gain allocation rules. In addition, because a successful business's goodwill and going concern value or other intangible asset are often its most valuable assets, the interaction of those rules with Section 197's rules for transferred intangibles generally must also be addressed.

This analysis discusses those issues in the context of the following generic fact pattern:

Target is an S corporation that conducts an active trade or business, most of the value of which is attributable to goodwill and going concern value that has zero or very low tax basis relative to its value. Buyer is a private equity fund or other investor, who will acquire a controlling, but less than 100%, interest in Target's business.

Advantages of the partnership acquisition vehicle

Although a significant purpose for structuring our generic acquisition using a partnership acquisition vehicle is to

enable the parties to achieve their respective objectives of amortizable basis step-up and deferral, there are other potential advantages, as well as certain disadvantages, to using such a vehicle that should be considered in determining whether a partnership acquisition vehicle is appropriate in any particular case.

Potential tax benefits to conducting Target's business in a partnership include:

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First, the partnership's taxable income increases the partners' basis in their partnership interests ('outside basis'), reducing any future gain on either a subsequent sale of their interests or liquidating distribution of cash from the proceeds of a sale of the partnership's assets. Although the partners must pay federal income tax on the partnership's taxable income, under the current federal income tax rate structure that tax is imposed at the same maximum marginal rate (35%) as the corporate income tax rate that would apply if the business were conducted by a C corporation. ⁿ² Consequently, the partnership can make tax distributions in amounts approximately equal to the tax it would pay directly if it were a corporation, with the result that the business is cash neutral while the partners' tax basis increases over time (assuming remaining cash is reinvested in the business or used to pay down debt) by the accumulated after-tax income of the partnership.

Second, the partners can deliver basis step-up in the partnership's assets to a subsequent buyer (assuming further appreciation in the partnership's basis) while incurring only a single level of tax, regardless of how the subsequent sale is structured -- sale of assets followed by distribution of proceeds, sale of 100% of the interests in which the buyer is treated as purchasing the partnership's assets ⁿ³ or sale of less than 100% of the interests in which the buyer obtains basis step-up under Section 743(b) as the result of a Section 754 election.

Third, a partnership, unlike a corporation, can issue 'profits interests' -- i.e., an interest solely in future profits or future appreciation -- as incentive equity to its management and other service providers. A profits interest is economically similar to a stock option and, like a stock option, a service provider is not taxed on the receipt of a profits interest assuming the *Rev. Proc. 93-27* administrative safe harbor requirements are satisfied ⁿ⁴ However, unlike a compensatory stock option, a profits interest is treated as a current interest for tax purposes, and hence the holder of a profits interest can receive a share of partnership income and the resulting outside basis build-up described above and will generally recognize capital gain on either a subsequent sale of the profits interest or allocation of gain from a sale of the partnership's assets ⁿ⁵

Fourth, a partnership can generally engage in divisive transactions, such as a sale or spin-off of a portion of its business, without triggering entity-level tax, while a corporation is subject to corporate-level tax on a taxable sale of a portion of its business and must run Section 355's gauntlet to avoid corporate-level tax on a spin-off of a portion of its business.

Fifth, because partnership debt is included in the partners' outside basis, so that new partnership borrowing increases outside basis commensurately, the partners can receive a 'leveraged' (i.e., debt-financed) distribution from a partnership on a wholly or substantially tax-deferred basis ⁿ⁶ In contrast, a shareholder of a corporation is subject to tax on a leveraged dividend (1) on dividend income to the extent of the shareholder's share of the corporation's current and accumulated earnings profits and (2) on capital gain to the extent the amount distribution exceeds both the shareholder's share of the corporation's earnings and profits and the shareholder's tax basis in the stock on which the distribution is made ⁿ⁷.

Disadvantages of the partnership acquisition vehicle

The potential tax disadvantages to conducting Target's business in a partnership include the following:

First, conducting a business in a partnership generally subjects the partners to substantially greater tax return filing burdens as compared with the filing requirements imposed on shareholders conducting a business through a C

corporation. This is especially true where the partnership conducts its business in multiple states, since most states tax out-of-state partners on their share of the partnership's income apportioned to the state and require each such out-of-state partner to file a state tax return reporting such income. Although many states permit a partnership to file a 'composite' return, and pay state tax, on behalf of its out-of-state partners, participation in such composite returns often requires the out-of-state partners to forego claiming certain deductions and exclusions they would be entitled to claim if they filed their own returns.

Second, a partnership may not be party to a Section 368 reorganization.

Consequently, it is difficult to structure a sale of the partnership to a corporation that qualifies as tax-deferred with respect to consideration consisting of the corporate acquiror's stock n8

Third, tax-exempt and foreign investors are generally averse to owning an interest in a partnership that conducts an active trade or business, either directly or through one or more tiers of partnerships, because a tax-exempt investor's share of the partnership's income will constitute unrelated business taxable income (UBTI) and a foreign investor's share of the partnership's income will constitute income effectively connected with the conduct of a US trade or business (ECI) n9 Because a substantial portion of most private equity funds' commitments are made by tax-exempt and foreign investors, most private equity funds are either required to avoid making investments that may produce UBTI or ECI or are subject to substantial limitations on the portion of total commitments that may be invested in UBTI- or ECI-producing investments n10

Fourth, a partnership may not avail itself of the bankruptcy or insolvency exclusions of cancellation of indebtedness income in the event of debt restructuring n11 These exceptions are unavailable to the partnership, because bankruptcy and insolvency are tested at the partner level, not at the entity level n12. In addition, the taxpayer-favorable rule treating a shareholder-debt holder's contribution of debt to the capital of a corporation as a satisfaction of the debt for an amount equal to the shareholder-debtor's basis in the contributed debt n13 apparently does not apply to a partner-debt holder's contribution of debt to the capital of a partnership.

Fifth, in the event the partnership raises capital in an IPO it will first convert to corporate form, and the conversion may start a new SEC Rule 144 holding period, restricting the former partners' (now shareholders) ability to sell the newly acquired IPO stock n14

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n1 The term 'partnership' as used in this article refers to any entity treated as a partnership for federal income tax purposes (e.g., a limited liability company that has not elected to be treated as a corporation).

n2 However, the federal income rate structure may change in the near future in a manner that significantly favors corporations over partnerships with respect to the taxation of operating income. It appears likely that the 2001 and 2003 individual tax rate reductions will expire at the end of 2010, at least for taxpayers in higher income brackets, so that the top marginal rate will revert to the 39.6% rate established in 1993. At the same time, prospects for a substantial reduction in the corporate income tax rate -- to a top rate in the range of 28% to 31%--appear to be gaining traction. See, e.g., Peter R Merrill, 'Competitive Tax Rates for US Companies: How Low to Go?', *122 Tax Notes 1009* (2/23/09).

n3 *Rev Rul 99-6, 1999-1 CB 432, Situation 2.*

n4 1993-2 CB 343. The conditions of this safe harbor are as follows: (1) the profits interest does not relate to a substantially certain and predictable stream of income, (2) the service provider does not dispose of the partnership interest within two years, and (3) the profits interest is not a limited partner interest in a publicly traded partnership.

n5 Some portion of such gain is usually characterized as ordinary income, under *IRC § 751(a)* in the case of a sale of the interest or as a direct result of the character of the partnership's assets (e.g., depreciation or amortization recapture under *IRC § 1245*) in the case of an asset sale.

n6 In the case of a non-corporate partner that is not personally liable for, and has not pledged property other than an interest in the partnership as security for, the partnership borrowing, net losses allocated in any prior period are subject to recapture under *IRC § 465(e)*.

n7 *IRC § 301(c) (1) and (3)*. Proposed regulations issued early in 2009 would apply this rule on a share-by-share basis solely to class of stock on which the distribution is made. *Prop Treasury Regulation § 1.301-2(a)*.

n8 Subject to step-transaction issues, it may be possible to incorporate the partnership prior to making it party to reorganization. For a discussion of the prospects for such a pre-reorganization incorporation to be respected as a separate transaction, see Martin D Ginsburg and Jack S Levin, *Mergers, Acquisitions and Buyouts* (Aspen Publishers 1/09) P 608.6. Alternatively, it is sometimes possible to structure an acquisition of a partnership as tax-deferred with respect to acquiror stock under *IRC § 351*.

n9 The tax consequences are particularly onerous to foreign corporate partners, because such a partner is subject to a 35% withholding tax on its share of the partnership's ECI and a 30% (or lower treaty rate) branch profits tax on distributions from the partnership. In addition, under Code § 875 a foreign partner is deemed to be engaged in the trade or business of any partnership in which it holds an interest (either directly or through one or more tiers of partnerships), and is consequently required to file federal income tax returns even for periods in which it is not allocated any taxable income.

n10 A typical solution to this UBTI/ECI problem is for the private equity fund to invest in a partnership through a special-purpose corporation (referred to as a 'blocker') formed solely to hold the fund's interest in the partnership. However, that ownership structure negates most of the potential tax advantages of conducting the business in a partnership with respect to the private equity fund's share of the income and gains from the business. Consequently, UBTI- and ECI-sensitive private equity funds generally invest in partnerships only to accommodate the interests of other owners (typically founders retaining an interest in the business and/or management equity holders).

n11 See *IRC § 108(a)(1)(A), (B)*.

n12 *IRC 108(d) (6)*. However, a partnership is permitted to make the election to defer cancellation of indebtedness income under newly enacted *IRC 108(i)*.

n13 *IRC 108(e) (6)*.

n14 For tax purposes, the conversion normally qualifies as tax-free under *IRC 351(a)*, and each partner's holding period in the conversion stock should (depending on how the conversion is structured) include either the partner's holding period in the partnership interest into which the stock was converted or the partnership's holding period in its assets. Rev Ruling 84-111, 1984-2 CB 88.

RELATED LINKS: For more information, see

- LexisNexis Tax Advisor -- Federal Topical 2D:5.01

For further information, see

- 2-12 Tax Planning for Partners, Partnerships, and LLCs 12.08

For related information, see

- 61-10 USC Law School Institutes On Major Tax Planning 10.syn

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USC Gould School of Law 2009 Tax Institute: Amortizing Intangible Assets

2009 Emerging Issues 4311

USC Gould School of Law 2009 Tax Institute: Tanden, Villmow & Sergi on Acquisitions Using Tax Partnerships--Maximizing the Rules for Amortizing Intangible Assets

By Raj Tanden, Keith Villmow and LD Sergi

September 23, 2009

SUMMARY: A business's goodwill and going concern value or other intangibles are often its most valuable assets. The interaction of the rules concerning acquisitions using tax partnerships and the Section 197 rules for transferred intangibles are addressed in such transactions. A partnership is generally allowed 15-year amortization for the cost basis in acquired intangibles from a sale or disguised sale, and stepped-up portion of basis in intangibles.

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ARTICLE: A successful business's goodwill and going concern value or other intangible asset are often its most valuable assets, thus the interaction of the rules concerning acquisitions using tax partnerships and the *IRC Section 197* rules for transferred intangibles generally must be addressed in structuring such transactions. n1

Tax Rules for Intangible Assets

A taxpayer is permitted to amortize its tax basis in purchased intangibles ("amortizable Section 197 intangibles") on a straight-line basis over a 15-year period if the following conditions are satisfied: (1) the intangible was acquired after August 10, 1993 (or after July 25, 1991 in certain cases); (2) the intangible is used in connection with a trade or business or an activity engaged in for the production of income; (3) the intangible was not created by the taxpayer (subject to exceptions for certain types of intangibles); and (4) the intangible is not subject to *IRC Section 197*'s anti-churning rules. Amortizable Section 197 intangibles include purchased goodwill and going concern value.

Purchased Intangibles and Section 734(b)--Basis Adjustments Affecting Partnerships

If the above requirements are met, and subject to the anti-churning rule limitation discussed below, a partnership is generally allowed 15-year amortization with respect to (1) the cost basis in any acquired intangibles attributable to a sale or disguised sale and (2) the stepped-up portion of any basis in intangibles attributable to *IRC Section 734(b)* or *743(b)*. See *Treas. Reg. Section 1.197-2(g)(3)*.

IRC Section 197's "anti-churning" rules generally prohibit the amortization of any purchased intangible that would otherwise constitute an amortizable Section 197 intangible if (1) the intangible constitutes goodwill, going concern

value, or any other intangible that would not have been amortizable but for *IRC Section 197*'s enactment ("anti-churning intangibles") and (2) a person related to the purchaser (or user of the intangible following the purchase) held or used the intangible at any time from July 25, 1991 to August 10, 1993.

For purposes of *IRC Section 197*'s anti-churning rule, a person is related to a partnership if the person owns, directly or indirectly, more than 20% of the capital or profits interest in a partnership. In the case of a sale or disguised sale of an anti-churning intangible to an acquiring partnership, "relatedness" is tested between the seller and the partnership. Hence, where a partnership takes a cost basis in an anti-churning intangible as the result of a sale or disguised sale of the intangible to the partnership, the partnership may not amortize the intangible if the seller holds (directly as a partner or constructively through another person that is a partner) a greater-than-20% capital or profits interest in the partnership.

However, a special rule under *IRC Section 197(f)(9)(E)* provides that "with respect to any increase in the basis of partnership property under *IRC Sections 732, 734, or 743*, determinations . . . shall be made at the partner level and each partner shall be treated as having owned and used such partner's proportionate share of the partnership assets." Consequently, any step-up in the basis of an intangible under *IRC Section 743(b)* as the result of a sale or exchange of a partnership interest is generally not subject to the anti-churning limitation if the transferor and transferee are not related to each other under the *IRC Section 197* anti-churning relatedness rules.

Similarly, the portion of any step-up in the basis of an intangible under *IRC Section 734(b)* that is allocable to any partner that is not the "distribute partner" (i.e., the partner that received the distribution that triggered such adjustment) and is not related to the distribute partner is generally not subject to the anti-churning limitation.

A transaction is treated as occurring between related parties for purpose of *IRC Section 197*'s anti-churning rules if the parties are related immediately before or immediately after the transaction. In the case of a "series of related transactions," the test for relatedness is applied "immediately before the earliest such transaction or immediately after the last such transaction."

Contributed Intangibles and Section 704(c) Allocations

To the extent a partnership takes a carryover basis in any "contributed intangible" (i.e., an intangible contributed to the partnership in a contribution to which *IRC Section 721* applies), such carryover basis is amortizable only in the hands of the partnership if it was amortizable in the hands of the transferor (e.g., the contributing partner).

Any carryover basis in a contributed intangible that is amortizable by the partnership under this "step in the shoes" rule" continues to be amortized on the same schedule as the schedule that applied to the basis in the hands of the contributing partner.

Final regulations under *IRC Section 197* contain the following rules for the application of *IRC Section 704(c)* to contributed intangibles:

(1) If the contributed intangible was amortizable in the hands of the contributing partner, then the partnership may make amortization deductions to its partners with respect to the contributed intangible under any of the methods permitted under *Treas. Reg. Section 1.704-3*.

(2) If the contributed intangible was not amortizable in the hands of the contributing partner, the partnership (a) may not make amortization deductions to its partners with respect to the contributed intangible if it elects to use the either the traditional method described in *Treas. Reg. Section 1.704-3(b)* or (subject to the discussion after rule (3) below) the curative method described in *Treas. Reg. Section 1.704-3(c)* with respect to the contributed intangible, but (b) may (subject to rule (3) below) make amortization deductions to its partners with respect to the contributed intangible if it elects to use the remedial method described in *Treas. Reg. Section 1.704-3(d)*.

(3) If the contributed intangible (a) constituted pre-8/11/93 goodwill, going concern value, or other intangible that would not have been amortizable but for *IRC Section 197*'s enactment and (b) the intangible was not amortizable in the hands of the contributing partner, the partnership may make remedial allocations (but not allocations under any other *IRC Section 704(c)* method) of amortization deductions to non-contributing partners other than any noncontributing partners that are related to the contributing partner.

The *IRC Section 197* regulations [*Treas. Reg. Section 1.197-2(h)(12)(vi)(B)*] appear, fairly clearly, to not permit a partnership to make curative allocations of amortization deductions with respect to a contributed self-created intangible, since such an intangible would not have been "an amortizable Section 197 intangible in the hands of the contributing partner" (with certain exceptions noted above). However, the preamble to the final regulations suggests (but does not clearly state) that the rule is not so restrictive, and is instead intended only to preclude a partnership from using the curative method with respect to an anti-churning intangible.

Practice Tip:

Interestingly, this less restrictive interpretation of the regulation is reflected in an example contained in the IRS partnership audit guidelines. Unfortunately, it is difficult, to say the least, to tease this broader interpretation out of the actual language in the final regulation, and hence cautious taxpayers will be reluctant to rely on the interpretation that was apparently intended but not implemented.

See Internal Revenue Service, Partnership-Audit Technique Guide-Chapter 3-Contribution of Property with Built-in Gain or Loss-*IRC Section 704(c)* (LMSB-04-1107-076, Rev. 12-2007), Example 3-9.

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n1 For a broader discussion of acquisitions using tax partnerships, see USC Gould School of Law 2009 Tax Institute: Tanden, Villmow & Sergi on Advantages and Disadvantages of Acquisitions Using Tax Partnerships.

RELATED LINKS: For further information, see

- [LexisNexis Tax Advisor -- Federal Topical § 1E:8.04](#)

For more information on this topic, see

- [1-7 Depreciation Handbook § 7.04](#)

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- [61-10 USC Law School Institutes On Major Tax Planning 10.syn](#)

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USC Gould School of Law 2009 Tax Institute: U.S., Europe and Asia Investments

2009 Emerging Issues 4329

USC Gould School of Law 2009 Tax Institute: Lee, Culbertson, and Hamer on Practical Strategies for Investment in the U.S., Europe, and Asia

By Lee Alexander, Culbertson Rob and Hamer Justin

September 23, 2009

SUMMARY: Although every investment is unique and requires an independent analysis of the facts and circumstances involved, the structure of many investments into Asia look very much the same. Similarly, many European investments, though unique, will implicate basic strategies that can be deployed to mitigate successfully the impact of taxation on operating profits and profit repatriation..

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ARTICLE: Although every investment is unique, and requires an independent analysis of the facts and circumstances involved, the structure of many investments into Asia look very much the same. Similarly, many European investments, though unique, will implicate basic strategies that can be deployed to mitigate successfully the impact of taxation on operating profits and profit repatriation. This is driven by the fact that all international structures are dependent upon the four, basic building blocks: (1) the existence and content of tax treaties; (2) the permanent establishment concept; (3) withholding taxes; and, (4) the treatment of capital gains. n1 In each instance, the tax practitioner should seek to ensure that withholding taxes do not apply to interest or dividend payments made on an investment, that foreign taxes on operating profits are minimized, and that capital gains on the eventual disposal of an investment are repatriated without being subjected to foreign tax, if possible.

Practical Strategies for Selected Cross-Border Investments in Asia

Below, we examine a typical Asian investment structure and explain how four key variables drive the basic tax structure.

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A. The Impact of Tax Treaties

The proposed structure above illustrates a typical investment into China and India by a United States investor. Although limited to these jurisdictions, the general rules below can be used to help structure similar investments into other Asian jurisdictions. Although the United States has entered into bilateral tax treaties with both India and China, these treaties are two of the *least* favorable bilateral tax treaties in existence. The United States has concluding more favorable tax treaties with other nations, so it is rare that a United States entity will invest directly into China or India.

B. The Impact of Permanent Establishment

The best method for analyzing the investment structure is to work from the bottom of the diagram. The creation of an operating entity in China, India, or any other Asian jurisdiction is typically a direct response to the aggressive stance both countries have taken with respect to the Permanent Establishment concept. It is very difficult to conduct business activities in a manner that avoids classification as a Permanent Establishment in either of these countries. In addition, various laws that limit the ability of foreign entities to engage in certain business activities exist. ⁿ² In addition, recent changes to the law require all real estate projects to be housed in a Chinese entity. As a result, the typical investment structure usually involves the formation of a foreign entity in the source country jurisdiction. Thus, the United States partnership would either (a) form a Chinese or Indian corporation to conduct business in China or India, or (b) purchase shares in an existing Chinese or Indian corporation.

C. The Impact of Capital Gains Taxation

Since many emerging countries tax capital gains, it is imperative that the tax structure provide sufficient flexibility to allow the disposition of the foreign investment without attracting capital gains taxes. Many developing Asian countries have yet to conclude tax treaties with the United States, or other developed nations. As a result, protection against the source country imposing capital gains taxes on the disposition of domestic corporate shares. In addition, the tax treaties with India and China do not provide the requisite exemption from capital gains taxes that exists in most United States bilateral tax treaties with European nations. As a result, most structures require the insertion of a holding company in either (a) a country with a favorable tax treaty with the country where the ultimate investment lies or (b) a tax-free jurisdiction. This allows the investor to sell the shares of the upper tier holding company and avoid capital gains taxes in the country of investment. The most common structure utilizes a Cayman Islands holding company that is typically sold when the investor decides to exit the investment. Of course, this structure is currently in limbo as tax practitioners around the world wait with baited breath to see the result in the *Vodafone* decision.

D. The Impact of Withholding Taxes

Some investments may involve nothing more than the purchase and sale of shares in a particular entity. In that scenario, direct investment through a Cayman Island company may be sufficient. However, there tends to be income that is distributed over the life of a typical investment, be it dividends, interest, royalties or other income. Since most countries have not concluded any tax treaties with any of the tax haven jurisdictions, any distributions from a subsidiary to a parent corporation in a tax haven will typically be subject to full withholding taxes (for example, 30% for a payment from a United States subsidiary to a Cayman Islands parent) without any tax treaty relief.

The best method for ameliorating the impact of the withholding taxes is to treaty shop for a country possessed of a favorable tax treaty with the source jurisdiction. Most importantly, a treaty country that has favorable limitations on the type of income stream that is most likely to be relevant in the particular business arrangement. In addition, one should select a jurisdiction that will impose little or no tax on the income stream to prevent the income tax in the holding company jurisdiction from completely wiping out any advantage that is gained by reducing the withholding tax from the

source country.

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In the above structure, the United States investor takes advantage of the tax treaties between (a) Mauritius and India, and (b) China and Hong Kong. Mauritius and India have a tax treaty that is far more favorable than the tax treaty between the United States and India. In addition, the cost of doing business in Mauritius is minimal. The tax rate is generally less than 3%, which typically is worth the savings from Indian tax that one enjoys by avoiding taxes on direct investment. Similarly, China and Hong Kong have a tax treaty that is more favorable to taxpayers than the tax treaty between China and the United States.

The benefit of doing business through a Hong Kong holding company is that Hong Kong has a territorial taxation system. Therefore, income derived in another country is not taxed in Hong Kong. As a result, distributions of interest, dividends, royalties and other gains from a foreign subsidiary are not subject to tax in Hong Kong. Thus, it is unlikely that an investor will pay any tax in Hong Kong by virtue of establishing a holding company there. Even if there is operational income that may be sourced to Hong Kong, the general tax rate of 17.5% is much lower than the income tax rates of most developed nations.

Practical Strategies for Selected Cross-Border Investments in Europe

The first task when advising a client that is investing in Europe is to consider whether the client should be investing directly into the target European jurisdiction, or whether it might be preferable to establish a holding company in a tax beneficial European state. In either case, the tax adviser should be considering the incidence of withholding taxes on profits and interest distributions and the impact of capital gains tax in the target jurisdiction. The terms of the tax treaty between the US and the target jurisdiction will dictate this, together with whether the target jurisdiction imposes capital gains tax on non-residents.

For the purposes of this paper, and to illustrate some European investment techniques, we will assume that the tax adviser is advising a U.S. based company intending to invest on a pan-European basis, and that, for commercial reasons, a European holding company is desirable.

There are a number of jurisdictions within Europe that prove favorable to the establishment of holding companies; for example Cyprus, the Netherlands, Switzerland -even Denmark and Spain all have their merits. Perhaps the most commonly used, however, are Luxembourg and the Netherlands. The diagram below illustrates a structure through which a Luxembourg holding company acquires a French operating company by establishing a French holding company, financing part of the acquisition through shareholder loans.

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In the case of Luxembourg, there is no withholding tax on interest payments, and, since 1 January 2009, no withholding tax on dividends, so long as those dividends are paid to an eligible entity established in a jurisdiction that has concluded a tax treaty with Luxembourg. The exemption from dividend withholding tax is subject to the condition that, at the time of the distribution, the parent company must have held (or committed to continue to hold), for an uninterrupted period of at least 12 months, (i) a shareholding of at least 10% in the Luxembourg dividend-paying subsidiary, or (ii) a shareholding with an acquisition cost of at least EUR 1.2 million.

LuxCo will not be subject to capital gains in France on an eventual disposition of the shares in French HoldCo by virtue of Article 7 of the tax treaty concluded between France and Luxembourg, which gives the taxing rights to

Luxembourg.

LuxCo will not be subject to tax in Luxembourg on dividends received from French HoldCo, nor on an eventual disposal of the shares in French HoldCo, provided the terms of the Luxembourg participation exemption are met.

Luxembourg's participation exemption regime will apply if, (i) on the date on which the dividend is paid, LuxCo holds, or commits itself to hold, during an uninterrupted period of at least 12 months, a direct shareholding of at least 10% in the distributing company, or the acquisition cost of the participation is at least EUR 1.2 million; and (ii) the distributing company is: (a) a qualifying European Union resident corporation, (b) a Luxembourg resident corporation fully liable to Luxembourg tax, or (c) a non-resident corporation liable for a tax corresponding to the Luxembourg corporate income tax. For that purpose, a rate of taxation of at least 11%, on a basis comparable to the Luxembourg basis, is generally required by the Luxembourg tax authorities. The holding period condition mentioned above need not be satisfied on a share-by-share basis. Accordingly, once the threshold of 10% (or EUR 1.2 million acquisition cost) is achieved, no holding period condition exists with respect to the part of the shareholding exceeding 10% (or EUR 1.2 million acquisition cost).

Under the terms of the European Union Council Directive 90/43/EEC (the "Parent/Subsidiary Directive"), dividends paid between a parent company and its subsidiary, in this case French HoldCo and LuxCo, are paid free of withholding tax. Similar provisions apply to withholding taxes on royalties and interest under the Interest and Royalties Directive 2003/49/EC, so that, in this case, no withholding tax will apply to interest payments made on the loan between LuxCo and French HoldCo.

French HoldCo and French OpCo form a consolidated group for tax purposes in France, so that the interest expense on the shareholder loan, and the third party bank debt, used to acquire French OpCo can be offset against the profits of French OpCo. The interest expense on the shareholder loan will be deductible only to the extent that the loan is on arm's length terms (so as not to infringe transfer pricing rules), however, and the debt to equity ratio must not breach French thin capitalization legislation.

To avoid being subject to tax on the interest receipts from French HoldCo, LuxCo creates a matching deduction through a back-to-back shareholder loan from the Non-EU Parent. Subject to certain conditions (mainly, the absence of bad debt and foreign exchange risks), the Luxembourg tax authorities require that a profit is made in Luxembourg on the interest receipt and usually agree that a taxable spread

Accordingly, once the threshold of 10% (or EUR 1.2 million acquisition cost) is achieved, no holding period condition needs to be satisfied with respect to the part of the shareholding that exceeds 10% (or EUR 1.2 million acquisition cost).

Conclusion

The above examples are representative of general transaction structures and, as such, are no substitute for specific tax planning that reflects the intricacies of the client, the investment, and the specific country of investment. However, the examples do demonstrate the impact the basic building blocks have on typical investment structures and provide a road map for practitioners to approach any foreign investment in Asia or anywhere else in the world.

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ⁿ¹ For an introductory look at the four building blocks, and their paramount importance, see, Lee, Culbertson, and Hamer on *Practical Strategies for Investment in the United States, Europe, and Asia Building*

Blocks: Four Key Strategies in International Tax Structuring, 2009 Emerging Issues 4328.

n2 For example, China has a list of "restricted" and "prohibited" businesses that may only be engaged in by Chinese entities (and in certain instances, must meet domestic ownership thresholds).

RELATED LINKS: For an in depth examination of these, and related, topics, see, Lee, et.al., A Little Knowledge Can Be a Good Thing: Practical Strategies For Investment in the United States, Europe and Asia, USC Gould School of Law 2009 Tax Institute.

■ 61-4 USC Law School Institutes On Major Tax Planning P 402

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Article 26 to the Rescue: Tax Treaty Provides Basis for U.S. -- UBS Settlement

2009 Emerging Issues 4321

Article 26 to the Rescue: Tax Treaty Provides Basis for U.S. -- UBS Settlement

By Michael Rinaldi II

September 23, 2009

SUMMARY: On August 19, 2009, the United States, Internal Revenue Service and UBS AG resolved their year long dispute over the summons which was served upon UBS by the Internal Revenue Service on July 21, 2008. The IRS announced (IR-2009-84) on September 21, 2009 a one-time extension of the deadline for special voluntary disclosures by taxpayers with unreported income from offshore accounts. Taxpayers have until October 15, 2009 to come forward.

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ARTICLE: On August 19, 2009, the United States, Internal Revenue Service and UBS AG resolved their year long dispute over the "John Doe" summons which was served upon UBS by the Internal Revenue Service on July 21, 2008.

The case began with the investigation of Igor M. Olenicoff, a U.S. taxpayer and billionaire real estate developer in California. Mr. Olenicoff had signatory authority over numerous financial accounts outside of the United States including accounts held at UBS. Form 1040, Schedule B requires a taxpayer to answer "yes" where they have an interest in or signature or other authority over a financial account in a foreign country where the combined value of such accounts exceeds \$10,000. Disclosure of the foreign country where such accounts are located is also required. On his United States income tax returns for the years 1998 through 2004, signed under penalty of perjury, Mr. Olenicoff answered "NO" to foreign accounts questions on Schedule B thus violating *IRC §7206(1)*, the perjury and false statement statute.

Olenicoff ultimately entered a plea agreement. Information obtained from the Olenicoff case, resulted in indictment of two bankers, Bradley Birkenfeld, a United States citizen and director of a private banking division of UBS, and Mario Staggi residing in Liechtenstein where he owns and operates a trust company. Olenicoff utilized the services of Birkenfeld and Staggi to evade US income taxes on \$200 million of assets in secret bank accounts in Switzerland and Liechtenstein.

Birkenfeld pleaded guilty in June, 2008 to conspiring to assist Olenicoff in evading \$7.2 million of federal income taxes and agreed to cooperate with the US. Birkenfeld provided testimonial and documentary information related to his employment as a private banker at UBS in Switzerland to the Permanent Subcommittee on Investigations chaired by Sen. Levin. According to Birkenfeld, UBS knew, among other things, that:

- Olenicoff was a United States citizen;

- A senior bank manager met with Olenicoff in Switzerland and in the United States;
- All income earned on Olenicoff accounts were subject to a Qualified Intermediary Agreement (QIA) with the IRS, whereby UBS was to report US clients' income in offshore accounts;
- UBS was violating the QIA;
- No Forms 1099 were issued by UBS to Olenicoff, as required; and
- No withholding or payment over of any taxes to the Internal Revenue Service was made by UBS as required.

Further, Birkenfeld provided that other UBS bankers concealed beneficial ownership of UBS accounts by assisting US clients in creating nominee offshore structures and transferring assets into UBS accounts in the name of the nominee offshore structure. Armed with the Birkenfeld information, that UBS was allegedly assisting US taxpayers in concealing foreign accounts, the IRS issued the summons to UBS.

The case ultimately resulted in a battle between the Swiss government defending its country's banking secrecy and the US' attempt to pierce it via use of the summons litigation. The Swiss government's position has been that information disclosure should only be handled pursuant to a treaty request under the US- Switzerland income tax treaty. This was a major point argued by UBS counsel in its brief in opposition to the summons.

Counsel for UBS argued two key points as regards the US-Swiss treaty:

1. That the U.S. Government, in its negotiating the tax treaty with the Swiss acknowledged the force and legitimacy that Swiss financial privacy laws have in constraining tax enforcement efforts.

2. That the IRS summons was far-reaching, as it requested account records of every U.S. taxpayer with signatory authority over a UBS account for which the bank did not possess a form W-9, as well as requests for account records from 2002 to July, 2008.

This "far-reaching" may be questioned in light of the United States position taken in its Model Treaty. A blanket request of information to the US from a treaty partner would not be met where it is viewed as a mere fishing expedition. Article 26, Paragraph 1 of the Technical Explanation to the 2006 United States Model Income Tax Convention provides: "The information to be exchanged is that which may be relevant for carrying out the provisions of the Convention or the domestic laws of the United States or of the other contracting state concerning taxes of every kind applied at the national level. However, the language 'may be' would not support a request in which a contracting state simply asked for information regarding all bank accounts maintained by residents of that contracting state in the other contracting state, or even all accounts maintained by its residents with respect to a particular bank."

The settlement agreement provides for an information exchange mechanism through a treaty request in accord with Article 26 of the U.S.-Switzerland income tax treaty. The IRS delivery to the Swiss Federal Tax Administrator of a request for administrative assistance is made pursuant to Article 26, seeking information with regard to accounts of certain U.S. persons maintained at UBS in Switzerland. The information exchange agreement is intended to meet the U.S. tax compliance goals of the UBS summons while respecting Swiss sovereignty.

The Article provides that the competent authorities (the persons who represent their respective country in the implementation of a tax treaty) of the U.S. and Switzerland shall exchange such information as is necessary for carrying out the provisions of the Treaty and for the prevention of tax fraud. This includes the providing of information in the form of authenticated copies of unedited original records or documents; and, further, that the exchange of information is not restricted to persons covered under the treaty.

Utilizing Article 26 as a basis for settlement appears a win for UBS and the Swiss government which can stand behind the treaty and its obligations thereunder as the justification for disclosing account information. The case has also resulted in increased U.S. tax compliance by U.S. taxpayers, both here and abroad, who have failed to report overseas bank accounts, entities and income, thus yielding a win for the IRS.

The U.S. and Swiss Confederation estimated that the number of open or closed accounts at UBS falling under the Treaty Request approximates 4,450. For these accounts UBS has agreed to provide a notice to account holders pursuant to the Treaty Request.

The settlement requires the U.S. to withdraw the summons with prejudice, on or after January 1, 2010, once it has received information on 10,000 open or closed undisclosed UBS accounts from any source. These sources include the Treaty Request, the Deferred Prosecution Agreement entered into by UBS on February 18, 2009, voluntary disclosures by U.S. persons, or through a waiver of bank secrecy by a UBS client.

The agreement between the U.S. and UBS encourages voluntary disclosure by U.S. persons. The settlement agreement requires UBS to provide a notice to US persons "to consult with a qualified U.S. tax advisor regarding their account with UBS and, if appropriate, to take advantage of the IRS's Voluntary Disclosure Practice."

The IRS announced on March 23, 2009 its offshore Voluntary Disclosure Practice. UBS account holders eligible to make a voluntary disclosure were initially required to do so by September 23, 2009. Details regarding the Voluntary Disclosure are available at the IRS website.

The IRS announced (IR-2009-84) on September 21, 2009 a one-time extension of the deadline for special voluntary disclosures by those taxpayers with unreported income from offshore accounts. Taxpayers now have until October 15, 2009 to come forward. The announcement provides that those taxpayers who do not voluntarily disclose their hidden accounts by the new deadline face much harsher civil penalties and, where applicable, possible criminal prosecution.

The one-time extension will allow those taxpayers who intended to come forward the opportunity to obtain advice from tax preparers and attorneys, as well as prepare the paperwork necessary to qualify for the special penalty provisions.

As discussed, UBS notices to account holders indicate that information may be provided to the IRS pursuant to the settlement agreement. Where the U.S. person receives this notice prior to October 15th, the notice does not by itself disqualify the account holder from making a voluntary disclosure by the October 15th deadline. Further, the voluntary disclosure deadline applies to all UBS account holders, even if they have not received a notification by such date.

Pursuant to the IRS memorandum of March 23, 2009 from Linda Stiff Deputy Commissioner for Services and Enforcement, agreements with taxpayers eligible to make voluntary disclosures to resolve the tax liabilities related to offshore issues are subject to the following:

1. Assessment of all taxes and interest due going back six years, with exception where an account or entity was formed or opened within the six-year look back period, taxes and interest will be assessed starting with earliest year in which account was opened or acquired or an entity formed.
2. Taxpayer must file amended returns and Form TDF 90-22.1 "Report of Foreign Bank and Financial Accounts ("FBAR").
3. Assessment of an accuracy or delinquency penalty on all years (no reasonable cause exception applies).
4. In lieu of all other penalties, including FBAR and information return penalties, assessment of a penalty of 20% of the amount in foreign bank accounts or entities in the year with the highest aggregate account or assessed value. However, where the taxpayer did not open or cause any account to be opened or entities formed, and where there has been no activity in any account or entity (i.e. neither deposits nor withdrawals) during the period the account or entity was controlled by the taxpayer, and where only the earnings of the account or entity have escaped taxation then the penalty is reduced to 5%.

The terms as outlined are only applicable to those taxpayers making voluntary disclosure requests and who freely cooperate with the IRS.

The disclosures pursuant to an Article 26 request are not limited to accounts at UBS. In a separate declaration the Swiss Confederation agreed to review and process additional requests for information by the IRS under Article 26 of the treaty if they are based on a pattern of facts and circumstances equivalent to those of the UBS case. This opens the door for disclosure of a U.S. person's account information from any Swiss bank, where a request is made by the IRS pursuant to Article 26.

Lastly, a new protocol will be signed no later than September 30, 2009 allowing such exchange of information to the extent as provided by Article 26 of the Organization for Economic Development (OECD) Model tax convention. The OECD Model language allows for information exchange in cases of both tax fraud and tax evasion where a specific and supported request has been made. The current Article 26 provision allows for information exchange only in cases for the prevention of "tax fraud or the like."

The UBS case demonstrates that tax treaties matter. They provide the rules for the game of taxes between countries. In the UBS-U.S. match, both sides claim a victory. Treaties can allow information to be shared or fishing expeditions blocked. Perhaps in this case there was a hidden consequence: Some very sleepless nights for people that thought "bank secrecy mattered." They probably had never read Article 26.

RELATED LINKS: For bank secrecy information, lexis.com subscribers may access analysis by Professor William H. Byrnes and Dr. Robert Munro at

■ 1-INT TAX HAVENS OF THE WORLD INT-14

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USC Gould School of Law 2009 Tax Institute: Building Blocks in Intl Tax

2009 Emerging Issues 4328

USC Gould School of Law 2009 Tax Institute: Lee, Culbertson, and Hamer on Practical Strategies for Investment in the United States, Europe, and Asia Building Blocks: Four Key Strategies in International Tax Structuring

By Alexander Lee, Rob Culbertson and Justin Hamer

September 23, 2009

SUMMARY: Though practical limitations will prevent most practitioners from dispensing advice regarding foreign tax laws, a U.S. tax practitioner may, nevertheless, effectively structure investments in a tax efficient manner without completely deferring to foreign counsel. Although numerous factors impact any investment, there are four key building blocks that most often influence transactions.

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ARTICLE: When considering an investment abroad, several factors are relevant. A client's organizational structure, the form of investment contemplated, and the type of income reasonably anticipated to be derived are all of great importance. n1 So, too, is an understanding of the rules of the foreign country in which one intends to invest. Though practical limitations will prevent most practitioners from dispensing advice regarding foreign tax laws, even if they have some familiarity with them, a U.S. tax practitioner may, nevertheless, effectively structure investments in a tax efficient manner without completely deferring to foreign counsel. Although numerous factors impact any investment, we concentrate on the four key building blocks that most often influence transactions, and do so to the greatest extent. n2

FOUR KEY VARIABLES IN INTERNATIONAL TAX STRUCTURING

Building Block #1- The Effects of Tax Treaties

The most important building block in any contemplated cross-border investment structure is the availability of a tax treaty. Tax treaties are important for many reasons, not the least of which is the fact that they effectively set the rules of engagement for any cross-border transaction. Although multi-purpose instruments, tax treaties main function is the elimination of double taxation for multi-national businesses. To achieve this purpose, tax treaties are designed to determine which country has the primary right to tax income -- the country in which income arises (the source country), or the country in which the taxpayer is resident (the residence country) -- and otherwise establish terms for the taxation of cross-border income between the signatory countries. The first thing any tax practitioner must do, therefore, is determine whether a tax treaty is applicable. n3

Since the United States has over 50 bilateral tax treaties with different jurisdictions, there is a very good chance

that an investor will derive the benefits of a tax treaty when investing abroad. There are, however, countries with which a client's home country will not have concluded a bilateral tax treaty. Investment in such jurisdictions will expose the investor to the full effects of the foreign jurisdiction's tax system without protection. As a result, some alternative structures for investment may be needed. Moreover, it is possible that, although a treaty may exist between the investor's home country and the country in which an investment is contemplated, the provisions of that treaty may not be as favorable to the investor as provisions in another bilateral tax treaty. Accordingly, even an investment in a jurisdiction possessed of a tax treaty may still require the need for some alternative tax structuring.

For this reason, many tax structures utilize intermediate holding companies in jurisdictions other than the one in which the ultimate investment lies. Though holding companies serve a number of corporate and administrative purposes, they are, perhaps, most often utilized by tax practitioners to obtain favorable treaty benefits. ⁿ⁴ Practitioners repeatedly place such holding companies in the same jurisdictions. That is no accident. These jurisdictions tend to have favorable tax rates, low administrative tax burdens, and a wide range of treaties available.

Building Block #2- Permanent Establishment

Once it has been determined whether a bilateral tax treaty exists, the practitioner should consider the role of foreign taxes. The OECD Model Treaty, and all U.S. bilateral tax treaties, include provisions addressing the taxation of the "business" or "industrial and commercial" profits of an enterprise. Generally, these provisions grant a country the right to tax the business profits of an enterprise, even if earned by a resident of another country, if that enterprise maintains a "Permanent Establishment" (PE) within that country. Host countries may only tax the business profits of the enterprise, and only to the extent that the profits are "attributable to" that Permanent Establishment, however. ⁿ⁵

Most tax treaties define a "Permanent Establishment" as a "fixed place of business through which the business of an enterprise is wholly or partly carried on." ⁿ⁶ The OECD Commentary imbues further meaning into the term "fixed place of business, stating that a place of business must be "fixed" to constitute a Permanent Establishment, as determined both by "location" and by "time." ⁿ⁷ Most treaties, including the U.S. Model Treaty and most older versions of the OECD Model Treaty, then include a specific (but not exclusive) list of types of business locations that qualify as a Permanent Establishment. ⁿ⁸ Most tax treaties provide a list relatively similar to that provided in the U.S. Model Treaty and older versions of the OECD Model Treaty.

Although most bilateral tax treaties between the United States and most European countries closely follow the U.S. Model Treaty, investment in Asia provides a far greater challenge, for several United States bilateral tax treaties with Asian countries significantly expand the definition of Permanent Establishment. ⁿ⁹ Especially in Asia, therefore, it is of critical importance to discuss Permanent Establishment issues with local counsel and to structure client's investment accordingly.

Building Block #3- Withholding Taxes (Interest, Dividends and Royalties)

Even if PE status is avoided, a foreign investor is not necessarily free from foreign income tax liability on its investments. Withholding taxes are typically imposed on certain types of passive investment income streams earned in a foreign jurisdiction. ⁿ¹⁰ Unlike the more complicated PE provisions in tax treaties, these sections tend to be relatively straight-forward, generally defining particular income streams and then placing limitations on the extent to which a country may tax a foreign investor's passive income stream of that type. Generally, this maximum rate is considerably lower than the general rate of tax. ⁿ¹¹ Typically, by contrast, most tax treaties do not provide a lower rate of tax on income earned by Permanent Establishments.

Building Block #4 -- Taxation of Capital Gains

In many respects, the taxation of capital gains could be categorized as another form of withholding tax. Capital gains taxes, however, ought to be analyzed separately for several reasons. First, the taxation of capital gains tends to differ from the taxation of other types of passive income streams in many bilateral tax treaties. Capital gains taxes are

also of particular import since they frequently arise in connection with the disposition of an entire investment in the foreign entity, and the amounts at issue may be much greater than general distributions, as a result. n12

In many jurisdictions, including the United States, gain from the sale by a foreign resident of shares of a domestic corporation is not generally subject to tax. Although section 861 specifically lists interest, dividends, royalties, and real property sales as United States source income, n13 section 865 sources income from the sale of personal property to the country of residence. n14 In effect, the United States will not impose withholding tax on a non-resident selling personal property, even if the property disposed is located in the United States. This allows foreign investors to purchase, and later sell, shares of U.S. corporations without incurring U.S. capital gains taxes.

The U.S. Model Treaty, as well as many of our bilateral tax treaties, contain Capital Gains provisions that source gains from the sale of personal property to the residence of the seller. n15 Thus, the sale of shares of stock by a non-resident, which does not have a PE, is not subject to taxation. This is of great importance since many other countries do not exempt foreign investors from capital gains taxes on sales of shares of corporations incorporated in that jurisdiction. If the other country imposes capital gains taxes on the sale of shares of a domestic corporation, the United States investor would need to rely upon the tax treaty to ensure that it was not subject to capital gains taxes and that the purchaser would not be required to withhold taxes under local law.

Most U.S. bilateral tax treaties with European nations contain a capital gains provision that follows the Model treaty to the letter. Contrast that, however, with the capital gains articles contained in the bilateral tax treaties conducted between the United States and Asian jurisdictions, particularly China and India. These articles generally impose capital gains taxes on foreigners who sell shares of a domestic corporation. n16 This state of affairs, of course, seriously affects the method by which U.S. investors would seek to structure investments when they venture into China or India.

To minimize, or eliminate, the impact of capital gains taxes, and other tax issues, practitioners should consider using one of several tax strategies.

Strategy 1: The Holding Company Structure to Eliminate Capital Gains Tax (but Beware of Limitation of Benefit Clauses)

The practitioner should treaty shop to locate a bilateral tax treaty between the country of investment and a third Country possessed of a more favorable capital gains provision than the United States' treaty. n17 A U.S. investor considering an investment in India could, for example, form a subsidiary corporation in Mauritius, which, in turn, would invest in the Indian corporation. When the U.S. investor wanted to exit the investment, the Mauritius subsidiary would sell the shares of the Indian company and invoke the protections in the India-Mauritius tax treaty to avoid Indian capital gains tax. This has been the preferred method for United States investment in India for years.

Treaty shopping, however, is not without its limitations. Even if, for example, the tax treaty provides beneficial treatment, the Indian taxing authority might, nevertheless, appeal to the judicial system to prevent abuse of the Mauritius tax treaty. Several decisions over the years have imposed increasing "substance" requirements on the Mauritius entity claiming treaty benefits. Nevertheless, it has historically easy and formula driven method by which to qualify for treaty benefits. Commentators have been stating that India is going to "shut the door" on the Mauritius loophole for almost 20 years, yet, the opportunity to invest through Mauritius still exists.

Beneficial treaty arrangements involving other Asian countries exist, n18 as well, and it is advisable to ascertain where the most benefit lies. Caution should be exercised, however, since treaties are subject to renegotiation more freely in Asia than in the United States or Europe. Caution should also be exercised to ensure that the Treaty does not contain an "Anti-Treaty Shopping" provision, or a "Limitation of Benefits" provision that would prevent the Holding Company from claiming the treaty benefits of the bilateral tax treaty with the source country.

Strategy 2: Use of a Holding Company in a Tax Haven (But Beware of Vodafone).

The second method typically utilized by tax practitioners for avoiding capital gains taxes is the insertion (or "stacking") of an extra holding company in a tax haven jurisdiction. At the time of disposition, the investor will avoid the direct sale of the shares of the target corporation by instead selling the shares of the holding company. n19

Thus, direct sales of Indian and Chinese companies are typically avoided by forming a holding company in a third jurisdiction. The holding company will then be the ultimate entity sold by the investor. The sale of the holding company effectively avoids the capital gains taxes in those jurisdictions. The jurisdiction where the holding company resides is typically a jurisdiction that does not impose an income tax (e.g., the Cayman Islands) no additional tax burden exists by virtue of selling the holding company shares. However, if the investment requires placing a holding company in a jurisdiction that imposes tax, investors tend to favor jurisdictions that impose minimal taxes (e.g., Mauritius) or have a system of taxation that exempts capital gains taxes (e.g., Hong Kong). n20

An Example of an Attack on Entity Stacking -- The Vodafone Case

In the landmark case of *Vodafone International Holdings B.V. v. Union of India et al.* n21 the Indian taxing authorities are attempting to assert jurisdiction over the sale of a company holding shares in an Indian entity. A win by the Indian taxing authorities could completely alter the manner in which capital investment is conducted in India. The case could also wider ramifications since other developing nations could use the case to expand their own abilities to impose capital gains taxes on foreign investment.

Vodafone involves the-sale of a controlling stake in India-based Hutch-Essar. Rather than sell the shares of the Indian corporation, Vodafone (through a Dutch subsidiary) purchased the shares of an intermediate holding company that owned a 67% stake in Hutch-Essar from Hong Kong-based Hutchison Essar. Because the transaction did not involve the purchase and sale of any Indian shares, Vodafone and Hutchison took the position that Indian taxes did not apply, and Vodafone did not withhold any capital gains taxes on the payment to Hutchison. Vodafone asserted that India does not have jurisdiction to tax transfers of ownership of a foreign corporation in another jurisdiction. Its position represents the general thinking of most international tax practitioners who structure investments by forming holding companies in other jurisdictions to hold the shares of Indian companies.

The Indian taxing authorities, however, asserted that the transaction was subject to Indian capital gains tax, and that Vodafone should have withheld 2 billion in taxes. The Indian taxing authorities, moreover, are taking the broader position that the holding company merely held shares of the Indian corporation, so that the transaction was really an indirect transfer of an Indian capital asset. Although the case has yet to be decided on its substantive merits, Vodafone has lost on several procedural grounds and may have to try the case in the Indian courts. Obviously, a loss on the merits would potentially allow India to assert tax on any transfer of shares of any corporation anywhere in the world if the entity's underlying asset is shares of an Indian corporation. Tax practitioners are closely monitoring this case.

Conclusion

The purpose of this article was to provide practical tips on how to structure foreign investment in light of the complicated web of tax laws, tax treaties and other international agreements. In effect, the practitioner should now be armed with a plan and methodology for analyzing a cross-border investment. However, providing tips, plans or basic methodology for analyzing the problems is no substitute for a practitioner rolling up his or her sleeves and carefully studying the particular facts and law relevant to the client's specific transaction.

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n1 For an introductory look at these topics, see, Lee, Culbertson, and Hamer on *Practical Strategies for Investment in the United States, Europe, and Asia -- A Little Knowledge Can be a Good Thing: Practical Strategies for Cross-Border Investment*, 2009 *Emerging Issues* 4315.

n2 The introductory discussion that follows addresses the key building blocks in general terms. For practical examples relating to their specific application to certain investments in Europe and Asia, see, Lee, et.al, on *Practical Strategies for Investment in the United States, Europe, and Asia -- Strategies for Selected Cross-Border Investment*, 2009 *Emerging Issues* 4329.

n3 Because most tax treaties are bilateral arrangements between two countries, in multi-jurisdictional investments, a practitioner may need to look at multiple tax treaties and the interplay between them.

n4 For example, a company located in Country A wishes to invest by purchasing shares in a company incorporated in Country B (assuming it will receive dividend distributions and may eventually sell the stock at a significant profit). Assume that there is no tax treaty between Country A and Country B (or that the treaty does not have favorable provisions). However, there is a comprehensive tax treaty between Country A and Country H, and between Country B and Country H. Both of these treaties effectively eliminate any withholding taxes on dividend payments to foreign persons in the two countries and exempt capital gains from source based taxation. It would be more favorable for the investor to form a holding company in Country H that would purchase and hold the shares of the company incorporated in Country B.

n5 The Permanent Establishment concept is a key building block because it determines whether the business operations will be subject to the general income tax rules of a particular jurisdiction. For example, assume that a company in Country A wishes to expand its sales activities into a foreign Country B. If the company avoids being deemed to have a Permanent Establishment, then the company will not be subject to general Country B income taxes on its sales activities. The company would only be subject to its Country A taxes as usual. Country B would be limited to taxing the company under other specialized articles (e.g. withholding taxes) where the nature and scope of the Country B taxes is minimized. Conversely, if the sales activities in Country B rise to the level of a Permanent Establishment, then the company will be subject to Country B income tax (like any other Country B business operation) on all profits attributable to the Country B.

n6 See, e.g., OECD Model Tax Treaty, Article 5(1).

n7 See Commentary on the Articles of the 2005 OECD Model Income and Capital Tax Convention, July 15, 2005, Article 5 paragraphs 5 and 6.

n8 See, e.g., Article 5(2) of the U.S. Model Treaty, which lists some examples of "places of business," including:

- *a "place of management"*
- *a branch*
- *an office*
- *a factory*
- *a workshop*

a mine, an oil or gas well, or any other place of extraction of natural resources.

n9 India, for example, has taken a particularly aggressive approach in defining "Permanent Establishment." See, United States--India Tax Treaty, Article 5(2). As a result, many investments into India are far more likely to qualify as a Permanent Establishment and, hence, trigger foreign taxation. In addition, India continues to take an aggressive stance with respect to agency and other Permanent Establishment issues. Likewise, has China proven far more aggressive in asserting Permanent Establishment than the UK, or other European jurisdictions. See, U.S.--China Tax Treaty, Article 5(3).

n10 Payments subject to withholding taxes include: interest, dividends, rents, royalties, and certain gains from the sale of real and personal property.

n11 For example, the United States typically taxes payments of passive income to foreigners at 30 percent. However, most bilateral tax treaties reduce the rate on payments to 15 percent or less.⁵⁰ This is generally much lower than the general 35 percent rate of tax that would apply if the foreign investor was deemed to have a Permanent Establishment.

n12 For example, an investment fund in Country A purchases shares in a company incorporated and doing business in Country B. After the value of the Country B company has increased significantly, the investment fund sells the shares of the company resident in Country B.

n13 26 USC 861(a).

n14 26 USC 865(a).

n15 Article 13(6) of the U.S. Model Treaty provides: "Gains from the alienation of any property other than property referred to in paragraphs 1 through 5 shall be taxable only in the Contracting State of which the alienator is a resident.

n16 For example, the capital gains article from the bilateral tax treaty between China and the United States effectively taxes a United States person who invests in shares of a Chinese company if they own more than 25% of the shares. *See*, U.S.-China Tax Treaty, Art. 12(5). India possesses an even more draconian provision that, in effect, allows each jurisdiction to impose capital gains taxes without limitation. Unlike a sale of shares of a United States corporation by a foreign resident, a sale by a United States resident of shares in an Indian corporation will generally attract a capital gains tax in India. *See*, U.S.-India Tax Treaty, Art. 13(1).

n17 For example, Mauritius has a tax treaty with India that has advantageous capital gains tax provisions. Most importantly, a sale of Indian shares by a Mauritius company is not subject to Indian capital gains. Mauritius once had a tax treaty with China that provided the same exemption, but that has recently been amended.

n18 For example, the tax treaty between Korea and Belgium has a favorable capital gains provision that prevents Belgian investors from paying Korean capital gains taxes. Belg.-Kor., Sep. 19, 1979, 1196 UNTS 189, Reg No. 19004, Article 13. However, the exemption has recently been under attack by the Korean taxing authorities. In addition, Article 16 of the Korea --United States tax treaty provides for a complete exemption from Korean capital gains tax on a sale of Korean corporate shares by a U.S. resident.

n19 For example, an investor in Country A wishes to invest in shares of a company incorporated in Country B. Country B imposes a capital gains tax on the sale of shares of a domestic corporation and there is no relief under the bilateral tax treaty between Country A and Country B. The investor in Country A forms a Cayman Islands corporation to invest in and hold the shares of the company in Country B. At disposition, the investor sells his shares of the Cayman Islands corporation (the Cayman Islands does not impose any capital gains taxes). Since there was no direct disposition of shares of the Country B entity, there is no capital gains transaction that would be subject to taxation by Country B.

n20 In *Vodafone International Holdings B.V. v. Union of India et al.*, Indian taxing authorities attempted to assert jurisdiction over the sale of a company holding shares in an Indian entity. The *Vodafone* case involved the sale of a controlling stake in India-based Hutch-Essar. Rather than sell the shares of the Indian corporation, Vodafone (through a Dutch subsidiary) purchased the shares of an intermediate holding company that owned a 67% stake in Hutch-Essar from Hong Kong-based Hutchison Essar. Because the transaction did not involve the

purchase and sale of any Indian shares, Vodafone and Hutchison took the position that Indian taxes did not apply, and Vodafone did not withhold any capital gains taxes on the payment to Hutchison. The Indian taxing authorities are taking the broader position that the holding company merely held shares of the Indian corporation, so that the transaction was really an indirect transfer of an Indian capital asset.

n21 *Vodafone International Holdings B.V. v. Union of India et al.*, Writ Petition No. 2550 of 2007, High Court of Judicature at Bombay (Dec. 3, 2008).

RELATED LINKS: For an in depth examination of these, and related, topics, see, Lee, et.al., A Little Knowledge Can Be a Good Thing: Practical Strategies for Investment in the United States, Europe and Asia, USC Gould School of Law 2009 Tax Institute.

■ 61-4 USC Law School Institutes On Major Tax Planning P 402

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USC Gould School of Law 2009 Tax Institute: Cross-Border Investment Strategies

2009 Emerging Issues 4315

USC Gould School of Law 2009 Tax Institute: Lee, Culbertson, and Hamer on A Little Knowledge Can Be a Good Thing: Practical Strategies for Cross-Border Investment

By Alexander Lee, Rob Culbertson and Justin Hamer

September 21, 2009

SUMMARY: When structuring investments across international borders, one must know not only U.S. law, but also the tax rules of the foreign jurisdiction. In addition, the practitioner must also have an in depth familiarity with the clients organizational structure, the form of the investment contemplated, and the type of income stream to be derived from that investment, among other things.

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ARTICLE: When structuring investments across international borders, one must know not only oneself, but also "the enemy." For the U.S. tax practitioner, the "enemy" is the tax rules of the foreign jurisdiction. Conversely, knowledge of oneself includes a thorough understanding of the domestic tax rules governing international investment. It also includes an in depth familiarity with the client's organizational structure, the form of the investment contemplated, and the type of income stream to be derived from that investment, among other things. Since unique circumstances will surround every client, it is impossible to cover all of the variables that might impact a particular client's cross-border investment. However, several threshold issues will typically impact a client's investment.

I. Client's Organizational Structure

One of the principal factors affecting the landscape of opportunity and exposure will be the client's pre-existing organizational structure. This because international tax planning must generally operate within the fundamental constraints established by the long-standing structural features of the entity. The two structures most commonly encountered are that of a multinational corporate group and that of an investment fund, each of which presents its own opportunities and constraints.

A. Multi-National Corporate Group

The multi-national corporate group is, of course, the traditional structure of many cross-border businesses. Such entities forego the pass-through treatment and single layered tax benefits a fund structure provides, but, in return, receive an opportunity for deferral of home-country taxation. In the United States (and in many other OECD countries), these deferral opportunities may be limited by controlled foreign corporation rules of Subpart F, and similar regimes.

Nevertheless, most active business operations conducted through a foreign subsidiary will produce income that is not subject to home country taxation until repatriated as a dividend, or upon liquidation. Thus, if earnings are "permanently reinvested" overseas, the value of such deferral will be important not only for reducing the group's current home country cash tax bill, but for financial accounting purposes, as well. To the extent that the level of foreign tax imposed on deferrable foreign earnings can be reduced below the home country rate, current cash tax savings, as well as the accounting benefit of a reduced global effective tax rate may result.

Particularly since the advent of the U.S. check-the-box classification rules, many U.S. based groups have established ownership and capital structures for their non-U.S. operations to maximize foreign tax planning opportunities while, at the same time, minimizing the applicability of subpart F. Indeed, the combination of deferrable foreign income, check-the-box planning, and foreign tax planning may produce a global effective tax rate substantially lower than the statutory U.S. rate for U.S. based multinationals permanently reinvesting foreign earnings outside the United States. On the other hand, certain constraints may limit the ability of a U.S. based company to realize such benefits. The earnings of a corporate entity's foreign operations may not be eligible for U.S. tax deferral, but may be subject, instead, to current U.S. taxation under the rules of subpart F. In such cases, permanent reinvestment will produce no U.S. accounting benefits, since the full U.S. tax would have to be provided for (and paid) in respect of such earnings. Similarly, if operational constraints require the current repatriation of offshore earnings, as opposed to their permanent reinvestment abroad, there will be no opportunity to harvest the tax and effective rate benefits of deferral. Instead, ensuring the full creditability of foreign taxes paid is likely to become the primary focus of the group's international tax planning. Since many companies routinely deem it necessary to repatriate at least some of their foreign earnings (or realize that the subpart F rules will effectively demand such repatriation for tax purposes), the management of the company's foreign tax credit position will often prove an important focus of tax planning for the group.

Foreign tax credit management involves a combination of deferral planning, repatriation planning, and foreign tax reduction to ensure the amount of foreign income recognized for U.S. tax purposes is sufficient to ensure the full creditability of the foreign taxes paid with respect to such earnings, given the constraints imposed by the U.S. foreign tax credit limitation. In general, the U.S. foreign tax credit limitation rules are intended to limit the foreign tax credit to the amount of U.S. tax imposed with respect to the non-U.S. earnings of the taxpayer. In other words, the United States seeks to avoid permitting a foreign tax payment to be credited against U.S. tax liability imposed with respect to U.S. income, since such a result would effectively cede taxing jurisdiction over that income to a foreign country. Managing the foreign tax credit will likely require attention to the timing and amount of repatriations from foreign subsidiaries, the timing and amount of other payments from subsidiaries (such as royalties for the use of intangibles), and the timing and amount of other foreign source income realized by the U.S. group, as well as efforts to reduce the amount of tax paid in high-tax foreign jurisdictions. Again, the flexibility afforded by the U.S. check-the-box rules has been an important element in this type of planning.

B. Fund Investment

In recent years, investment funds have become significant players in the cross-border investment arena. When compared to multi-national corporate groups, investment funds are driven by a different set of economics and this fact alters the tax structure of the investment significantly.

One of the most important differences between multi-national corporate groups and investment funds is the use of pass-through entities to avoid corporate level taxes, in the case of the latter. Since investment funds are typically composed of individuals, or tax-exempt entities, the pass-through structure obviates corporate level taxes, thus increasing the overall after-tax yield on the investment. The investments are typically structured through the use of pass-through entities that do not incur direct taxation. The introduction of the check-the-box rules has provided United States investors added flexibility, since they can use corporate entities, in addition to pass-through entities, under local law. However, the tax advantages of the pass-through entity are offset by the lack of deferral that a corporate structure typically provides. n2

Investment funds must also be more acutely aware of its investors than multi-national corporations need be. The use of pass-through entities may subject the fund investors to direct taxation on particular types of impermissible income. Many investors in funds, for example, are tax-exempt entities, or other specialized entities (e.g., real estate investment trusts), that may not directly receive any type of unrelated business income. To avoid this, these entities typically inquire about the insertion of a corporate "blocker" to prevent direct attribution of impermissible income streams. At the same time, however, the need for a corporate blocking structure is counterbalanced by the existence of individual investors. These investors have no prohibitions against the direct attribution of income and are, accordingly, quite sensitive (and opposed) to any structures that would insert an additional layer of entity level taxation.

In addition, individual investors are generally afforded specialized tax treatment with respect to gains and losses derived from investments not afforded to corporate taxpayers. As a result, an investment fund may require its tax exempt entities to invest through "blocker" entities rather than putting a corporate entity into the investment structure below the fund. The path is riddled with different motivations from different investors and investor groups. Ultimately, a fund will end up being structured with several layers of pass-through entities (and possibly some corporate entities), and very close monitoring of the type of income that might arise by virtue of the cross-border investment should be the norm.

II. Form of Cross-Border Investment

Taxpayers may make cross-border investments in many ways. The type of investment will have an impact on the taxes imposed by both the source country and investor's own country of residence. There are times when the taxes imposed by a particular country dictate the form of the investment as opposed to situations where the form of the investment controls. Regardless, we present some of the investment forms and potential issues that might arise by virtue of the particular form of investment.

A. Acquisition

The most common form of investment involves an acquisition of most, or all, of a foreign business. Whether the investment involves an acquisition of business assets, a stock purchase, or a merger may depend upon what is permissible under the corporate laws of the particular jurisdiction. In fact, the tax laws may actually dictate which form of acquisition is utilized, as the particular tax laws of the jurisdiction might provide for better treatment in one situation or another. If the transaction is structured as an acquisition, the taxpayer must consider the taxation of the acquired company under foreign law, and whether the taxation will be altered by virtue of the ownership change. The type of entity, or business, being acquired will impact the holding structure. For example, the taxpayer may wish to form a holding company in the target jurisdiction to purchase assets rather than purchase assets directly through a foreign corporation. Much of the decision rests upon the type of income produced by the acquired entity and the tax burdens (e.g., withholding taxes) imposed by the foreign jurisdiction.

B. Joint Venture

Unlike the typical acquisition of an existing entity (or the business assets of an existing entity), joint ventures typically involve formation of a new entity by the investor and another, third-party investor. An investor might choose to invest in a joint venture rather than make an acquisition for many reasons. Local law, for instance, may require that the investor have a domestic partner if they choose to operate certain types of business entities. Another reason would be the need to team up with another investor that has the necessary financing, intellectual property, or other specialized assets, or knowledge to best support the business endeavor. Since the joint venture involves the creation of a new entity, the investor may have more flexibility in structuring the joint venture vehicle from a tax perspective. However, the investor may not be able to take full advantage of the tax advantages if the other investor is from a different jurisdiction

and is pushing for different structuring to take best advantage of the tax laws of his own jurisdiction. Finally, the amount of the investment, as well as the make up of other significant investors might trigger the controlled foreign corporation rules.

C. Debt

Although most cross-border investments involve an acquisition of equity, investments can be made in the form of debt financing.

1. Debt as the Investment Vehicle

Although one commonly thinks about senior lenders financing investments, many cross-border investments are financed with secondary financing. In fact, many investments begin as some form of convertible debt that later ripens into an equity investment. Nevertheless, in the pre-conversion period, it remains a debt instrument and the use of debt instead of equity will give rise to a different income stream. The investment returns interest income instead of dividends and/or capital gains. The taxation of income, the rate at which the income is taxed, and amounts of withholding tax may be different for interest income.

2. Role of Debt Financing

Although not a separate form of investment, any acquisition, joint venture, or other investment may require significant debt financing. The taxation and deductibility of interest is an important consideration in any tax structure. Use of debt financing will also bear great importance for the tax exempt investors in a fund structure.

D. License Arrangement/Royalty

The investment may also be in the form of a type of license/royalty arrangement. As is the case with debt, royalties may be taxed in a different manner or at a different rate (by either jurisdiction) and may attract different withholding taxes. Thus, an investor who wishes to structure an investment as a license must be aware of the separate and distinct tax consequences in each jurisdiction of the license. If the investment involves the development of intellectual property, there are also specialized cost-sharing rules that may be relevant and must be considered.

E. Acquisitions of Minority Interests

Whether a joint venture or an acquisition of equity in an existing entity, special considerations will be raised if a United States investor in a foreign company, or other structure, acquires less than 50% of target foreign company stock. One key consideration is that the controlled foreign corporation rules will not apply. However, if the foreign entity generates significant passive income, the passive foreign investment company (PFIC) rules must be considered. n3

If the company has active income, foreign tax credits would be available if earnings are distributed currently. But if earnings are reinvested, and gain realized later upon disposition of shares, no United States tax benefit would arise for the foreign tax burden, effectively resulting in double taxation, given inapplicability of section 1248 to the minority position.

III. Type of Cross-Border Income

The type of income stream that will be generated by the cross-border investment will have as much impact on the tax structuring as will the client's organizational structure and the form of the investment. Thus, it is another factor that, when thoroughly considered, will provide the practitioner with the "knowledge of self" necessary to structure an investment as advantageously as possible from a tax perspective. Many jurisdictions, like the United States, have anti-deferral regimes that differentiate between "active" and "passive" income. The taxation of the investor may shift radically depending upon whether income can be classified as active or passive.

A. Active Income

As noted, deferral of tax can be limited by the CFC rules and similar anti-deferral regimes. These rules, however, are typically aimed at preventing the deferral of passive income streams. Thus, if the income generated by the foreign investment produces active business income, the operations conducted by a foreign subsidiary will typically not be subject to any to home country taxation until the income they produce is repatriated as a dividend or upon liquidation.

The types of income that will qualify as active income may vary from jurisdiction to jurisdiction. In addition, the practitioner must pay careful attention to particular regimes that pick up income that would generally not be viewed as passive income to the untrained investor. For example, the United States has rules that prevent deferral of what would normally be viewed as active sales income. Section 954(d) prevents deferral in situations where sales are made by a particular foreign subsidiary to purchasers in another jurisdiction and a portion of the sales chain involves a related party.⁴ This rule may also apply to related party services income.

Finally, it is important to note that any active income that is deferred from home country taxation may need to be repatriated. As a general matter, the repatriation of income will trigger home country taxation. However, it may also attract source country withholding taxes. It is important for the tax practitioner to be aware of the tax burden at both levels and maximize any foreign tax credits that might be available by virtue of the repatriation of foreign income.

B. Income

Passive income typically consists of interest, dividends, rents, royalties, and gains from the sale of real or personal property. The controlled foreign corporation rules require United States shareholders of controlled foreign subsidiaries to include passive income earned by the foreign subsidiaries in the United States shareholders gross income. In non-controlled situations, the passive foreign investment company rules require the United States shareholders to either include the passive income in their gross income on an annual basis or pay additional taxes and interest upon any later sale or distribution of income from the foreign subsidiary. In either case, the rules are designed to prevent a United States shareholder from deferring passive income earned by foreign subsidiaries.

As a result of anti-deferral regimes (both in the United States and other jurisdictions), it is critical for the tax practitioner to identify the income streams that will be produced by the foreign investment and determine whether they will qualify as passive income subject to the anti-deferral rules.

If an investment is going to produce income streams that are subject to any anti-deferral regimes, the tax practitioner might forego using a corporate structure that offers deferral in favor of a pass-through regime.

IV. Conclusion

The practitioner should now be armed with a plan and methodology for analyzing a cross-border investment. However, providing tips, plans or basic methodology for analyzing the problems is no substitute for a practitioner rolling up his or her sleeves and carefully studying the particular facts and law relevant to the client's specific transaction. Once he has a thorough grasp on the client's business structure, the form of investment considered, and its nature, the practitioner can turn her attention to another series of factors, including the applicability of tax treaties, the

permanent establishment concept, and potential exit strategies. Crucially important though they all are, these are topics for another day.

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n1 In this regard, the existence and terms of bilateral tax treaties, the permanent establishment concept, withholding taxes, and, relatedly, capital gain tax provisions are of crucial importance. For an introductory look at these topics, *see*, Lee, Culbertson, and Hamer on *Practical Strategies for Investment in the United States, Europe, and Asia Building Blocks: Four Key Strategies in International Tax Structuring*, 2009 *Emerging Issues* 4328. For insight into their practical application in Europe and Asia, *see*, Lee, et.al, on *Practical Strategies for Investment in the United States, Europe, and Asia Strategies for Selected Cross-Border Investment*, 2009 *Emerging Issues* xxx..

n2 We note that the income streams of many investment funds constitute passive income. As a result, the controlled foreign corporation rules may prevent deferral of income. This negates the advantages of using a corporate entity to obtain deferral and further encourages the use of pass-through entities for investment funds.

n3 *See, e.g., 26 U.S.C. 1297.*

n4 *26 U.S.C. § 954(e).*

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Kemp on State Death Tax: Understanding Limitations on Transfers

2009 Emerging Issues 4303

Kemp on State Inheritance and Estate Taxes: Understanding Limitations on Transfers in which Decedent Held Interest

By Kristen Kemp

September 16, 2009

SUMMARY: Inheritance tax imposes a tax on the right of succession, while estate tax is a tax against property. The former is enforceable against the individual transferees or those with dominion and control over the property, while the latter is due by way of estate representatives. In the interest of making estate transfers transparent so that transfers in estates do not go unnoticed, states have provisions in effect to impose limitations on transfers.

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ARTICLE: State death taxes are imposed in approximately half of the states. Inheritance tax imposes a tax on the right of succession, while estate tax is a tax against the property. The former is primarily enforceable against the individual transferees or those who exercised dominion and control over the property, while the latter is usually due by way of the estate representatives. Notwithstanding, in the interest of making transfers within a decedent's estate transparent so that transfers in estates do not go unnoticed, states have provisions in effect to impose limitations on transfers.

Many states have requirements that were enacted to impose limitations on transfers of property if a decedent had an interest in the property at the time of death.

The property interests are not necessarily limited to probate property. In fact, the requirements are stricter for intangibles. The limits affect the actions of the personal representative, trustee and any individual or holding institution that can exercise dominion and control over the property. Certain steps are required prior to these individuals transferring the property. Violations of the statutory requirements come with hefty liabilities, with the individuals charged with the violation held personally liable for the death taxes and, in some cases, an additional penalty.

All death tax schemes apply, generally, to all property interests owned by the state's domiciliary decedents.

The property includes all real property and personal property. In a state estate tax context, the traditional definition of realty was real estate and the fixtures incidental to it. Real estate will have the death tax applied by the jurisdiction in which it is situated. Personalty, or personal property, historically followed the owner from one situs to the next and the decedent's domicile at death would be the jurisdiction to assess death taxes accordingly. While the lines for application

of death taxes were clear at one juncture, legal maneuvering has blurred the lines with the incept of funding, with real estate, trusts, family limited partnerships, limited liability corporations, and land contracts; and therefore, the ability to change realty into personalty with relative ease. The property value is taxed on the fair market value at stepped-up basis. n1 Further, the manner in which property is held might trigger some abnormalities as it relates to purposes of valuation.

In the case of the personal representative (or other termed individual charged with the duties of administering the estate), it is generally plainly stated in any individual state's statute that no assets of the decedent can be transferred until the death taxes are paid. n2 Connecticut's statute is extremely expansive in that it states that "executors, administrators, trustees, grantees, donees, beneficiaries, and surviving joint owners" are personally liable for the tax. n3 Most states hold the personal representative, the trustee, or the transferee liable for the tax on any premature transfers. Those holding the personal representative, minimally, liable include: District of Columbia, Indiana, Maryland, Massachusetts, Minnesota, New Jersey, New York, Ohio, Pennsylvania, Vermont, and Washington.

In addition to charging liability on the personal representative, many states have "form requirements" that must be met before a transfer can occur.

Generally, to meet form requirements, a state must certify that it agrees to the transfer or waives the liability against a transferor for a particular transfer. The transferors can include personal representatives and trustees; however, it is important to note that the holding institutions can be charged with duties and held liable for tax and penalties. Holding institutions are generally required to obtain copies of these forms, sometimes referred to as "tax waivers." However, in many states, the forms are consensual releases and do not waive the tax liability in any manner. n4 Within the form itself, there may be instructions for the holding institution to not complete the transfer in its entirety. Penalties and tax liabilities may be imposed on the holding institution for failure to follow the instructions on the form.

The primary purpose for the additional requirements is to provide notice to the taxing authority about the existence of a potentially taxable transfer.

The form requirements also provide notice to the individual charged with filing the return, typically the personal representative, of the existence of the property and to whom it was transferred. The requirements prevent nonprobate transfers, which would otherwise go unnoticed, from escaping the watchful eye of the representatives in charge of the estate. Additionally, they protect the beneficiaries against fraud, limit the potential for a race to the bank, and minimize the possibility for individuals to abscond with unknown funds. Finally, these requirements protect the fiscal well-being of the state and the estate by providing safeguards for the collection of revenue and method of accounting for estate assets. The most notable safeguard is the ability of states to control the property transfers in the estate context in order to secure the state's interest in the tax base.

While tax waivers' are the most common type of form requirement, many states require forms be filled out and filed or approved before real or personal property can be transferred. Additionally, states have a reporting requirement for the payment of life insurance proceeds. All of the forms combined ensure that the various types of estate property (both probate and nonprobate) are traceable, distributed corrected, and do not go untaxed.

Practitioners must note that many courts require a copy of the state revenue department's closing letter or tax determination letter as demonstration that the estate/inheritance tax determination was finalized. This process ensures that the final distributions are not made until the tax liabilities are paid in full by the individuals charged with ensuring same.

Practice Tip:

Knowing the requirements of each state in which a holding institution does business can save time, money, and the imposition of statutes.

State:

Requirement:

Source:

Connecticut

Application for Certificate Releasing Estate Tax Lien.

Form CT-4422 and Form CT-792.

District of Columbia

No limits on transfers.

Indiana

P.R., trustee, and transferee liable. Ind. Code § 6-4.1-8-1. Application for Consent to Transfer Securities or Personal Property of Any Description Owned by a Resident Decedent; Notice of Intended Transfer of Personal Property; Life Insurance Statement.

Form IH-14, Form IH-19, and Federal Form 712.

Illinois

No limits on transfers.

Iowa

Application for Release of Inheritance Tax Lien, Inheritance Consent/Waiver of Lien,

Form 60-047, Form 60-014.

Kansas

No limits on transfers.

Kentucky

No limits on transfers.

Louisiana

Inheritance Tax Waiver and Consent to Release.

Form R-3313

Maine

No limits on transfers.

Maryland

No limits on transfers.

Massachusetts

No limits on transfers.

Minnesota

No limits on transfers.

New Jersey

Preliminary Report to Secure Consents to Transfer; Affidavit & Self-Executing Waiver; Resident Decedent Affidavit Requesting Real Property Tax Waiver; Non-Resident Decedent Affidavit Requesting Real Property Tax Waiver.

IT-L-4; IT-L-8; IT-L-9; IT-L-9-NR

New York

Application for Release of Estate Tax Lien; and Life Insurance Statement.

Form ET-30, ET-117, and Federal Form 712.

North Carolina

No limits on transfers.

Ohio

Application for Consent to Transfer Property or Other Interest of a Resident Decedent; Application for Consent to Transfer Property or Other Interest of a Nonresident Decedent; Application for Consent to Transfer the Proceeds of Insurance Contracts, Employer Death Benefits and Retirement Plans for Resident and Nonresident Decedents; Tax Release.

§§ 5731.09, 5731.39

Forms ET12, ET12A, ET13, and ET14

Oklahoma

Life Insurance Statement; Notice of Payment Under an Annuity Contract, Income Policy, or Settlement Option at the Death of a Payee; Notice of Transfer for Financial Institutions; or general release (upon completion of estate audit)

Forms 472A, 472B, 411.

Oregon

No transfer limitations.

Pennsylvania

Request for Waiver or Notice of Transfer

Form REV-516

Rhode Island

Application for Estate Tax Waiver, Discharge of Estate Tax Lien

T-79, T-77

Tennessee

Application for Inheritance Tax Waiver, Inheritance Tax Release for Real or Personal Property

RV-F1400301, RV-F1401501

Vermont

No limits on transfers.

Washington

No limits on transfers.

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n1 Basis is defined as "[t]he value assigned to a taxpayer's investment in property and used primarily for computing gain or loss from a transfer of the property." See Black's Law Dictionary 161 (8th ed. 2004). The basis, by the simplest definition is the amount that is paid for property, or the "cost." It is understood that while the basis may fluctuate (i.e., in the event of depreciation or improvements made to the property), causing an adjusted basis; for purposes of this discussion, basis is referred to in general terms. The basis determined for the transfer of property to an individual depends on the method of transfer.

n2 See Conn. Gen. Stat. § 12-403; Ind. Code § 6-4.1-8-2; Md. Code § 7-216.

n3 See Conn. Gen. Stat. §12-392.

n4 See Ind. Code § 6-4.1-8-4; Ohio Rev. Stat. §§ 5731.09 and 5731.39.

RELATED LINKS: For more information on this topic, see
■ [2-28 Bender's State Taxation: Principles and Practice 28.syn](#)

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Laskin on Textron and on New IR-2010-9 Reporting Requirements

2009 Emerging Issues 4216

Laskin on U.S. v. Textron, Inc. and IR-2010-9: Accrual Work Papers, the Attorney Work Product Doctrine, and Uncertain Tax Position Reporting Requirements

By Sheldon Laskin

September 2, 2009

SUMMARY: The U.S. Court of Appeals for the First Circuit has held that tax accrual work papers, prepared by a publicly-traded corporation to produce financial statements that are certified by an independent auditor pursuant to federal securities requirements, are not protected by the attorney work product doctrine when requested by an IRS administrative summons. An unrelated I.R.S. Announcement proposes new uncertain tax position reporting requirements.

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ARTICLE: The United States Court of Appeals for the First Circuit, sitting *en banc*, has ruled that tax accrual work papers, prepared by a publicly-traded corporation to produce financial statements which are certified by an independent auditor pursuant to federal securities requirements, are not protected from production by the attorney work product doctrine when requested by an IRS administrative summons. *United States of America v. Textron, Inc.*, 2009 U.S. App. LEXIS 18103 (1st Cir. R.I., Aug. 13, 2009).

A recent and important I.R.S. Announcement, unrelated to the decision in *Textron*, nevertheless impacts uncertain tax position reporting requirements. IR-2010-9. Discussion about this key development appears at the end of this article.

The Internal Revenue Service issued a summons to require Textron to produce tax accrual work papers because Textron had engaged in nine listed transactions involving tax shelters that are subject to abuse.

Textron is a publicly traded conglomerate with over 190 subsidiaries. In 2003, the Internal Revenue Service commenced a corporate income tax audit of Textron for tax years 1998 -- 2001. During the course of the audit, the IRS determined that a Textron subsidiary -- Textron Financial Corp. -- had engaged in nine listed transactions. n1 In each of the nine instances, Textron Financial had purchased equipment from a foreign utility or transit operator and leased it back to the seller on the same day. Although such sale-in, lease-out ("SILO") transactions can be legitimate, a SILO is a listed transaction because it is a potential tax shelter subject to abuse by taxpayers. n2

After ascertaining that Textron Financial had engaged in nine SILO transactions, the IRS issued an administrative summons that Textron produce, among other documents, tax accrual work papers and supporting materials to document

Textron's analysis of its creation of a tax reserve for these transactions in the event the IRS successfully challenged the SILOs as abusive tax shelters. Textron refused to produce the tax accrual work papers, asserting they were protected from disclosure under the attorney client privilege, the tax practitioner privilege and the attorney work product doctrine. The IRS then filed a petition in the United States District Court for the District of Rhode Island, to enforce its administrative summons.

Textron's tax accrual work papers were prepared by Textron's Tax Department, including its tax attorneys, to justify the amounts included in the tax reserve. The tax reserve is reported on Textron's publicly audited financial statements, as required by federal securities law.

The tax accrual work papers consisted of spreadsheets prepared by Textron's Tax Department which list each transaction that Textron's tax attorneys determined were subject to challenge by the IRS. For each transaction, the Tax Department included the dollar amount subject to challenge and the attorneys' percentage estimate of the IRS's chance of prevailing in its challenge. Multiplying the amount by the percentage fixed the reserves entered on Textron's books and reported to its stockholders as a tax reserve on the audited financial statements. Federal securities law requires a publicly-traded corporation to include such a reserve in its financial statements. In addition, the tax accrual work papers included backup e-mails or notes that further supported the calculations.

The District Court ruled that the tax accrual work papers were protected from disclosure by the attorney work product doctrine and a divided panel of the First Circuit affirmed.

The District Court ruled that the tax accrual work papers were protected from production to the IRS by the attorney client privilege, the tax practitioner privilege codified at 26 U.S.C §7525(a)(1), and the attorney work product doctrine. However, the Court also ruled that Textron had waived both the attorney client privilege and the tax practitioner privilege by showing the tax accrual work papers to the outside auditor. *United States of America v. Textron, Inc.*, 507 F. Supp. 2d 138, 2007 U.S. Dist. LEXIS 63921 (D.R.I., 2007).

On appeal to the United States Court of Appeals for the First Circuit, a divided panel affirmed the decision of the district court that the work papers were protected by the attorney work product doctrine. *United States v. Textron, Inc.*, 553 F.3d 87, 2009 U.S. App. LEXIS 1538 (1st Cir., R.I. 2009).

In ruling that the tax accrual work papers were prepared in anticipation of litigation, and thus subject to the attorney work product doctrine codified in *Fed. R. Civ. P. 26(b)(3)(A)*, the panel majority applied the "but for" test originally established by the United States Court of Appeals for the Second Circuit in *United States v. Adlman*, 134 F. 3d 1194 (2d Cir. 1998) and in the First Circuit in *Maine v. United States Dep't. of Interior*, 298 F. 3d 60 (1st Cir. 2002). Under the "but for" test, a document is prepared in anticipation of litigation if, "in light of the nature of the document and the factual situation in the particular case, the document can be fairly said to have been prepared or obtained because of the prospect of litigation". *Maine*, 298 F. 3d at 68.

On the other hand, a document is not prepared in anticipation of litigation under the "but for" test if it is "prepared in the ordinary course of business or would have been created in essentially similar form irrespective of litigation." *Maine*, 298 F. 3d at 70. In *Textron*, the majority ruled that the work papers would not have been prepared at all but for the fact that Textron anticipated the possibility of litigation with the IRS.

While recognizing that the necessity to create a tax reserve on the audited financial statement constituted an independent business purpose for the preparation of the work papers, the majority nevertheless ruled that, but for the possibility of litigation or another adversary proceeding with the IRS, Textron would not have had a reason to create the reserve at all. Therefore, notwithstanding that Textron had a dual purpose in creating the work papers, the work papers were prepared in anticipation of litigation and were protected by the work product doctrine.

The majority remanded the case to the district court to determine whether the work product doctrine had been waived because Textron showed the tax accrual work papers to the outside auditor.

Writing in dissent, Judge Boudin also applied the "but for" test. But based on his reading of *Adlman* and *Maine*, a document prepared in the ordinary course of business or for an independent regulatory purpose is not protected by the work product doctrine, even if the document was prepared because of the prospect of litigation. According to Judge Boudin, the "but for" doctrine only protects documents that were created in order to be useful in litigation. Because the work papers were created in the first instance to prepare the reserve figures for Textron's books and statements and to satisfy the outside auditors that the reserves were adequate, they were not created in order to be useful in litigation and are therefore not protected.

Sitting en banc, a closely divided Court reversed the panel decision and ruled that the work papers are not protected by the attorney work product doctrine.

Following the panel decision, the First Circuit, sitting *en banc*, vacated the panel decision and set the case for reargument *en banc*. *United States v. Textron, Inc.*, 560 F. 3d 513, 2009 U.S. App. LEXIS 10679 (1st Cir. 2009).

By a 3-2 vote, the *en banc* court reversed the panel decision, ruling that the tax accrual work papers are not protected by the work product doctrine. Judge Boudin, who had dissented from the panel decision, wrote the opinion for the Court and Judge Torruella, who had written the panel opinion, wrote the dissent. *United States of America v. Textron, Inc.*, 2009 U.S. App. LEXIS 18103 (1st Cir. R.I., Aug. 13, 2009).

The majority opinion essentially adopted the rationale of Judge Boudin's dissent from the panel opinion. Under the majority's interpretation of the "but for" test, dual purpose documents are not protected by the work product doctrine unless they are prepared for use in litigation. Since it was undisputed that the tax accrual work papers were prepared in the first instance to establish and support the tax reserve figures for the audited financial statements, they were not prepared for use in litigation notwithstanding that they were prepared in response to the prospect of litigation.

Judge Torruella, joined by Judge Lipez, vigorously dissented from the majority opinion. The dissent rejected the majority's "prepared for use in litigation" formulation of the "but for" test as unsupported by *Adlman* and *Maine*. Furthermore, the dissent asserted that the "prepared for use in litigation" formulation was in fact a new test for determining whether a document is prepared in anticipation of litigation; a new test that goes beyond both the "but for" test and the more permissive "primary purpose" test used by the Fifth Circuit to determine when dual purpose documents are protected by the work product doctrine. *United States v. El Paso*, 682 F. 2d 530 (5th Cir. 1982). The dissent raised a number of policy objections to this new test.

First, the dissent asserts that the "prepared for use" test is inconsistent with the plain language of *Federal Rule of Civil Procedure* 26, which protects documents "prepared in anticipation of litigation *or* for trial." The conjunction "or" would be surplusage if the protection afforded by the rule were limited to documents prepared for use at trial. *Textron*, 2009 U.S. App. LEXIS 18103, *39.

Second, the dissent argues that the majority's "prepared for use" test ignores the fundamental purpose of the work product doctrine -- to protect an attorney's "privacy, free from unnecessary intrusion by opposing parties and their counsel." *Textron*, 2009 U.S. App. LEXIS 18103, *40, quoting *Hickman v. Taylor*, 329 U.S. 495 (1947). Concerns that such documents might be subject to disclosure might lead an attorney to refrain from writing down his thoughts, opinions and strategy regarding a disputed matter. This in turn would lead to inefficiency, unfairness and sharp practices regarding legal advice and the effect on the legal profession would be demoralizing.

Finally, the dissent notes that the effect of the majority's "prepared for use" test cannot be limited to the production of tax accrual work papers or tax disputes in general. If tax accrual work papers that were produced to assist in calculating a tax reserve for disputed tax matters are discoverable, then any analysis of the litigation risks of any business decision would be similarly discoverable.

The dissent urges the Supreme Court to review the case to establish a national test for applying the attorney work product doctrine to dual purpose documents.

It should be noted that the dissent closed its opinion with an impassioned invitation to the Supreme Court to grant *certiorari* to formulate a national test for determining when the attorney work product doctrine applies to dual purpose documents. Counsel outside of the First, Second and Fifth Circuits would be well advised to note the extremely narrow division of opinion among the judges in the *Textron* case as to the correct formulation of the rule. Counting the district court judge, five judges voted in support of *Textron* and four voted in favor of the IRS. n3 It is an open question whether such a narrowly divided interpretation of a venerable evidentiary doctrine will be very persuasive authority outside of the First Circuit.

Recent I.R.S Announcement proposes new uncertain tax position reporting requirements.

The IRS has announced that it is considering changes to reporting requirements imposed on certain corporate income taxpayers with uncertain tax positions, in order to improve tax compliance and administration. *IRS Announcement 2010 - 9, 2010 - 7 IRB 1* (January 26, 2010). The IRS is soliciting public comments on its proposed schedule that will require taxpayers to report uncertain tax positions taken on their tax returns. The schedule is to be filed with Form 1120, U.S. Corporation Income Tax Return, or other business tax returns. Taxpayers will be required to file the schedule if they must establish a tax reserve for uncertain tax positions under FIN 48 or other accounting standards. In addition, uncertain tax positions will include any position related to the determination of any US federal income tax liability for which a taxpayer or a related entity within the meaning of *IRC sections 267(b), 318(a), or 707(b)* has not recorded a tax reserve because the taxpayer expects to litigate the position or the taxpayer has determined that the Service has a general administrative practice not to examine the position.

As contemplated by the Service, the schedule will require a concise description of each uncertain tax position in sufficient detail so that the Service can determine the nature of the issue. To be sufficient, the description must contain:

1. The Code sections implicated by the position;
2. A description of the taxable year or years to which the position relates;
3. A statement that the position involves an item of income, gain, loss, deduction, or credit against tax;
4. A statement that the position involves a permanent inclusion or exclusion of any item, the timing of that item, or both;
5. A statement reciting whether the position involves a determination of the value of any property or right; and
6. A statement reciting whether the position involves a computation of basis.

Finally, the schedule will require the taxpayer to specify for each uncertain tax position the entire amount of US federal income tax that would be due if the position were disallowed in its entirety on audit. This amount is the maximum tax adjustment for the position reflecting all changes to items of income, gain, loss, deduction, or credit if the credit is not sustained. Taxpayers will not be required to disclose the taxpayer's risk assessment or tax reserve amounts, even though the Service can compel the production of this information through a summons. In all other respects, the Service is proposing to retain its existing policy of restraint as stated in *Announcement 2002 - 63, 2002 - 2 C.B 72*, and *IRM 4.10.20*.

Practitioners should note that the proposed additional disclosure requirements are more limited than the information the Service sought to obtain in *Textron*, which specifically included disclosure of the taxpayer's risk assessment and tax reserve amount. In announcing the proposed changes before the New York State Bar Association Taxation Section Annual Meeting on January 26, 2010, IRS Commissioner Doug Shulman remarked that the IRS "could have asked for more ... a lot more but chose not to." I.R.S. News Release IR-2010-13 (January 26, 2010).

Although neither the Announcement nor Commissioner Shulman's statement specifically mention *Textron*, best

practices require practitioners to be aware of the continuing distinction between sufficient disclosure of uncertain tax positions on a return and what the Service is likely to require on audit.

[Return to Text](#)

n1 A "listed transaction" is a transaction that the IRS lists as being "the same as or substantially similar to one of the types of transactions that the [IRS] has determined to be a tax avoidance transaction." 26 *C.F.R.* §1.6011-4(b)(2) (2009).

n2 A SILO allows a tax-exempt organization, such as a charity or city-owned transit authority, to transfer equipment that is subject to depreciation and interest deductions, from which they cannot benefit, to taxable entities that use them to shelter income from tax. When the only motive of a SILO is tax avoidance, the IRS can disregard the transaction and assess tax on the wrongly sheltered income.

n3 In compiling this tally, the author has counted Judges Boudin and Torruella twice, since these judges participated in both the three judge panel decision and the *en banc* decision.

RELATED LINKS: For additional discussion and analysis of the attorney work product doctrine and accrual work papers, see

- Lexis Explanation IRC Sec. 7602(a);
- LexisNexis Tax Advisor -- Federal Topical 5B:7.02;
- LexisNexis Tax Advisor -- Federal Topical 5B:11.03

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article, "Only a Name? Trademark Royalties, Nexus and Taxing That Which Enriches" was published in the 2007 issue of the Akron Tax Journal.

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Exclusion for Sale of Qualified Small Business Stock Increased

2009 Emerging Issues 4194

Exclusion for Sale of Qualified Small Business Stock Increased

By Philip Fink

August 31, 2009

SUMMARY: A new law encourages individuals to make investments in corporations, by allowing them to temporarily exclude a greater amount of the gain on the sale of qualified small business stock than they normally could, thereby further reducing the effective tax rate on the gain on the sale of such stock.

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ARTICLE: The Percentage Exclusion for the Sale of Qualified Small Business Stock Increased to 75%, for Stock Acquired Before 2011

IRC Section 1202(a)(3) was added by the *American Recovery and Reinvestment Act of 2009* (the Act). It encourages individuals to make investments in corporations by allowing them to temporarily exclude a greater amount of the gain on the sale of qualified small business stock than they normally could under prior Section 1202, thereby further reducing the effective tax rate on the gain on the sale of such stock.

The amount of the exclusion: Prior to the Act, the exclusion was generally 50% of the amount of the gain. The Act increases the percentage exclusion to 75% for stock issued after February 17, 2009 and before January 1, 2011.

Example 1: Janet acquires stock from the National Corporation on March 10, 2009 for \$100,000. The stock is qualified small business stock. She sells it for \$200,000 on March 10, 2019. She can exclude \$75,000 $[(\$200,000 - \$100,000) \times 75\%]$. Thus, she has to report only a gain of \$25,000 $(\$100,000 - \$75,000)$.

Caveat: Under the law prior to the Act, the exclusion was 60% of the realized gain from the sale of stock of a corporation in certain empowerment zones. The exclusion for the issuance of stock of a corporation in those certain empowerment zones after December 31, 2010 will be 60%

What is qualified business stock? In general, the stock of a corporation is considered to be qualified small business stock if it is a domestic corporation with assets under \$50 million. In addition, the stock has to be held for a period of more than five years. As long as an individual makes a contribution to such a corporation when its assets are less than \$50 million, the stock continues to qualify for the special treatment even if the assets exceed \$50 million at a

later time. However, those individuals who make contributions to the corporation once its assets have exceeded \$50 million are not entitled to the special treatment. If an individual purchased a block of stock at a time when the stock qualified for the special treatment and purchased another block at a subsequent time when it no longer qualified, the first block purchased would still be entitled to the special treatment even though the second block would not.

Example 2: Steve purchased stock from the United Corporation for \$50,000 on June 19, 2009. At that time the stock is qualified small business stock. On April 23, 2010, he purchased another block of stock from the United Corporation for \$50,000. However, as of April 23, 2010, its assets were in excess of \$50 million, so the second block of stock does not qualify for the special treatment. On January 11, 2017, Steve sells each block of stock for \$120,000. He can exclude \$52,500 $[(\$120,000 - \$50,000) \times 75\%]$ of the gain on the stock purchased on June 19, 2009. Accordingly, he only has to report a gain of \$17,500 $(\$70,000 - \$52,500)$. However, he must report the entire gain on the stock that he acquired on April 10, 2010. It should be noted that the block of stock that Steve acquired on April 10, 2010, would be treated as a long term capital gain. Thus, it would be subject to the applicable long term capital gain tax rate at the time it was sold.

Tax rate on qualified small business stock: The tax rate on the sale of qualified small business stock is 28%.

Example 3: In example 2, Steve will report a gain of \$17,500 on the block of stock that he purchased on June 19, 2009. Thus, the tax applicable to the gain on that block of stock will be \$4,900 $(\$17,500 \times .28)$. The effective tax rate is just 7% $[(100\% - 75\%) \times 28\%]$.

Example 4: In example 2, Steve will report a gain of \$70,000 on the block of stock that he purchased on April 23, 2010. It will be treated as a long-term capital gain. If the long-term capital gain tax rates are no different than they are currently, the tax applicable to the gain on that block of stock will be \$10,500 $(\$70,000 \times 15\%)$.

Limitation: The amount of the exclusion is subject to a limitation of the greater of \$10 million or ten times the adjusted basis of the stock.

Example 5: Helen founded the Seagate Corp. on June 3, 2009 by making a capital contribution of \$3,000,000. The stock of Seagate is considered to be qualified small business stock. She sold the stock on August 2, 2015 for \$75 million. Her realized gain is \$72 million (\$75 million less \$3 million). Of this amount, she can only exclude \$30 million (ten times her adjusted basis in the stock). Thus, her recognized gain is \$42 million (\$72 million less \$30 million).

Relation to IRC Section 1244: IRC Section 1244 allows individuals to deduct up to \$50,000 (\$100,000 on a joint return) on the sale of stock of a corporation as an ordinary loss rather than a capital loss if it is a small business corporation. In general, a small business corporation is one that has assets less than \$1 million.

Caveat: If an individual or a group of individuals form a new corporation with assets less than \$1 million, there is a win-win situation. That is, if the corporation is successful and a shareholder sells his or her stock for a gain, up to 75% of the gain can be excluded. On the other hand, if the stock is subsequently sold for a loss, up to \$50,000 (\$100,000 on a joint return) can be deducted as an ordinary loss.

State income taxes: Many states do not allow the exclusion. Thus, an adjustment on the state income tax return may be required.

Impact on estate planning: Although this exclusion is very beneficial from an income tax standpoint, its use may be detrimental from an estate planning standpoint. Three estate tax provisions contain minimum ownership requirements for an estate to take advantage of tax saving planning strategies:

1. *IRC Section 2032A*, actual use valuation.
2. *IRC Section 2033A*, family-owned business exclusion.
3. *IRC Section 6166*, extension of time to pay estate tax.

If an individual sells qualified small business stock, his or her estate may not be able to take advantage of these generous estate tax provisions.

Recordkeeping: Taxpayers and/or their tax advisers should have sufficient records to be able to substantiate that the stock that they sell is qualified small business stock. From a practical standpoint, if they have a copy of the corporation's balance sheet at about the time that the stock was issued to them, that should be sufficient.

RELATED LINKS: ; Image1

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Making the Most of the 2008 Small Business Net Operating Loss Carryback

2009 Emerging Issues 4116

Making the Most of the 2008 Small Business Net Operating Loss Carryback

By Philip Fink

August 14, 2009

SUMMARY: The American Recovery and Reinvestment Act of 2009 temporarily increased the carryback period for net operating losses of certain small businesses. Although this is a temporary tax benefit, it may be extended if Washington feels that the challenging economic environment is continuing in 2009. The Act allows only eligible small businesses to elect to carry back an NOL for a 3-, 4-, or 5-year period for an applicable 2008 NOL.

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ARTICLE: Making the Most of the 2008 Small Business Net Operating Loss Carryback

The American Recovery and Reinvestment Act of 2009 (the Act) added *IRC §172(b)(1)(H)(i)* which temporarily increases the carryback period for net operating losses (NOLs). Only C corporations and individuals are permitted an NOL deduction, since losses of partnerships and S corporations pass through to their owners. This provision will give partial relief from the recession in 2008. Although this is a temporary tax benefit, it may be extended if Washington feels that the challenging economic environment is continuing in 2009.

Existing law: Prior to the Act, an NOL could generally be carried back 2 years and carried forward 20 years to offset taxable income in those years. If a taxpayer so elects, it can carry forward the loss rather than carrying it back.

New law for 2008 NOLs of small businesses: The Act allows only eligible small businesses to elect to carry back an NOL for a 3-, 4-, or 5-year period for an applicable 2008 NOL. This extended carryback period increases the chances that the loss can offset taxable income from a wider time frame assuring that a greater part (or, perhaps all) of the NOL from the applicable 2008 year will reduce taxable income in the carryback period, and produce an immediate refund, rather than carrying it forward and diminishing the present value of the tax benefit of the NOL carryforward.

Tax planning: In general, a corporation is better off carrying an NOL back rather than forward, since that increases the present value of the tax benefit of an NOL. However, if it is predicted that the corporation's future tax rate will be greater than the rates over the past five years, the corporation should consider carrying the NOL forward. Realistically, a corporation will have no idea what its future tax rate will be, so from a practical standpoint, a carryback will be made.

This way, it can get an immediate infusion of cash. Moreover, if it just incurred an NOL, it might be in dire need of cash that will result from a carryback.

What is an eligible small business?: An eligible small business is generally a C corporation that has average annual gross receipts for the 3-taxable year period ending with the year prior to the year of the NOL of \$15 million or less.

Example: The Moore Corp. had an NOL of \$500,000 for its 2008 tax year. Its gross receipts for the prior three years were: \$8 million in 2005, \$10 million in 2006, and \$24 million in 2007. Its average annual gross receipts is \$14 million $[(\$8 + \$10 + \$24)/3]$. Accordingly, Moore is an eligible small business.

Caveat: Gross receipts are *all* income whether or not they are included in gross income. Thus, if a C corporation received \$1 million as a result of life insurance proceeds on the life of one of its executives, the \$1 million is included in its gross receipts even though it would *not* be considered to be gross income.

What is an applicable 2008 NOL?: This is a taxpayer's NOL for any taxable year ending in 2008, or if elected, the NOL for any taxable year beginning in 2008.

Example: The Baker Corp. has an NOL of \$100,000 for its fiscal year ending on June 30, 2008. It is an eligible small business. Therefore it can elect to carry back its loss to its tax year ending in any of the previous five taxable years.

Tax planning: The Act allows a fiscal year corporation to elect to treat a tax year beginning in 2008 to include its applicable 2008 NOL rather than a year ending in 2008. Thus, if a corporation reported taxable income for its fiscal year ending in 2008, but reports an NOL for its fiscal beginning in 2008, it would want to elect the 5-year carryback if the fifth prior year had a greater amount of taxable income than the second prior year.

Example: The United Corp. has a fiscal year ending June 30. It had the following amounts of taxable income or loss for the following years:

June 30, 2003

June 30, 2004

June 30, 2005

June 30, 2006

June 30, 2007

June 30, 2008

June 30, 2009

\$80,000

\$320,000

\$45,000

\$70,000

\$50,000

\$20,000

\$(30,000)

United can elect to use its fiscal year beginning in 2008 (ie., July 1, 2008 June 30, 2009) as its applicable 2008 NOL. By doing so, it can elect to carry back its \$30,000 loss to its tax year ending June 30, 2004, when it was in the 39% tax bracket. If it were not for the election, it would either have to carry it back two years or carry it forward. If it carries its loss back two years to its year ending June 30, 2007, it will reduce its income only in the 15% tax bracket, rather than the reduction in its fiscal year ending June 30, 2004 when it was in the 39% tax bracket. If it carries the loss forward, it will probably be in a lower tax bracket than it was in 2004, and it will lose the present value of the tax benefits by carrying the loss forward.

Impact to state income taxes: Most states will most likely not allow the election to make a carryback of the NOL in a manner similar to federal law. Accordingly, each state's tax laws should be analyzed with respect to a carryback.

Will this temporary provision be extended?: Although the Act makes the election of the carry back a temporary provision, depending on the rate of recovery from the recession of 2008/2009, Washington may decide to extend this provision for one year or more.

RELATED LINKS: For more information, see

- LexisNexis Tax Advisor -- Federal Topical § 1D:15.03

and

- 1-10 Tax Planning for Corporations and Shareholders § 10.02

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Effectively Applying the Depreciation Mid-Quarter Convention

2009 Emerging Issues 4110

Effectively Applying the Depreciation Mid-Quarter Convention

By Philip Fink

August 11, 2009

SUMMARY: Taxpayers may claim a half-year of depreciation in the year of a property's acquisition and also in the year of disposition. However, if certain conditions are met, taxpayers must use the mid-quarter convention in the year of acquisition and the year of disposition. The mid-quarter convention prevents taxpayers who place a substantial amount of personal property in service at the end of the year from taking a half year's depreciation.

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ARTICLE: Effectively Applying the Depreciation Mid-Quarter Convention

Generally, under MACRS, taxpayers are allowed to claim a half-year of depreciation in the year of a property's acquisition and also in the year of disposition. However, if certain conditions are met, then taxpayers are required to use the mid-quarter convention in the year of acquisition and the year of disposition. The purpose of the mid-quarter convention is to prevent taxpayers who place a substantial amount of personal property in service toward the end of the year from taking a half year's worth of depreciation. See *IRC Section 168(d)(3)*.

When does the mid-quarter convention apply?: The mid-quarter convention applies when more than 40% of the aggregate bases of all property in the personal property recovery classes is placed in service during the final quarter of the taxable year.

Example 1: Universal, Inc is a calendar year taxpayer. During the current taxable year, it placed in service the following assets:

February 5

April 22

July 22

November 2

computer equipment

factory equipment

furniture

factory equipment

\$120,000

300,000

180,000

500,000

In this example, the mid-quarter convention applies since the factory equipment placed in service in the fourth quarter is equal to 45.5% ($\$500,000/\$1,100,000$) of all the personal property placed in service during the taxable year.

Caveat: The convention does not pertain to real estate, or take into account real estate that is placed in service during the course of the year.

Example 2: Assume the same facts as in example 1, except that the factory equipment placed in service on November 2, is a warehouse. Since a warehouse is real estate, then there is no personal property placed in service in the fourth quarter of the year; thus, the mid-quarter convention does not apply.

Applicable depreciation rates: The depreciation rates for the mid-quarter convention are in *Revenue Procedure 87-57, 1987-2 C.B. 687*. Below is an abbreviated table for the depreciation rates used when the mid-quarter convention applies for the first three years for the acquisition of factory equipment (seven-year recovery class).

Recovery

Year

1

2

3

First

Quarter

25.00%

21.43%

15.31%

Second

Quarter

17.85%

23.47%

16.76%

Third

Quarter

10.71%

25.51%

18.22%

Fourth

Quarter

3.57%

27.55%

19.68%

Example 3: The American Corp. is a calendar year taxpayer. It placed in service \$500,000 of factory equipment on September 5 of the current year and \$1 million of factory equipment on October 17 of the current year. Since 67% (\$1,000,000/\$1,500,000) of the personal property that it placed in service in the current taxable year was placed in service during the fourth quarter, it must use the mid-quarter convention. Thus, its depreciation for its two acquisitions for the current taxable year is:

Date

Acquired

Sept 5

October 17

\$500,000 x 10.71%

\$1,000,000 x 3.57%

= \$53,550

= 35,700

\$89,250

Impact to the expensing election and additional first year depreciation: Regardless of when personal property is placed in service, the full amount of the expensing election and the additional first year depreciation can be taken for eligible property.

Example 4: The Acme Corp. is a calendar year taxpayer. It acquired \$500,000 of new factory equipment in the final quarter of 2009. This was the only acquisition of personal property it made during the course of 2009. It is entitled to take the full amount of the expensing election and the full amount of the additional first year depreciation despite the fact that all of the factory equipment was acquired in the last quarter of 2009. Its total cost recovery deduction for 2009 is \$379,463:

Expensing election

Additional first year depreciation

$(\$500,000 - \$250,000) \times 50\%$

MACRS depreciation using the mid-quarter convention

$(\$500,000 - \$250,000 - \$125,000) \times 3.57\%$

\$250,000

125,000

4,463

\$379,463

Tax planning opportunities: If a taxpayer has acquired personal property throughout the year, but is required to use the mid-quarter convention, it should elect to use the expensing election for the personal property that it acquired in the fourth quarter. Such an election allows a taxpayer to achieve the best of both worlds: getting an immediate deduction for the personal property that it acquired in the fourth quarter plus being able to take advantage of the larger MACRS deduction for acquisitions in the earlier part of the year.

Example 5: The Simmons Corp. is a calendar year taxpayer. It placed in service \$250,000 of factory machinery on February 9, 2009. In addition, it placed in service \$250,000 of factory machinery on November 28, 2009. Since more than 40% of the personal property that it placed in service during the year was in the fourth quarter, it is required to use the mid-quarter convention. However, it can elect to use the expensing election on the factory equipment that it placed in service on November 28. By doing so, it can write off the entire cost of that property in 2009 rather than just 3.57%. Furthermore, under the mid-quarter convention, it can write off 25% of the cost of the factory equipment that it acquired in the first quarter. This is a win-win situation since not only can it write off the entire cost of the equipment that it acquired during the fourth quarter of 2009, but also it can write off 25% of the cost of the equipment that it placed in service in the first quarter whereas under the half-year convention, it can only write off 14.79% in the year of acquisition.

Application to dispositions: If personal property is acquired in a year when the mid-quarter convention applies, then when such equipment is disposed of, depreciation is allowed up to the mid-point of the quarter in which it is disposed.

Example 6: The Lester Corp. is a calendar year corporation. In 2007, it acquired factory machinery for \$50,000 in

the fourth quarter. It was required to use the mid-quarter convention for all of that personal property. It sells the asset on July 28, 2009. Its MACRS deduction for 2009 on the factory machinery is \$6,150 ($\$50,000 \times .1968 \times 2.5/4$).

Application to a consolidated group: A special rule applies to a consolidated group. That is, to determine whether the mid-quarter convention applies to personal property placed in service by members of a consolidated group during a consolidated return year, the depreciable bases of all such property acquired by all the companies in the group are counted in applying the 40% test.

Example 7: ABC Corp. and DEF Corp. are in an affiliated group. They file a consolidated tax return on a calendar year basis. Their acquisitions of personal property for the current taxable year are as follows:

Quarter

1

2

3

4

ABC Corp.

\$100,000

15,000

35,000

20,000

DEF Corp.

\$10,000

20,000

15,000

300,000

Since the group placed in service 62% ($\$320,000/\$515,000$) of its personal property in the fourth quarter, it must use the mid-quarter convention in preparing its consolidated tax return.

State income tax adjustment: Many states do not recognize the mid-quarter convention, so an adjustment may be required to be made in certain states.

RELATED LINKS: For more information, see

- 1-2 Depreciation Handbook 2.syn

and

- LexisNexis Tax Advisor -- Federal Topical § 1D:7.07

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Shareholder Retained Beneficial Interest Despite Being Ousted from Management

2009 Emerging Issues 4063

Shareholder Retained Taxable Beneficial Interest Despite Being Ousted from Management

By Howard Godfrey

July 28, 2009

SUMMARY: An owner of record of S corporation stock may hold the stock for the benefit of another, such as a nominee or passthrough entity. In that case, income, losses, and credits of the S corporation are passed through to the beneficial owner, not the record owner. A taxpayer is the beneficial owner if the taxpayer controls the property or has economic benefit of ownership of the property. Disputes often arise regarding who is a beneficial owner.

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ARTICLE: Shareholder Retained Taxable Beneficial Interest Despite Being Ousted from Management

Generally, income, losses, deductions, and credits of an S corporation pass through pro rata to shareholders on their individual income tax returns based on days of ownership, whether or not the income is distributed. *IRC Secs. 1363(a)* LK:NON: irc-file S1363(A) , 1366(a), 1366(c), 1377(a)(1). Ordinarily, the person who would be taxable on a dividend if the corporation were a C corporation is considered to be the shareholder of an S corporation. *26 CFR 1.1361-1*.

In many cases, a person may seek to qualify as a stockholder in order to claim deductions and credits of the corporation on the individual income tax return. In other cases an individual may seek to avoid reporting income from an S corporation by claiming that he or she does not own stock in the corporation.

Let's examine in detail *Hightower v. Commissioner, TC Memo 2005-274*.

The IRS determined deficiencies in Glenn Hightower's federal individual income tax of \$7,535,620 for 2000 and \$389,455 for 2001. Hightower unsuccessfully fought a forced buyout of his shares (under a stockholder buy/sell agreement) in California State courts from 2000 to 2003. Hightower had a stock basis of \$8,315,584. The selling price was \$47 million, subject to certain adjustment for dividends paid, etc. The tax controversy involved:

(1) the date on which he sold the stock, which established the year he should recognize the gain on the sale of stock, and

(2) the date on which Hightower gave up beneficial interest in the stock and was no longer required to report his allocable share of corporate income.

Buyout Provisions in Shareholder Agreement

Hightower owned 50 percent of the stock of Green Hills Software, Inc., which was an S corporation. The remainder of the stock was owned by Daniel O'Dowd. Hightower was chairman of the board and secretary, and O'Dowd was president and treasurer. They were Green Hills' only directors. They entered into a shareholders' agreement in 1992 which provided that any dispute between them would be resolved through binding arbitration. It also provided that either of them could compel a buyout of the stock held by the other at a price determined by a formula.

Glenn Hightower's Corporate Divorce

Relations between O'Dowd and Hightower deteriorated in 1997 and 1998. When Hightower went to Green Hills' headquarters on March 15, 1998, O'Dowd demanded that Hightower leave and threatened to call the police if petitioner refused. On March 25, 1998, O'Dowd notified Hightower that his access to the company was denied, that the locks had been changed, and that his employment and access to the computer system had been terminated.

Key Dates

1992. Adoption of buy/sell agreement (price based on formula) subject to binding arbitration.

March 25, 1998. Hightower's employment terminated, locks changed, etc.

June 26, 1998. O'Dowd triggered the buy/sell provision of the shareholder agreement by offering either to sell his shares to Hightower for \$47 million or to buy Hightower's shares for \$47 million.

December 1, 1999. The arbitrator issued a proposed interim award finding that O'Dowd had not acted improperly in his attempt to buy Hightower's shares.

September 24, 1998. The arbitrator established September 24, 1998 as the effective date of the sale of the stock, which would be used in computing amount to be received later at settlement.

March 8, 2000. The arbitrator issued a partial final award. O'Dowd's actions were consistent with the buyout provision of the shareholders' agreement. O'Dowd had the right to pay \$47 million for the shares by **September 24, 1998**, which was 90 days after O'Dowd invoked the buyout provision of the shareholder agreement. Purchase price would be reduced by dividends and salary (net after payment of taxes) paid to Hightower for the period after September 24, until O'Dowd completed the purchase of petitioner's stock, Hightower would receive all dividends in accordance with the shareholders' agreement, and such payments would offset the purchase price for the shares.

October, 2000. An accountant estimated the adjusted total purchase price for petitioner's shares to be \$42,862,230.95 as of October 15, 2000.

October 13, 2000. O'Dowd delivered checks in the amounts of \$32,585,388 and \$9 million as payment for petitioner's shares in Green Hills. Both checks were dated October 13, 2000. O'Dowd drafted a receipt for the checks that read in pertinent part:

Receipt of ... [checks] aggregating \$41,585,388 as payment for all of the shares of Glenn Hightower in Green Hills Software, Inc. is hereby acknowledged.

October 13, 2000. Hightower crossed out the phrase as payment for all of the shares of Glenn Hightower in Green Hills Software, Inc., signed the receipt and deposited the checks in an interest-bearing bank account that he had opened in his own name solely to hold the funds.

October 13, 2000. In a letter to O'Dowd dated October 13, 2000, Hightower's attorney stated: (a) Hightower would tender his shares of Green Hills to O'Dowd, as required by the arbitrator's award under protest, and without waiver of any rights or remedies; (b) the shares were to be held in trust; and (c) Hightower was not entitled to the checks.

Hightower delivered his stock to O'Dowd on October 13, 2000, but did not endorse the shares.

August 29, 2001. Final award in the arbitration proceedings: (1) O'Dowd's purchase of Green Hills stock for \$41,585,388 was effective on October 13, 2000; (2) the payment belonged to Hightower without restriction; (3) Hightower's acceptance of the payment on October 13, 2000, terminated his interest in Green Hills; (4) Hightower was entitled to an additional \$52,783 (to correct an earlier computational error); (5) O'Dowd was entitled to \$604,105.30 for attorney's fees, costs, and expenses; and (6) the net amount Hightower owed O'Dowd was \$551,322.30.

Offer under Buy/Sell Agreement

On June 26, 1998, O'Dowd triggered the buy/sell provision by offering either to sell his shares to Hightower for \$47 million or to buy Hightower's shares for \$47 million. Hightower did not want to sell his stock. Instead, he wanted to exercise his right under the shareholder's agreement to buy O'Dowd's stock for the amount O'Dowd had offered for his stock (\$47 million). However, Hightower could not obtain financing. O'Dowd compelled a buyout of Hightower's stock.

Hightower opposed the buyout in binding arbitration proceedings. On December 1, 1999, the arbitrator issued a proposed interim award finding that O'Dowd had not acted improperly in his attempt to buy petitioner's shares.

Hightower's Stock Basis and Share of Corporate Income

On December 31, 1999, Hightower had a basis in the stock of \$8,315,584. The corporation allocated income of \$4,275,909 to Hightower as his distributive share of income through October 13, 2000.

Hightower was the record owner of his shares until October 13, 2000. He retained the right to vote his stock and to receive dividends until that date. He received dividends in 1998 and 1999, no dividends in 2000, and a salary of \$13,822 in 1998, \$51,381 in 1999, and \$16,666 in 2000.

Decision Regarding Date of Sale

Hightower contended that he did not receive a payment from O'Dowd in 2000 because he held O'Dowd's payment in trust in a segregated account. He asserted that there was no sale in 2000 because of the claim of right doctrine (i.e., income is received if there is a receipt of income under a claim of right and without restriction as to its disposition). The court noted that Hightower received the funds and deposited them in an account he had opened in his name. There is no evidence that he held the funds in trust.

Hightower also argued that the funds were not income until the litigation was final and that the sale was incomplete because he tendered his shares without endorsing the certificates. However, the arbitrator found in the partial final award in 2000, which the California courts later affirmed, that Hightower's stock was purchased in 2000. The Tax Court concluded that petitioner received payment for his stock in 2000 when he received the checks.

The stock payment Hightower received for his share of Green Hills was taxable income in 2000 because it was received without restriction as to its disposition and because Hightower had no fixed legal obligation to restore the funds to any other party.

The court provided a description of certain factors that might support the position that Hightower had lost beneficial interest before the sale date and noted that those factors did not support Hightower's position.

1. Fixed legal obligation to restore the funds. The stock payment Hightower received for his share of Green Hills was taxable income in 2000 because it was received without restriction as to its disposition and because Hightower had no fixed legal obligation to restore the funds to any other party. See *North American Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932).

2. Possibility of sale being voided. The possibility that the stock transaction could have later been undone by a California court does not alter the analysis. See *Healy v. Comm'r*, 345 U.S. 278, 284 (1953).

3. Terms of Sale Result in Violation of State Law. Hightower's contention that the transaction may have left Green Hills with a negative net worth in violation of state law was irrelevant. See *Wentworth v. Comm'r*, 510 F.2d 883, 886 (6th Cir. 1975) (The liability of closely held corporations and their shareholders for federal taxes should not be made to depend upon their compliance with state laws. *James v. United States*, 366 U.S. 213, 219-20 (1961)).

4. Dominion over the funds. Hightower's unilateral intent not to claim and exercise dominion over the funds does not affect his tax liability. See *Comm'r v. Alamitos Land Co.*, 112 F.2d 648, 651 (9th Cir. 1940).

Hightower Position on Flow-through of Corporate Income

The corporation reported \$4,275,909 as Hightower's distributive share of income through October 13, 2000. On his 2000 return, did not include a distributive share of income from the corporation. Hightower took the position that he was not the beneficial owner of the corporate stock in 2000, and no corporate income passed through to him, because beginning before 2000 O'Dowd improperly excluded him from the benefits of ownership of that stock

Decision Regarding Flow-Through of Earnings

An owner of record of S corporation stock may actually be holding the stock for the benefit of another, such as a nominee, agent, or passthrough entity. In that case, income, losses, deductions, and credits of the corporation are passed through to the beneficial owner of the stock, not to the record owner. CFR 1.1361-1(e). LK:NON: eft-all S1.1361-1(E) A taxpayer is the beneficial owner of property if the taxpayer controls the property or has the economic benefit of ownership of the property. The court found no reason to conclude that the bad relationship between Hightower and the other shareholder caused Hightower to lose his beneficial ownership, prior to the time that the sale took place.

Hightower was required to report the pass-through distributive share of Green Hills's income allocated to him in 2000. Even though Hightower's role in Green Hills management may have been restricted, he still retained beneficial ownership of his shares through the October 13, 2000 sale date. Contrary to Hightower's assertions, the arbitration award did not have the effect of divesting him of beneficial ownership of his Green Hills shares in 1998. Rather, it merely gave O'Dowd the financial benefit of the bargain retroactively once the sale took place in 2000.

The Tax Court noted that courts have frequently considered whether an individual is a beneficial owner of the stock of an S corporation in deciding whether that person will be treated as a shareholder of that corporation for tax purposes. However, in none of those cases was the profit of an S corporation not passed through to one of its shareholders because of a poor relationship between the shareholders. The Tax Court concluded that the beneficial ownership test did not relieve Hightower from passthrough of Green Hills profits.

Recommendations.

As in Hightower, when several steps are involved in buying or selling S corporation stock, it is especially important to determine the date of sale. This is crucial in order to help determine who can claim deductions or credits, who is ultimately liable for any income tax, and how capital gain treatment will be applied. In some cases, there may be a special arrangement regarding benefits to be enjoyed from ownership of S corporation stock. Each of these situations presents a need for the taxpayer to determine if and when the benefits of ownership have been transferred from one person to another. Clearly, care should be exercised to determine the facts of the situation, and apply the law to those facts.

A hypothetical case will help clarify why it is necessary to determine the date of sale. Seller, an individual, owns all of the stock of an S corporation that has a basis of \$200,000 on January 1, 2010. Seller has owned the stock for 5 years. Seller agrees to sell the stock for \$350,000. Seller will receive \$350,000 in cash on January 1, 2010, if the sale is

effective on that date. If the sale is effective at the end of 2010, seller will receive \$350,000, less any dividends paid to seller in 2010. During 2010, the corporation has taxable income of \$100,000 and pays a dividend of \$20,000 in 2010.

Effective Date of Sale

Jan. 1, 2010

Dec. 31, 2010

Seller's basis of Stock on January 1, 2010.

IRC Sec. 1016(a)(17)

\$200,000

\$200,000

Taxable income flow-through Increase in basis

IRC Sec. 1366, 1367

\$100,000

Dividend paid to seller Reduce basis in stock

IRC Sec. 1367(a)(2)(A)

--\$20,000

Seller's basis of Stock on December 31, 2010

IRC Sec. 1016(a)(17)

\$200,000

\$280,000

Selling Price

IRC Sec. 1001

\$350,000

\$350,000

Adjustment for dividends paid to seller

Agreement

--\$20,000

Adjusted Selling Price

Agreement

\$350,000

\$330,000

Basis of stock on date of sale (above)

IRC Sec. 1016(a)(17)

\$200,000

\$280,000

Gain on Sale Capital Gain

IRC Sec. 1221, 1(h)

\$150,000

\$50,000

Flow-through of income Ordinary Income

IRC Sec. 1366

\$100,000

Total income Recognized

IRC Sec. 1001

\$150,000

\$150,000

In this hypothetical case, Seller will receive cash of \$350,000 whether the sale is effective on January 1 or December 31. However, if the sale is effective on January 1, the seller will have a long-term capital gain of \$150,000, all taxable at a maximum rate of 15%. If the sale is effective December 31, there will be ordinary income of \$100,000 taxable at rates up to 35%. There is a potential for an increase in income tax of 20% of \$100,000, or \$20,000. This means that once the decision has been made to sell the stock under terms like those described above, the seller has an incentive to close the sale promptly, in order to maximize the part of the gain treated as long-term capital gain. It should also be noted that the special top tax rate of 15% for many long-term capital gains is set to expire at the end of 2010.

RELATED LINKS: For more information, see

- 2-13 Tax Planning for S Corporations § 13.02

For more information, see

- LexisNexis Tax Advisor -- Federal Topical § 2B:3.07

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Corporations Must File Form 2553 to Elect S Status and Avoid Problems

2009 Emerging Issues 4044

Corporations Must File Form 2553 to Elect S Status and Avoid Problems

By Howard Godfrey

July 23, 2009

SUMMARY: An election to be treated as an S corporation is made by preparing, signing and filing Form 2553. Controversy often arises regarding whether Form 2553 was prepared properly and timely filed.

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ARTICLE: Business owners often choose to operate a new corporation as an S corporation when operating losses are expected in the first few years. IRC Section 1363 provides that an S corporation generally is not required to pay income taxes. IRC Section 1364 requires shareholders of an electing S corporation to report their shares of corporate income or loss items on their personal income tax returns.

An election to be treated as an S corporation is made by preparing, signing and filing Form 2553. IRC Section 1362 provides that all shareholders must consent to the election of S status.

Controversy often arises regarding whether Form 2553 was prepared properly and timely filed.

Dansby Case -- TC Memo 2009-70

Robert Dansby organized a new corporation called Edgenics, Inc. He owned 97% of the stock of the company. The court record showed that Dansby instructed his attorney to organize Edgenics, Inc. as a C corporation in Delaware. The incorporation was effective on June 2, 2000. Edgenics incurred substantial losses. Form 1120 was filed for Edgenics for two years.

An IRS audit of Dansby's personal income tax return resulted in a substantial increase in taxable income, caused by distribution of over \$300,000 received from an IRA, but not initially reported on his return. Dansby then claimed that Edgenics was an S corporation and he should be able to claim the corporate losses on his personal income tax return. Dansby claimed that he had filed Form 1120 (rather than Form 1120S for an S corporation) because he had never received a notice from the IRS indicating that the application for S status had been approved.

The burden of proof is on the taxpayer. In court, Dansby was unable to prove that Edgenics had filed a Form 2553 with the IRS to apply for S corporation status or that the IRS ever received or processed a Form 2553 on behalf of Edgenics. This meant that Dansby would not be allowed to deduct the corporate losses on his personal return.

Filing Form SS-4

A new corporation must file Form SS-4 to obtain an Employer Identification Number. When filing this form, it is necessary to identify the income tax form that will be filed by the corporation, either Form 1120 for a C corporation or Form 1120S for an S corporation. The instructions for Form SS-4 state: "If you entered "1120S" after the "Corporation" checkbox, the corporation must file Form 2553 no later than the 15th day of the 3rd month of the tax year the election is to take effect. Until Form 2553 has been received and approved, you will be considered a Form 1120 filer." Form SS-4, which was filed for Edgenics, indicated that it was a "regular C corporation".

Filing Form 2553

IRC Section 1362(a)(1) provides that a small business corporation may elect to be an S corporation, in accordance with the provisions of IRC Section 1362. IRC Section 1362(b)(1) provides that a small business corporation may make an election to be an S corporation for any taxable year (A) at any time during the preceding taxable year, or (B) at any time during the taxable year and on or before the 15th day of the 3rd month of the taxable year.

For example, if a calendar-year small business corporation makes an S election on or before March 15, 2010, the election will be effective for 2010, and beyond. However, if the corporation files the election later in 2010 (or in the first 2-1/2 months of 2011), it will be effective for 2011.

Regulation Section 26 CFR 1.1362-6(a)(2) provides that a small business corporation makes an election to be an S corporation by filing a completed Form 2553.

Small Business Corporation

IRC Section 1361(a) defines a "small business corporation" as a corporation having no more than 100 shareholders, and only one class of stock. A small business corporation must meet stock ownership requirements such as: (1) no nonresident alien stockholder and (2) no corporation or partnership as a stockholder. Insurance companies and financial institutions are not eligible. It is important to note that IRC Section 1244 provides special loss limits for sale or worthlessness of corporate stock in a small business corporation, as defined in IRC Section 1244. A corporation meeting the IRC Section 1244 definition of a small business corporation may not be a small business corporation under IRC Section 1361.

Damage Control.

When a corporation discovers that it has failed to properly file Form 2553, this may not be the end of the story. IRC Section 1362(b)(5) authorizes the IRS to treat late elections as if they had been timely filed, where there is reasonable cause for the late filing.

Two options for obtaining relief should be considered where a company has failed to file Form 2553.

Option 1.

One option is to seek a letter ruling from the IRS, granting permission to file Form 2553 late. As noted earlier, if an S election is made within the first two and one-half months of a corporation's taxable year, the corporation generally will be treated as an S corporation for the year in which the election is made. (IRC Section 1362(b))

If an election is filed late, or if no such election is filed, the company may be able to prove to the IRS that there was reasonable cause for the failure to timely file the election. In that case, the IRS may overlook the error and treat the company as having timely filed the election.

In Letter Ruling 200919026 the IRS concluded that there was reasonable cause for failing to make a timely election. The IRS ruled that the company would be treated as having timely filed an election provided it made an

election to be an S corporation by filing a completed Form 2533 with the appropriate service center within 60 days following the date of the letter ruling, and attaching a copy of the letter ruling to Form 2553.

Option 2.

Another option may be available under *Rev. Proc. 2007-62* when a company discovers that Form 2553 has not been filed. The relief is available only if the corporation intended to elect S status, but failed to qualify for that status only because of its failure to file a timely Form 2553. Furthermore, the corporation must not have filed an income tax return for the intended election year.

Instead of requesting a letter ruling, a company can file a Form 2553, Election by a Small Business Corporation, and a Form 1120S, U.S. Income Tax Return for an S Corporation, for the first tax year the entity intended to be an S corporation. However, this relief is available only if the forms are filed no later than six months, excluding extensions, after the tax return due date.

The completed Form 2553 must include a statement explaining the reason the entity failed to timely file the election. (*Rev. Proc. 2007-62*). An advantage of using the procedure under *Rev. Proc. 2007-62* is that there is no user fee to be paid by the taxpayer, which is required with a letter ruling request.

Possibly More Important Than You Think.

Getting retroactive approval of S status can eliminate an intervening C corporation year.

Assume a corporation is organized on January 1, 2010, operates profitably in 2010, and obtains approval of S status for 2011. The delay in getting S status has a number of possible disadvantages.

First, the corporation will have a tax liability for 2010, which is a C year.

Second, any appreciation in assets held on January 1, 2011, will be subject to the IRC Section 1374 built-in gains tax at the corporate level when the assets are later sold. The corporate tax liability on the gain will be computed at the highest corporate income tax rate. Shareholders will still report the flow-through of the gain on sale, less the corporate tax paid (IRC Section 1366(f)).

Third, if the after-tax profits (earnings and profits) from 2010 are not paid out, the S corporation will have accumulated earnings and profits, a condition that makes the corporation liable for the IRC Section 1375 income tax on excess passive income.

Fourth, if the S corporation has excess passive income and a balance in its earnings and profits account for three consecutive years, it will then lose its election, under IRC Section 1362(d)(3).

All of these potential problems can be avoided by a new corporation that makes sure it has S status starting on the first day of its first tax year.

Recommendations.

Give careful and timely consideration when making a decision about electing S status. If S status is chosen, carefully prepare Form 2553, providing all necessary information and signatures. File the form with the IRS, and obtain proof of filing. File the annual tax returns using Form 1120S. When a company determines that it has failed to effectively elect S status, consider the relief provisions available that will allow the company to retroactively obtain S status.

RELATED LINKS: For further information, please see
 ■ LexisNexis Tax Advisor -- Federal Topical § 2C:10.02

For further information, please see

- 2-10 Tax Planning for S Corporations § 10.02

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Converting a Partnership to an S Corporation Under Revenue Ruling 2009-15

2009 Emerging Issues 4027

Converting a Partnership to an S Corporation Under Revenue Ruling 2009-15

By Howard Godfrey

July 23, 2009

SUMMARY: Oftentimes, a partnership is converted to an S corporation. It is important to remember that S status is elected to avoid problems that come with having the corporation taxed as a C corporation. Therefore, it is important to avoid having an intervening C tax year between the last partnership tax year and the first S corporation tax year.

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ARTICLE: **Converting a Partnership to an S Corporation Under Revenue Ruling 2009-15**

If partners in a partnership prefer to operate their business as an S corporation, the following steps must be completed: (1) the partnership contributes all of its assets and liabilities to a newly formed corporation, (2) the partnership receives stock in the corporation, (3) the partnership distributes the stock to the partners, (4) the partnership is terminated, and (5) the new corporation elects S status. (Alternatively, the partners may contribute their partnership interests to the newly created corporation, and receive corporate stock in exchange. See Rev. Ru. 84-111.)

It is important to remember that S status is elected to avoid problems that come with having the corporation taxed as a C corporation. So it is important to avoid having an intervening C tax year between the last partnership tax year and the first S corporation tax year. Furthermore, an S corporation is not allowed to have a partnership or a corporation as a shareholder under IRC Sec. 1361(b). This means the corporation (that is seeking S status) should not be treated as having a partnership as a stockholder on any day.

To get the best results, it is important to have the newly created corporation organized, receive assets and liabilities of the partnership, and immediately elect S status, without an intervening C corporation tax year.

Under *Rev. Rul. 2009-15*, these steps are deemed to happen essentially instantaneously, in a manner that rules out unwanted consequences described below.

Fallout From C Tax Years.

If a new corporation operates as a C corporation for one or more years, before its S status becomes effective, the corporation may bear several burdens before and after election.

First, the corporation may incur a corporate income tax liability in the C year(s) under IRC Section 11(a).

Second, any appreciation in assets held on the date the S election becomes effective will be subject to the Section 1374 built-in gains tax at the corporate level when the assets are later sold. The corporate tax liability on the gain will be computed at the highest corporate income tax rate. Shareholders will still report the flow-through of the gain on sale, less the corporate tax paid (IRC Section 1366(f)).

Third, if the after-tax profits (earnings and profits) from C years are not paid out as dividends, the S corporation will have accumulated earnings and profits, a condition that makes an S corporation liable for the IRC Section 1375 income tax on excess net passive income, if it has such income.

Fourth, if the S corporation has excess passive income and a balance in its earnings and profits account for three consecutive years, it will then lose its election, under IRC Section 1362(d)(3).

These problems are avoided by an S corporation that has never been a C corporation.

Revenue Ruling 2009-15

Rev. Rul. 2009-15 provides guidance for partnerships that take either of two routes for obtaining S status. The first approach described here involves a partnership that elects to be treated as a corporation for federal tax purposes under 26 CFR 301.7701-3(a).

The second involves a conversion of a partnership into a corporation, under a state law formless conversion statute. The new corporation will be treated as a corporation for federal tax purposes, because 26 CFR 301.7701-2(b)(1) defines the term "corporation" to include "a business entity organized under a federal or state statute, ... if the statute describes or refers to the entity as incorporated or as a corporation,..."

In both cases, the problems described above can be avoided.

Option No. 1. Electing Corporate Status and S Status.

If a partnership elects to be classified as a corporation under 26 CFR 301.7701-3(c)(1)(i), the following is deemed to occur: the partnership contributes all of its assets and liabilities to the corporation in exchange for stock in the corporation, and immediately thereafter, the partnership liquidates by distributing the corporate stock to its partners.

The election to change the classification from partnership to corporation for federal tax purposes is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur as a result of a change in classification are treated as occurring immediately before the close of the day before the election is effective. (26 CFR 301.7701-3(g))

Example. An election is made to change the classification of an entity from a partnership to a corporation effective January 1, 2010. The deemed transactions (including the liquidation of the partnership) are treated as occurring immediately before the close of December 31, 2009 and must be reported by the owners of the entity on December 31, 2009. Thus, the last day of the partnership's taxable year will be December 31, 2009, and the first day of the corporation's taxable year will be January 1, 2010. The corporation will not be deemed to have a partnership as a shareholder at any time in its tax year beginning January 1, 2010. This means the corporation will be eligible to elect S

status effective the first day of its first tax year. In addition, there will not be an intervening short C taxable year. The corporation should file an election to be treated as an S corporation under IRC Section 1362(a) [Form 2553] on or before March 15, 2010, and the election will be effective from January 1, 2010.

Option No. 2. Conversion to Corporation under State Statute

A calendar-year partnership (or other entity that is treated as a partnership) may convert into a corporation under a state law formless conversion statute. As a result of the conversion, the entity is classified as a corporation for federal tax purposes.

Under *Rev. Rul. 2004-59*, an unincorporated entity classified as a partnership that converts to a corporation under a state law formless conversion statute will be treated in the same manner as one that makes an election to be classified as a corporation under 26 CFR 301.7701-3(c)(1)(i). Thus, the description presented above for the deemed transactions and their tax impact are equally applicable to a conversion into a corporation under a state law formless conversion statute.

Example. A calendar-year partnership (or other entity that is treated as a partnership) is organized on January 1, 2009. The partnership converts into a corporation under a state law formless conversion statute on January 1, 2010. On February 1, 2010, the corporation files an election to be treated as an S corporation under IRC Section 1362(a), effective January 1, 2010. There is no change in stock ownership during the period covering the events described here. The S election will be effective January 1, 2010.

Summary

In both cases, an entity that has been taxed as a partnership becomes a corporation for federal tax purposes. In both cases, the corporation is eligible to elect to be taxed as an S corporation effective for its first taxable year, and it will not be deemed to have an intervening short taxable year in which it was a C corporation.

Recommendation. When either of these options is chosen, take all necessary steps assure that S status is obtained for the first year in which the entity is a corporation under state law, or is treated as a corporation under the Internal Revenue Code. If there is a delay in electing S status, and there is a year or more of operations as a C corporation, the S corporation may have to deal with the built-in gains problem, the passive income tax problem, or both.

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For more information, please see

- 2-13 Tax Planning for S Corporations 13.01

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S Corporation One Class of Stock Requirement Clarified

2009 Emerging Issues 4020

S Corporation One Class of Stock Requirement Clarified

By Howard Godfrey

July 20, 2009

SUMMARY: An S corporation must be a small business corporation and have only one class of stock. If an S corporation issues a second class of stock, it ceases to be a small business corporation and S corporation status is terminated. A corporation that issues one class of stock may treat certain shareholders or creditors in a manner that causes it to be considered to have more than one class of stock. This can cause S corporation qualification problems.

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ARTICLE: S Corporation One Class of Stock Requirement Clarified

One Class of Stock.

An S corporation must be a small business corporation, which must have only one class of stock. If an S corporation issues a second class of stock, it ceases to meet the definition of a small business corporation, and its S corporation status is automatically terminated. A corporation that has issued only one class of stock, may treat certain shareholders or creditors in a manner that causes it to be considered to have more than one class of stock.

The one-class-of-stock rule prevents the corporation from having complexity associated with allocating earnings to multiple classes of owners.

As a general rule, a corporation has only one class of stock if all outstanding shares of stock of the corporation provide identical rights to stockholders regarding distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation do not indicate that there is more than one class of stock.

A corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.

A determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and any binding agreements relating to distribution and liquidation proceeds.

Linda K. Minton Case.

Minton raised the second-class-of-stock issue in a 2007 court case. Her parents had started a janitorial and paper-supply company that elected S status. As her parents aged, Linda and her brother took control of the company, each owning 50% of the stock. The corporation retained most of its earnings, but did distribute enough dividends to enable shareholders to pay their personal income tax on their shares of corporate income. Then, the corporation stopped making the tax-payment dividends, leaving Linda with a substantial income tax liability and no corporate distributions to cover the liability. Linda believed this was part of the efforts of her father and brother to squeeze her out of the business.

Linda took an unusual position for a stockholder -- that the S election had been lost, and the tax on corporate earnings should be imposed on the corporation rather than on the shareholders. She took the position that certain extra payments made to her parents from the S corporation indicated that her parents had preference as to dividends. Such a preference would mean there was a second class of stock. If Linda could support that argument, the S election had been lost, and Linda would not owe income taxes on her share of the corporate taxable income.

The court found little evidence on which to base a conclusion regarding the nature of the extra corporate payments to her parents. Accordingly, Linda was not able to meet the burden of proof needed to show that there was a second class of stock. Therefore she was liable for income taxes on her share of the income of the S corporation. *TC Memo 2007-372*.

Practice Tip: To minimize the risk of losing S status, give close attention to the requirement that the corporation have only one class of stock.

Voting Rights Flexibility.

The Subchapter S Revision Act of 1982 added the flexibility of allowing a company to issue voting and non-voting stock without running afoul of the one-class-of-stock requirement. Voting stock may be given to those family members who are most qualified to run the business, with non-voting stock given to other family members. However, the stock must have the same rights to distributions, or the S election will be lost. Furthermore, as noted below, it is important to use care in setting terms for loans to the corporation, and to avoid using debt instruments that have characteristics that are normally associated with stock, causing the debt to be treated as a second class of stock.

Potential gain from proving loss of status.

The amount of tax saved by proving that the S status has been lost is limited when the stockholder is in the process of selling the stock.

Assume the corporation had ordinary taxable income of \$100,000 for the current year, and the only stockholder: (1) had a basis of \$600,000 in the stock at start of the year, (2) did not receive a dividend from the company, and (3) sold the stock for \$900,000 at the end of the year. With a C corporation, the stockholder would report a gain of \$300,000 on sale of the stock (\$900,000 minus \$600,000 basis), which is likely to be taxed as a capital gain, currently at a maximum tax rate of 15%.

With an S corporation, the stockholder would report: (1) flow-through ordinary income of \$100,000, (2) an increase in stock basis of \$100,000, and (3) a gain of \$200,000 on sale of the stock, which is likely taxed as a capital gain, currently at a maximum tax rate of 15%.

The total amount of income to be reported by the shareholder (\$300,000) would not change, although the tax rate on some of the income would potentially be higher with the C corporation assumption. In this hypothetical case,

administrative appeals and litigation would likely cost more than the potential savings from such actions.

Some situations that involve a second class of stock.

1. State law requires that permission be obtained from the State Commissioner of Corporations before stock may be issued by a corporation. The State Commissioner grants permission to S Corporation to issue its stock subject to the restriction that any person who is issued stock in exchange for property, and not cash, must waive all rights to receive distributions until the shareholders who contributed cash for stock have received distributions in the amount of their cash contributions.

The condition imposed by the Commissioner pursuant to state law alters the rights to distribution and liquidation proceeds conferred by the outstanding stock of S Corporation, so that those rights are not identical. Accordingly, S is treated as having more than one class of stock and does not qualify as a small business corporation. (26 CFR 1.1361-1(l)(2)(vi) Ex. 1). The facts above are similar to those in *Page v. USA* (580 F2d 960), in which a California corporation was held to have more than one class of stock.

2. S Corporation has a binding agreement with its shareholders to modify its normal distribution policy by making upward adjustments of its distributions to those shareholders who bear heavier state tax burdens. The adjustments are based on a formula that will give the shareholders equal after-tax (i.e. after state tax) distributions. This binding agreement relates to distribution or liquidation proceeds. The agreement is a governing provision that alters the rights conferred by the outstanding stock of S to distribution proceeds, so that those rights are not identical. S is treated as having more than one class of stock. (26 CFR 1.1361-1(l)(2)(vi) Ex. 6).

3. Interest on debt is paid only if the corporation has earnings, or is interest payments are tied in some way to dividend policy. The corporation may be treated as having more than one class of stock. (26 CFR 1.1361-1(l)(5)(i))

Some cases that may not involve a second class of stock.

The regulations list the following situations that do not involve a second class of stock. Caution is advised, because the result may be different if the circumstances indicate there is an attempt to avoid the one-class-of-stock requirement, etc. When in doubt about whether a debt or other contract is considered a class of stock, the regulations should be consulted for a more complete explanation of the rules.

1. Straight Debt. Debt is not treated as a second class of stock if: it is a written unconditional obligation, regardless of whether embodied in a formal note, to pay a sum certain on demand, or on a specified due date; it does not provide for an interest rate or payment dates that are contingent on profits, the borrower's discretion, the payment of dividends with respect to common stock, or similar factors; It is not convertible (directly or indirectly) into stock or any other equity interest of the S corporation; it is held by an individual (other than a nonresident alien), an estate, or a trust described in IRC Section 1361(c)(2). (26 CFR 1.1361-1(l)(5)(i))

2. Debt held proportionately. Obligations of the same class that are considered equity under general principles of federal tax law, but are owned solely by the owners of, and in the same proportion as, the outstanding stock of the corporation, are not treated as a second class of stock. (26 CFR 1.1361-1(l)(4)(ii)(B)(2))

3. Buy-sell agreements. Agreements among shareholders restricting the transferability of stock, are disregarded in determining whether a corporation's outstanding shares of stock confer identical distribution and liquidation. (26 CFR 1.1361-1(l)(2)(iii))

4. Redemption Agreements. Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation's shares of stock confer identical rights. (26 CFR 1.1361-1(l)(2)(iii)(B))

5. Fringe Benefits. S Corporation is required under binding agreements to pay accident and health insurance premiums on behalf of certain of its employees who are also shareholders. Different premium amounts are paid by S Corporation for each employee-shareholder. S Corporation is not treated as having more than one class of stock. (26 CFR 1.1361-1(l)(2)(vi) Ex. 4)

6. Employment Agreements. Ann and Beth are shareholders of S Corporation. Ann is also an employee of the company. By agreement, the company will redeem Ann's shares on the termination of her employment. The agreement is disregarded in determining whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds. (26 CFR 1.1361-1(l)(2)(vi) Ex. 8)

7. Change in Stock Ownership. An S corporation governing instrument provides that the amount of distribution will be adjusted to take into account the fact that a stockholder owned stock for less than the full year. The corporation is not treated as having more than one class of stock. (26 CFR 1.1361-1(l)(2)(iv))

8. Below Market Loans. Ed is a shareholder of S Corporation. S Corporation makes a below-market loan to Ed that is a corporation-shareholder loan to which Section 7872 applies. Under Section 7872, Ed is deemed to receive a distribution with respect to the stock by reason of the loan. The facts and circumstances do not reflect that a principal purpose of the loan is to circumvent the one class of stock requirement. S Corporation is not treated as having more than one class of stock. (26 CFR 1.1361-1(l)(2)(vi) Ex. 5)

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Stock Basis Limits Deduction for Flow-Through of S Corporation Losses

2009 Emerging Issues 4018

Stock Basis Limits Deduction for Flow-Through of S Corporation Losses

By Howard Godfrey

July 20, 2009

SUMMARY: An S corporation shareholder's deduction of his or her share of the S corporation's losses is limited to the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder. When an S corporation is incurring losses and financing those losses with borrowed funds, its stockholders may face a limit on their ability to deduct the losses on their individual income tax returns. There are specific actions to take and to avoid.

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ARTICLE: Stock Basis Limits Deduction for Flow-Through of S Corporation Losses

A shareholder of an S corporation reports his or her pro rata share of the S corporation's items of income, loss, deduction, or credit, under IRC Sec. 1366(a).

However, a shareholder's deduction of his share of the S corporation's losses is limited to:

- (1) the amount his adjusted basis in his stock of the S corporation, IRC Sec. 1366(d)(1)(A), and
- (2) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder, IRC Sec. 1366(d)(1)(B).

Any S corporation losses that are limited because of insufficient basis may be carried forward indefinitely. IRC Sec. 1366(d)(2).

It is important to focus on the phrase: "basis of any indebtedness of the S corporation to the shareholder." In order for the shareholder to have basis in debt, an S corporation must have a liability to the shareholder, not a liability to some other entity, even if payment is guaranteed by the shareholder.

A recent case emphasizes this. Mr. Russell and Mr. Kopseng owned United Energy Corp. which (on and after September 1, 1997) was the common parent of a consolidated group of corporations including Missouri River Royalty Corporation (MRRC). MRRC had been an S corporation (owned equally by Russell and Kopseng) until it revoked its S corporation election, effective September 1, 1997, resulting in a short taxable year from January 1 through August 31, 1997. After revocation, stock in MRRC was contributed to United Energy in a Sec. 351 tax-deferred transaction.

MRRC reported a loss of \$1,117,540 for the final short year as an S corporation. Russell claimed a 50% share of the loss on his joint individual income tax return. However, Russell's basis in the stock of MRRC was only \$150,151. Russell had made a loan to MRRC, which had a balance of \$65,527 on August 31, 1997. Russell's basis in the stock and debt of the corporation were not adequate support his loss flow-through deduction of \$558,770 (50% of the corporate loss). Other debt of MRRC included: (1) loans from a bank (cosigned by Russell and Kopseng), (2) loans from a corporation and a partnership owned by Russell and Kopseng. Russell took the position that he had sufficient basis in the stock and various corporate debt to support the full deduction of his share of the corporate loss.

The Tax Court [*Russell, TC Memo 2008-246*] concluded that Russell had basis only in debt of \$65,527 (less certain adjustments), which was the amount loaned directly from Russell to the corporation.

The court summarized the principles developed in prior cases that apply to a shareholder's basis in corporate debt.

1. To have basis in corporate debt, a shareholder must make an actual economic outlay.
2. The economic outlay must leave the taxpayer "poorer in a material sense."
3. The S corporation's indebtedness must run directly to the shareholder. A debt to a passthrough entity does not satisfy the statutory requirements if the passthrough entity: (a) advances funds to taxpayer (S corporation) and (b) is closely related to the taxpayer
4. No form of indirect borrowing (a guaranty, surety, accommodation, comaking or otherwise) gives rise to indebtedness from the corporation to the shareholders until and unless the shareholders pay some or all of the debt.

Practice Tip: When an S corporation is incurring losses and financing those losses with borrowed funds, the stockholders may face a limit on their ability to deduct the losses on their individual income tax returns. Corrective action may be recommended where a stockholder expects to have more loss flow-through than the total of: (1) basis in stock and (2) basis in direct loans from the stockholder to the corporation. The stockholder can personally loan money (possibly obtained by borrowing) to the corporation, which the corporation can use to pay down its debt to other lenders. This will create basis the stockholder can use to support a larger loss deduction on the individual return.

Better Results in the *Timothy Miller* Case

Timothy Miller, who was the majority owner of an S corporation, successfully deducted corporate losses because he had basis in his loans to his corporation. [*Timothy J. Miller, TC Memo 2006-125*].

In mid-December of 1992, the company's accounting firm notified the Miller that he would not have enough basis in stock and debt to fully deduct the loss that was expected for 1992, and the losses that had been suspended in prior years due to inadequate basis.

Miller was a guarantor on substantial bank loans of the company. On December 30, 1992, Miller borrowed \$750,000 from the bank, and loaned that money to his S corporation. The corporation then paid the \$750,000 to the bank to reduce the corporate loan balance. As collateral for its borrowing from Miller, the corporation assigned to Miller a security interest in its assets, and Miller in turn assigned to the bank his note receivable and all of his rights under his loan to the company. The corporation paid the \$750,000 to the bank in full satisfaction of an existing corporate debt.

The Tax Court concluded that the series of transactions qualified as an economic outlay by Miller that left him economically poorer, and he was entitled to deduct the flow-through losses.

Word of Caution.

In the *Russell* case described above, the stockholders lost in their attempt to increase basis (enabling the deduction of corporate losses) for S corporation debt that did not run directly to the stockholders. The Tax Court found that this debt clearly failed to increase basis.

In *Miller*, Miller borrowed money on a personal note and loaned the money directly to the corporation. Despite the steps taken by Miller to incur personal debt, and make a direct loan to the corporation, the IRS took the position that Miller's borrowing should be disregarded. The IRS viewed the series of transactions as being in substance a loan from the bank to the corporation, with Miller as a guarantor. The IRS noted that Miller assigned his notes receivable from the corporation to the bank -- a step that the IRS said caused the bank to own the note from the corporation to Miller. In contrast, Miller asserted that the corporate note was assigned to the bank in order to provide collateral for the Miller bank loan.

The Tax Court found the IRS arguments to be unpersuasive. Despite the strength of the case for deduction of the losses, Miller was able to deduct those losses only after litigating the matter.

This simply means that owners of S corporations that are encountering losses in excess of stock basis need to be especially careful when making loans that will support the write-off of such excess losses. Hopefully, building a strong case that a loan generates basis will reduce the likelihood of an expensive IRS challenge.

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A State Tax Revenue Consequence of the ARRA of 2009 in Cancelling Debt Income

2009 Emerging Issues 3912

Andrew Swain on a State Tax Revenue Consequence of the ARRA of 2009 in Cancelling Debt Income, a Maryland Practice Insight

By Andrew Swain

June 28, 2009

SUMMARY: This Emerging Issues Analysis discusses a specific consequence of the recently enacted American Recovery and Reinvestment Act of 2009, as it amends IRC § 108, Income from Discharge of Indebtedness. Since most states conform to the federal rules regarding discharge of indebtedness, unless states decouple from the CODI provision, there may be troubling shortfalls in states' income revenue.

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ARTICLE: Andrew Swain on a State Tax Revenue Consequence of the American Recovery and Reinvestment Act of 2009 in Cancelling Debt Income, a Maryland Practice Insight

Insight

The recently enacted *American Recovery and Reinvestment Act of 2009* amended IRC § 108 by adding a provision cancelling debt income. This provision allows taxpayers to elect to defer the recognition of income realized from the discharge of indebtedness until 2014, when they may then spread the deferred income ratably over five years or until 2018. Since most states conform their income tax laws to the federal tax code, states risk seeing significant revenue declines over the years 2009 through 2011 unless they decouple the relevant portion of their income tax law from the cancellation of debt income (CODI) provision. Maryland has recently done this, enacting legislation that decouples its income tax code from the Internal Revenue Code.

Analysis

On April 19, 2009, Maryland's Governor Martin O'Malley approved House Bill 101/Senate Bill 166, n1 also known as Chapter 487 or the *Budget Reconciliation and Financing Act of 2009* (BRFA). n2 The BRFA explicitly and permanently decouples Maryland's income tax from a provision of the *American Recovery and Reinvestment Act of 2009* (ARRA), enacted in February of 2009. The ARRA amends § 108 of the Internal Revenue Code (IRC), and allows taxpayers to defer income that arises from the discharge of indebtedness. n3 By decoupling its state income tax provision from § 108 as amended by ARRA, Maryland avoids a loss in state income tax revenue of approximately \$186 million during fiscal years 2010 and 2011. n4

This practice insight examines the BRFA enacted in Maryland and its implications by first briefly reviewing the treatment of income arising from the cancellation of debt by IRC § 108 prior to its amendment by the American Recovery and Reinvestment Act of 2009 (ARRA), then discussing the CODI provision that the ARRA added to § 108(i), n5 and, finally, reviewing Chapter 487, § 10-210.1, Maryland's decoupling legislation, and examining its projected effect on the state's revenues.

I. The Treatment of Discharge of Indebtedness Under IRC § 108

Prior to its amendment in February 2009, IRC § 108 in coordination with IRC § 61(a)(12), provided that gross income included, with noted exceptions, "any amount which . . . would be includable in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer. . . ." n6 In effect, the two sections, prior to amendment by ARRA, provided that amounts borrowed by the taxpayer are not considered income unless and until the lender forgives, discharges or cancels part or all of the amount borrowed. Ordinarily, income arising from the discharge of indebtedness is recognized in the same year it is earned. n7

II. ARRA's Amendment of IRC § 108

The CODI provision allows the deferral of federal income arising from the discharge or cancellation of debt. It is found in § 1231 of the ARRA. n8 The provision amends IRC § 108 by adding subsection (i), which provides the following in pertinent part:

At the election of the taxpayer, income from the discharge of indebtedness in connection with the reacquisition after December 31, 2008, and before January 1, 2011, of an applicable debt instrument shall be includable in gross income ratably over the five-taxable-year period beginning with (A) in the case of a reacquisition occurring in 2009, the fifth taxable year following the taxable year in which the reacquisition occurs, and (B) in the case of a reacquisition occurring in 2010, the fourth taxable year following the taxable year in which the reacquisition occurs. n9

Indebtedness is broadly defined as "any indebtedness of the taxpayer (1) for which the taxpayer is liable, or (2) subject to which the taxpayer holds property. n10 Section 108 also defines "acquisition", after which "reacquisition" is broadly defined. The definition includes "an acquisition of [a] debt instrument for cash, [and] the exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument). . . ." n11

The CODI provision captures a variety of transactions wherein a taxpayer remits to a lender an amount less than what was borrowed. The transactions include, among others, a taxpayer's restructuring or refinancing of a debt or debt instrument in which the restructured amount is less than the original; a lender's offering the taxpayer a complete or partial forgiveness of an unconditional, legally enforceable debt; and a business's repurchasing its debt on the open market at a discount. n12 Ordinarily, the income arising from the discharge of indebtedness would be recognized by the taxpayer in the same year it was earned. The CODI provisions of ARRA, as captured in IRC § 108(i), however, permit the taxpayer to restructure a debt instrument, receive a partial or complete forgiveness of a true debt, or repurchase its debt on the open market at a discount in 2009 or 2010 and defer reporting the CODI as taxable income until 2014. Once the taxpayer has elected to defer, the taxpayer may then spread the deferred taxable income ratably over five years from 2014 through 2018. n13

The income tax codes of most states are based on the IRC. Consequently, in most states, the CODI provision of ARRA will cut state as well as federal tax revenues. Since the CODI provision in ARRA is retroactive to the beginning of 2009, and since businesses, including those that could benefit from the provision, pay estimated taxes each calendar quarter, some states will experience decreased state income tax revenue as early as the second quarter of 2009. n14

III. Maryland's Budget Reconciliation and Financing Act of 2009

In April of this year, Maryland became one of several states to enact legislation effectively decoupling its state

income from the federal income tax law. Section 210.1 of Title 10 in Maryland's Code, as amended by the BRFA, provides in pertinent part that gross income includes "income from the discharge of indebtedness and the allowance of any deduction with respect to original issue discount without regard to IRC § 108(i). . . ." n15 Through this provision, Maryland ensures that taxpayers who realize income from the discharge of indebtedness recognize the state's portion of the income in the same year in which it was earned, preventing a projected decline in state income tax revenues of up to \$116 million in fiscal year 2010 and \$69.6 million in fiscal year 2011, a total of approximately \$186 million over two years. n16

Maryland, with respect to its state income tax code, is what is known as a "rolling conformity" state. As the IRC changes, Maryland's tax code does too. Unless Maryland decoupled its state income tax code from the CODI provision as have other rolling conformity states, the state could have experienced revenue loss as early as the current quarter. n17 Maryland's move, like that of other states, to decouple its relevant provision from the CODI provision is not deemed radical or even unprecedented. n18 Maryland has decoupled select provisions of its state income tax from the federal tax code before. The state's *Budget Reconciliation and Financing Act of 2002*, for instance, provided for a permanent decoupling of its state income tax law from two components of the *Job Creation and Worker Assistance Act of 2002*. n19

The available literature suggests few if any disadvantages that will outweigh the projected benefits of Maryland's decoupling legislation. In fact, evidence seems to suggest more cost than benefit to a state that complies with the CODI provision. Both the *Center on Budget and Policy Priorities* and the *Urban-Brookings Tax Policy Center* have concluded that the stimulative effect of both the CODI provision and state compliance with it are highly questionable. n20

IV. Implications for the State of Indiana

Indiana's state income tax law, like that of Maryland and most other states, is closely tied to the IRC. Like most other states, Indiana risks suffering revenue loss as a result of the CODI provision unless it decouples its state income tax law from IRC § 108(i). *The Center on Budget and Policy Priorities* estimates that the state could see declines in its income tax revenue of approximately \$117 million over fiscal years 2009 through 2011 should it fail to decouple its state income tax law from the CODI provision. n21 Decoupling a state tax law provision from the federal tax code is neither radical nor unprecedented. Though the process of decoupling varies depending on whether a state is a rolling-conformity state or fixed-date-conformity state, it ordinarily involves a state's amending a provision or provisions in its income tax law so as to decouple them from their federal analogs.

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n1 Available at <http://mlis.state.md.us/2009rs/billfile/HB0101.htm>.

n2 See H.B.101, 2009 Sess. Laws, Reg. Sess. (MD 2009).

n3 See Letter from Peter Franchot, Comptroller of Md., to Martin O'Malley, Governor of Md. (Apr. 27, 2009), available at http://www.marylandtaxes.com/publications/fiscalrpts/ARRA_60_Day_Report.pdf.

n4 See Letter from Peter Franchot to Martin O'Malley, *supra* at 3.

n5 26 USCS §108(i).

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n12 See Michael Mazerov, *Obscure Tax Provision*, *supra* note 7, at 2.

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n19 See *Decoupling from Federal Income Tax Laws*, Maryland Income Tax Administrative Release No. 38, Sept. 2008, http://www.marylandtaxes.com/publications/bulletins/it/ar_it38.pdf.

n20 See Michael Mazerov, *Obscure Tax Provision*, *supra* note 7, at 6.

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President Obama's International Tax Proposals in a Policy Context

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Prof. William Byrnes Discusses President Obama's International Tax Proposals Relating to International Financial Centers ("Tax Havens")

By Prof. William H. Byrnes

June 22, 2009

SUMMARY: Faced with growing pressure to close the rapidly increasing budget deficit, President Obama outlined a series of proposed changes to the international tax system. The plan is touted as 'levelling the playing field' and filling tax loopholes that allow U.S. corporations operating overseas to avoid U.S. income tax. The following is a discussion of some of the more important aspects of the proposals and the effects of the plan in a policy context.

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ARTICLE: A Survey of President Obama's International Tax Proposals

Faced with growing pressure to close the rapidly increasing budget deficit, President Obama outlined in a May 4, 2009 speech a series of proposed changes to the international tax system that the Treasury Department claims would help close the budget gap by an estimated \$209.9 billion over a ten-year period. The following is a survey of some of the more important aspects of President Obama's tax proposals, firstly applicable to corporations and secondly to individuals that will impact deferral and international financial centers ("tax havens"). However, for sake of brevity, this survey does not address the reduction of U.S. withholding tax pursuant to equity swaps referencing U.S. equities.

(1) Deny immediate deductions on foreign investments when profits are deferred. Currently, businesses that invest outside of the United States are allowed to take immediate deductions on expenses supporting their overseas investments, while also deferring paying U.S. taxes on the profits made from the investments. The Obama administration gives the example of a U.S. corporation that borrows money for the purpose of acquiring stock of a foreign corporation. The U.S. corporation is often able to take an immediate deduction against its U.S. taxes for the interest on the debt. This is the case even though the U.S. taxes on any income generated by the foreign investment can be deferred indefinitely. The proposed change follows Congressman Rangel's from 2007 (H.R. 3970) to not allow a business to take these deductions until it pays taxes on the offshore profits. Interestingly, President Obama is seeking a major tax incentive carve-out for research and experimentation expenses, allowing these to be immediately expensed. Ironically, this tax incentive will be a boon to the tech and pharmaceutical companies whose use of deferral is a substantial driver for closing down the deferral loopholes.

(2) Revise the "check-the-box" rules to hamper foreign tax avoidance. U.S. companies are required to report

income shifted from one foreign subsidiary to another as passive income subject to U.S. taxation. During the Clinton administration the "check-the-box" rules were added which allows companies to elect whether a foreign affiliate will be treated as a separate corporation or as a non-separate entity for tax purposes by simply checking a box. Under this system, U.S. companies easily can shift U.S. profits offshore by routing them through a non-tax haven country and then to a tax haven. The U.S. company elects to treat the tax-haven affiliate as a corporation for purposes of the non-tax-haven country's tax system, but as a non-separate entity for U.S. tax purposes, avoiding taxes in both the U.S. and the non-tax haven country.

The Obama administration gives an example of a U.S. company that owns a holding company in the Cayman Islands that has two subsidiaries, one in Germany that makes cars and another in the Cayman Islands that lends money to the German carmaker. The German carmaker makes interest payments to the other subsidiary in the Cayman Islands. The German carmaker can take deductions against the taxes it would otherwise pay the German government. The Cayman Islands subsidiary has income (interest payments from the German carmaker), but the Cayman Islands does not tax it. Because both subsidiaries are owned by the Cayman Islands holding company, when the U.S. parent "checks" the box to disregard them for tax purposes, the subsidiaries for US purposes are categorized as the same entity as the holding company. Therefore the holding company has loaned itself money for which it paid itself interest -- a nonevent pursuant to US tax law. However, for treatment by the German Tax Office, the Cayman Islands entity is recognized as a separate corporation. Thus, the German subsidiary takes a deduction for the interest payments, mitigating its tax liability to the German government. President Obama's proposal would amend the check the box rules so that U.S. companies that establish certain offshore subsidiaries must treat them as corporations rather than as disregarded entities for U.S. tax purposes, effectively eliminating this technique for reducing foreign tax without triggering US taxation.

(3) Further limit the deductibility of interest payments by "expatriated" parties (earning stripping). Citing the findings of a 2007 Bush Administration Treasury Department Report that foreign "inverted" parent companies that have acquired U.S. companies are employing techniques to reduce the U.S. taxes of their U.S. subsidiaries via outbound interest payments, President Obama re-introduces altering the current earning stripping provisions. The proposal is that debt between related "inverted" parties may not claim the debt-to-equity safe harbor of 1.5 to 1, and that any interest deduction corresponding to this related party debt be reduced to a maximum 25% of adjusted taxable income, from 50%. Moreover, such related parties will only be able to carry forward the excess interest deduction for ten years as opposed to indefinitely, while the normal three-year carry forward of the excess allowable interest limitation will be eliminated for this small class of taxpayers.

(4) Limit the shifting of income to a tax haven through the transfer of intangible property. The transfer of intangibles among related parties, generally from a U.S. taxpayer to a lower taxed foreign, is the subject of substantial tax controversy via IRC Sections 482 (26 USCS § 482) and 367(d) (26 USCS § 367(d)). The controversy almost always surrounds the valuation of the intangible. To mitigate future controversy, President Obama proposes that for IRC Sections 482 and 367(d) workforce in place, goodwill and going concern will be included when determining the value of intangible property, and that such value will be determined at the standard of its "highest and best use." For multiple transfers of intangibles amongst related parties whereby each intangible is valued separately without regard toward one another, President Obama's proposal would grant the IRS the ability to value the transfers on an aggregate basis to ascertain a more reliable value.

(5) Close loopholes in foreign tax credit application. A foreign tax credit ("FTC") may prevent double taxation when a foreign government has levied tax on U.S. taxpayer's income earned abroad by reducing the U.S. tax obligation for that "foreign source" income. However, U.S. companies have devised two loopholes that allow an FTC to reduce the U.S. tax obligation on U.S. income. The first loophole occurs when corporations use the FTC to claim FTCs for foreign tax paid on profits that are not subject to U.S. tax. For example, a U.S. corporation that owns a part of a foreign entity characterizes the foreign entity as a partnership for purposes of claiming the FTC (allowing immediate claim of the FTC), but at the same time characterizes the foreign entity as a corporation for purposes of deferral. President Obama's proposal would not allow this "splitting" of foreign taxes from foreign income.

A second loophole occurs when a U.S. parent controls several foreign subsidiaries and manipulates which of the foreign subsidiaries repatriates dividends based upon which among the subsidiaries has incurred substantial levels of foreign tax. In some cases, the U.S. parent is "deemed" to have paid a share of the foreign taxes paid by the foreign subsidiary. In these cases, the U.S. parent instructs the payment of a dividend from these foreign subsidiaries, and not from the other ones that may have incurred little or no foreign taxation. By selecting payment from highly taxed subsidiaries, the resulting FTC can be staged to offset any U.S. tax that would normally be levied because the U.S. tax obligation is calculated only based upon the repatriated portion of the foreign income. President Obama's proposal requires that the FTC be calculated on a consolidated basis of all the foreign subsidiaries' income, both high and low taxed. Thus, the US tax obligation may exceed the FTC resulting from the limited repatriation of foreign earnings.

(6) Eliminate special tax treatment of U.S. companies with 80% foreign revenue. While dividends and interest paid by U.S. companies to foreign persons are normally subject to a 30% withholding, for over three decades a congressionally carved out exception has survived. A U.S. company ("80/20" company) with at least 80% of its gross income over a three-year testing period arising from foreign source active trade or business is not required to withhold on dividends and interest paid to foreigners. The term "80/20" company gained substantial notoriety the past two years, and raised eyebrows of state revenue departments, when a major U.S. retailer and an international fast food chain were reported to be leveraging these vehicles to mitigate millions in state tax. Most states do not take into account foreign earnings when calculating company income tax, and treat the 80/20 company as foreign. President Obama proposes to eliminate this federal withholding tax exception.

(7) Prevent tax avoidance when repatriating tax-deferred earnings via cross-border reorganizations. President Obama proposes to shut down the technique whereby a U.S. company reduces or eliminates U.S. tax on the repatriated tax-deferred earnings of its foreign subsidiaries via a cross-border reorganization pursuant to IRC section 356 (26 USCS § 356) by eliminating the "boot-within-gain" limitation whenever the acquiring corporation is foreign and the US shareholder's exchange has the effect of the distribution of a dividend determined by 356(a)(2).

(8) Revise Qualified Intermediary ("QI") program. The U.S. exempts certain types of U.S. income received by foreigners from U.S. tax that would otherwise be taxable if received by a U.S. taxpayer, whereas other types of income received by foreigners is subject to U.S. tax, normally in the form of a final withholding tax. By example, U.S. companies that pay dividends to foreigners must act as a tax agent, collecting a 30% withholding tax unless the foreigner provides documentation that she resides in a foreign country with which the U.S. has a tax treaty, and that the tax treaty reduces the withholding to be collected. The U.S. company withholding agent forwards the tax collected along with documentation about the recipient of the dividend to the IRS whether or not a treaty benefit is claimed.

The QI program was established to address two issues relevant to foreign investors. Firstly, the QI program addresses the concerns of a foreign investor that does not want her information provided to the IRS regardless of full payment or a mitigated one of the withholding tax. By example, certain foreign taxpayers may not want this information "shared" with their home country. Secondly, in the case of multi-investor foreign investment funds, foreign direct investment into the U.S. may be discouraged if withholding is applied to the fund's entire U.S. income as opposed to being applied at the correct amount pursuant to each underlying investors' specific situation, such as tax treaty mitigation and U.S. taxpayer status.

Foreign financial institutions may become self regulating QIs by agreeing with the IRS to employ know-your customer rules about their underlying recipients of any funds, which is an obligation pursuant to all jurisdictions' anti money laundering regulations. The QI is then authorized to instruct the U.S. withholding agent regarding if any, and at what level, U.S. taxes should be collected. Thus, the QI assumes the responsibility for determining the correct withholding tax on its underlying recipients, albeit subject to an annual third party audit of its compliance with correctly making such determinations. When submitting the information to the U.S. withholding agent, the QI is not required to reveal the identity of the foreign individuals upon which the withholding is based. However, the QI program requires that the QIs share information regarding their U.S. customers with the IRS who are the recipients of U.S. income.

There are several holes in the dyke of the QI system: 1) QIs are not required to report to the IRS foreign income of their U.S. customers allowing QIs to maintain a clientele of US tax evaders as long as the evaders do not invest in the U.S.; 2) U.S. taxpayers receiving U.S. income can avoid being reported to the IRS by holding their foreign accounts via non-QIs; 3) QIs are allowed to have affiliates that are not QIs, thus encouraging U.S. customers to shift to intra non-QI affiliates for any business that could result in reporting, and finally 4) an income recipient can self-certify her non-US taxpayer status to a non-QI which does not have the QI agreement in place to verify on behalf of the IRS, and thus by example escape paying tax on capital gains as if they were earned by a foreigner.

The Obama administration proposes several plugs for these weaknesses: 1) U.S. financial institutions must withhold 20-30% of all payments of U.S. income to non-QIs with the burden on the underlying income recipient to seek a refund by providing her identity and foreign bona fides; 2) QIs may not have any affiliates that are non-QIs; 3) QIs must file a 1099 form for each U.S. customer, just as U.S. banks must; 4) create a presumption of "convincing evidence" that every account held by a U.S. person at a non-QI breach the \$10,000 threshold requirement for filing of an annual Foreign Bank and Financial Account Report ("FBAR"), thus allowing the imposition of an annual maximum \$100,000 civil fine. Moreover, a failure by the U.S. taxpayer to file an annual FBAR for any account that breached over \$200,000 would be deemed to be willful, thus adding criminal sanctions of up to \$250,000 and five years in prison on top of the civil sanctions.

(9) Bolster IRS' ability to promote international reporting compliance. President's Obama's plan would include hiring 800 new IRS staff to increase international enforcement and increase the IRS's enforcement budget by nearly \$400 million. The statute of limitations would be increased on international tax enforcement to six years after the taxpayer submits required information. U.S. taxpayers would be required to report transfers of money or property made to or from non-QI foreign financial investments on their income tax returns if the U.S. taxpayer owns more than a 50% interest and any transfer exceed \$10,000. The accuracy related penalties would be doubled to 40% when taxpayers fail to make required disclosures for foreign financial accounts. Finally, the President seeks to substantially raise the penalty for failure to report Foreign Trust Income to a maximum 35% of the unreported amount and including a compounding of a \$10,000.00 penalty every thirty days of non-compliance until the taxpayer is deemed to be cooperative by the IRS in determining the correct tax assessment.

Draft Legislation to Implement Proposed Changes

President Obama was a cosponsor of The Stop Tax Haven Abuse Act (S. 506) ("STTHAA") while he was in the Senate. The bill was initially introduced on February 17, 2007. On March 2, 2009 a revised version of the bill was introduced by Senator Carl Levin. This bill is the first piece of the puzzle to implement President Obama's proposals.

The Stop Tax Haven Abuse Act (S. 506) major proposals include:

(1) Blacklist countries. The 34 countries and jurisdictions on this list will be penalized using a similar standard as the USA Patriot Act. The penalties will vary based on the level of the perceived offense. Penalties could range from increased financial reporting requirements for banks, to an outright prohibition of transactions with the jurisdiction. To stay off this list, Treasury must annually determine that a jurisdiction has with the United States "prompt, obligatory, and automatic exchange" information sharing; just as is in use in the European Union regarding interest payments on savings accounts, to prevent tax avoidance by U.S. taxpayers and that the jurisdiction is not included on the OECD or like intra-government organization list as being an uncooperative with international tax enforcement.

(2) Increase in reporting requirements. U.S. Banks and foreign banks that are QIs have to prevent U.S. taxpayers from escaping taxation via shell corporations that mask the true ownership of bank accounts. Anti-money laundering laws mandate banks know beneficial owners of all accounts. The STTHAA would require this information be filed with the IRS. The STTHAA also requires financial institutions that establish a trust, corporation or a bank account in a tax haven jurisdiction to report this information with the IRS.

(3) Revised residency test. Generally, the U.S. uses the jurisdiction of a company's incorporation to determine residency for tax purposes. The STTHAA proposes that if a corporation is publicly traded or has assets of \$50 million or more, and its management and control occur primarily in the U.S., the corporation will be considered domestic for U.S. tax purposes. The bill targets both U.S. multinationals attempting to slip out of the U.S. tax net via inversions and offshore hedge funds that are usually set up in tax havens.

(4) Changing withholding requirements from U.S.-sourced dividends to "dividend equivalents". Currently, dividends sent to tax havens are subject to a 30% withholding tax. To avoid this withholding tax U.S. investment banks have worked with hedge funds to "artificially" shift ownership to U.S. corporations not subject to the withholding taxes, and then after the dividend payment, shift ownership back to the original foreign owners. The STTHAA proposes to close the loophole by extending the withholding tax to "dividend equivalents" instead of U.S. sourced dividends.

Will the Plan have the Desired Policy Effect?

President Obama's tax plan is touted as "leveling the playing field" and filling tax loopholes that allow U.S. corporations operating overseas to avoid U.S. income tax. The plan, and the charged language used to sell it to the American public, come at a time when seething anger over the state of the economy has heightened skepticism about the wisdom of Wall Street and business leaders. So while the President's plan may have merit, some of its support is founded on the emotional appeal of hitting back at the companies that "ship jobs and stash profits overseas."

Discussions of the U.S. system of international taxation are often premised on the idea that foreign investment eliminates domestic investment dollar-for-dollar and job-for-job. Under this reasoning, the prudence of the President's plan may seem self-evident. Higher taxes on the foreign income of domestic companies should shift investment home by discouraging foreign investment. And when foreign investment by U.S. firms decreases, investment in the U.S. should expand proportionally, bringing back lost dollars and jobs. If these assumptions hold true, it's in the U.S.'s interest to end or heavily curtail all incentives for investing overseas. But there is reason to believe that U.S.'s national interest lies in maintaining the current system of deferral.

Recent research into investment patterns of U.S. firms has shown that foreign direct investment (FDI) by U.S. companies generally increases those firms' investment in the U.S. In hard numbers. The study found that a 10% increase in foreign investment correlates with a 2.6% increase in domestic investment. And a 10% increase in the compensation of foreign employees correlates to a 3.7% increase in domestic employee compensation. These increases, for example, result from increases in demand by foreign affiliates for U.S. research and development and exports. As a result, a domestic company that ships its manufacturing jobs overseas may simultaneously increase its demand for engineers.

But, even assuming that foreign investment correlates with an increase in domestic investment, some U.S. families will be hurt by the shifts in employment resulting from foreign investment. And this migration of some jobs overseas may disproportionately hurt the most vulnerable lower income families. So while the utilitarians among us may shrug and justify the harm as a necessary evil, it's doubtful a family of five facing unemployment and foreclosure will be heartened to know their suffering is part of a greater scheme to increase the prosperity and happiness of some of their fellow citizens. So while Wall Street groans and fires up its war wagons to oppose the plan, Main Street's support for the President's tax plan is unlikely to wane.

The concern with fairness in taxation has a long, distinguished history. The administration's call to fix "special interest loopholes that allow some corporations and wealthy individuals to avoid paying their fair share of taxes" reverberates with echoes of Adam Smith. Smith's fairness principle states that every citizen, corporate or individual, "should contribute towards the support of the government.. in proportion to the revenue they respectively enjoy under the protection of the state." In the administration's view, corporate citizens conducting international business and utilizing tax havens are not carrying their share of the tax burden. The Tax Code is viewed as giving multinationals special treatment by providing them tax advantages that are unavailable to individuals and the small domestic companies. After all, Joe the Plumber doesn't have the option of delaying the withholding tax that siphons off a portion

of his biweekly paychecks. And the local hardware store cannot forego one of the quarterly estimated tax payments that threatens to give the business one last push over the edge. So why should corporations operating in foreign countries have the option of deferring a portion of their income until a time that's convenient for them to repatriate the funds?

Under this view of deferral, President Obama's plan does nothing more radical than bring taxation of the multinational in line with taxation of the carpenter's paycheck and of the mom and pop hardware store's modest revenue. But while it may be difficult to argue with the emotional appeal of this call to fairness, fairness is only one part of the analysis. Other principles and additional economic analysis must inform any examination of tax reform.

Of primary importance to the debate is an analysis of the economic consequences of foreign investment by domestic companies. Answering the clamor for fairness is an equally vociferous reply that in today's global village, U.S. economic welfare and leadership are dependent on the tax benefits provided to domestic companies operating overseas. The argument is made that limitations on deferral hurt U.S. global competitiveness and reduce the U.S.'s economic health and growth.

Multinationals argue that if the U.S. is committed to taxing worldwide income of U.S. companies, deferral is the only way to keep U.S. companies competitive in the world economy. Taxing foreign income before it is repatriated is taxing the income too soon, which hurts the business. This argument reflects Adam Smith's principle of convenience, which says that "[e]very tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it." So, for instance, rather than taxing landlords on the full value of a lease at its signing, before rent has been received, the principle of convenience says that the landlord should be taxed after she receives payment from the tenant, when cash is available and payment of tax is "convenient" for the landlord. Taxation on repatriation, free-market advocates would argue, is precisely the time most convenient for payment of taxes on foreign income.

Counter to this view is the belief that deferral takes the principle of convenience too far, levying tax at the convenience of the business. But deferral, say the multinational, is not about giving benefits to big business, it's about keeping the U.S. competitive in the global marketplace. U.S. companies paying U.S. tax rates on overseas income complain that they are at a disadvantage when operating overseas. The U.S. effective corporate tax rate is one of the highest in the world. Without deferral, U.S. companies pay foreign income tax on their income and then pay U.S. tax on that same income, net the foreign tax credit. Thus the total tax rate on foreign income of U.S. multinationals is generally equal to the U.S. rate. So companies domiciled in a foreign jurisdiction are taxed only in that jurisdiction, while U.S. companies are subject to tax at the U.S. rate, which is most often higher than the rate paid by the foreign company.

Deferral comports with the convenience principle by subjecting foreign income to U.S. tax when that income is repatriated, thus moving it outside the arena in which that income may be employed to build its foreign business and compete with foreign companies. Commandeering the Obama administration's language, deferral operates to "levels the playing field" when U.S. companies are operating in jurisdictions with a lower tax rate than the U.S.. Without deferral, U.S. companies have less incentive to invest overseas. But how much do U.S. corporations save on their tax bill by operating a branch overseas? A recent study found that U.S. companies with overseas subsidiaries have an effective tax rate that is only 1.5% lower than companies without foreign subsidiaries. So while this lack of a substantial difference between tax rates affecting domestic companies and multinationals may signal that deferral's detractors are making much ado about nothing, the data can also be interpreted to mean that deferral reform will not result in the dramatic reduction in FDI that some commentators have predicted.

Consider the following example exhibiting the effect an elimination of deferral may have on U.S. firms operating overseas. China's average multinational effective tax rate (AERT) is 17%, compared to the U.S.'s multinational AERT of 27%. So, without the option of deferring tax on income earned overseas, for every \$100 earned by a U.S. company in China, that company will pay about \$27 in Chinese and U.S. income taxes, leaving \$73 to reinvest. But a foreign company that either does not pay tax on its foreign-source income or has the option of deferring the tax will have \$83 dollars of income left after paying the Chinese tax. This additional sum allows the competitor to sell its products at a

lower price than its U.S. competitor and to reinvest in its business. The results are less dramatic in high tax jurisdictions like Europe, with a multinational AERT of 24%. But while the difference in after-tax revenue for a U.S. company operating in Europe is not as dramatic as that of a U.S. company operating in China, a 3% decrease in profit is significant enough to give management pause to evaluate the wisdom of its investment.

In addition to the fairness and convenience principles, the principle of neutrality should play a primary role in evaluating the wisdom of tax reform. "Neutral" tax reform does not distort the economy by influencing behavior in the marketplace. Adam Smith addressed neutrality as part of his efficiency principle. His efficiency principle stated that tax policy should strive to do two things: (1) minimize the costs of securing compliance and (2) allow citizens to hold onto as much wealth as possible. Smith believed that an inefficient system of taxation would artificially direct entrepreneurs away from otherwise productive engagements.

Evaluating deferral reform under the efficiency principle, limiting or eliminating deferral of tax on foreign profits will discourage U.S. companies from operating overseas. As discussed earlier, one purpose of deferral is to keep the U.S. competitive in the global economy. So if U.S. corporations believe they cannot operate profitably overseas, they may reduce or eliminate their foreign investment activities. Some may hail this pullback as a heartening sign, calling for the Tax Code to be wielded by the U.S. Government like a stick driving U.S. companies home. Others will see the change as hearkening the end of the U.S.'s place as the world's leading economic power. They argue that the US will permanently disable US business on the world stage by discouraging U.S. investment abroad at a time when the population of the U.S. makes up only 5% of the world's population. They fear that China, India, and other emerging economic powers will be happy to pick up any slack left when U.S. companies decrease their foreign investment activities. And companies may choose to abandon the U.S. altogether rather than just reducing their foreign direct investment. Tax motivated migration occurred in 2008 in the U.K., with a number of firms leaving the U.K. looking for more favorable tax treatment in Ireland and other low tax jurisdictions. n1 While this kind of migration from the U.S. is a possible side effect of the tightening of the international tax rules, it is by no means certain. Taxation is not the only factor influence choice of corporate residence.

While reforming deferral may motivate some nascent companies to form overseas and some existing companies to leave the U.S., low tax rates as an incentive to domicile in a jurisdiction are more important for smaller economies than for the world's larger economic powers. Tax rates are only one factor informing a company's decision as to residence. Infrastructure, ready access to markets, political stability, and compliance costs other than taxation are significant factors determining desirability of a particular jurisdiction as a corporate residence. So while taxation is a significant factor affecting corporate residency decisions, it is not the only factor.

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- White House Press Release, *Leveling the Playing Field: Curbing Tax Havens and Removing Tax Incentives for Shifting Jobs Overseas*, May 5, 2009, *available at* <http://www.whitehouse.gov/the-press-office/2009/05/05/leveling-the-playing-field>.

http://www.whitehouse.gov/the_press_office/LEVELING-THE-PLAYING-FIELD-CURBING-TAX-HAVENS-AND-REMOVING-TA

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n1 See Kevin Markle & Douglas A. Shackelford, *Corporate Income Tax Burdens at Home and Abroad* 3 (2009).

RELATED LINKS: See also

■ Tax Havens of the World;

Martin A. Sullivan, Economic Analysis: Proposals to Fight Offshore Tax Evasion, Part 3 , April 30, 2009),

■ Economic Analysis: Proposals to Fight Offshore Tax Evasion, Part 3 , April 30, 2009),

and Steve Wamhoff, Rebecca Wilkins,

■ Obama's Offshore Tax Proposals Could Be Stronger, Citizens for Tax Justice Says

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California's Corporate Tax Penalty Creates Firestorm

2009 Emerging Issues 3810

Roberts and Gustafson on Exploring California's Controversial 20% Corporate Understatement Penalty

By Carley A. Roberts and Timothy Gustafson

June 18, 2009

SUMMARY: Difficult economic times sometimes result in states finding new and more creative ways to generate additional revenue. California's 20% corporate understatement penalty may be just such a case in point. Carley A. Roberts and Timothy Gustafson of Morrison & Foerster explore the controversy surrounding the penalty and its application.

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ARTICLE: By 1487, over thirty years of violent conflict had ravaged a nation. Two warring factions had nearly torn the great isle apart. A newly-crowned king sought to reunify and rebuild his kingdom, but his coffers were empty. On what basis could he, Henry VII, raise revenue? The Lord Chancellor of England, John Morton, posed a philosophical solution. Tax commissioners, armed with what would become known as "Morton's Fork," were sent across the land to collect funds for the crown by telling the rich that they could afford to contribute and accusing the poor of harboring concealed wealth. Either way, the crown won and the money poured in.

Fast forward to 2008. Years of fiscal irresponsibility had ravaged a state. Two warring parties had nearly torn this former Republic apart. A once-mighty Governor sought to reunify and rebuild his land, but his coffers were empty. On the brink of insolvency, how could California solve its financial woes? In the dead of night, the powers that be posed a fiscal solution. The state tax agency, armed with a Morton's Fork of its own, was sent across the land to collect funds for the Capitol by telling corporations to either pay more money now or pay much more money later. Either way, the taxpayer lost, and by June 1, 2009, the money poured in.

Enactment of the Corporate Understatement Penalty Met With Overwhelming Disapproval from Taxpayers and Practitioners.

The current situation first came about on October 1, 2008. At that time, Governor Arnold Schwarzenegger approved and signed into law California Senate Bill No. 28 ("SBX1 28"), which enacted the California 20% Understatement Penalty (the "Penalty"), Cal Rev & Tax Code § 19138, less than two weeks after the bill was introduced and passed by both houses of the California legislature on September 19, 2008. Eschewing historical justifications for the imposition of a civil penalty-- voluntary compliance, deterrence, punishment--the Legislature arguably viewed SBX1 28 as a means to an estimated \$1.4 billion end. Needless to say, SBX1 28's existence, content and passage came

as quite a surprise to California taxpayers, who often closely monitor relevant proposed tax legislation through the legislative process and readily capitalize on every opportunity for public comment.

What did not come as a surprise was the overwhelming disapproval of the new Penalty that was voiced by industry representatives and tax practitioners alike during the first opportunity for public comment. At an Interested Parties Meeting held on December 5, 2008, many attendees called upon the Franchise Tax Board ("FTB") to seek a legislative repeal of the bill, and if unsuccessful, to interpret the language as broadly as possible in favor of the corporate taxpayer. Instead of encouraging "affirmative self-assessment," many attendees argued that the new Penalty would lead to deliberate overstatements of corporate tax liability, thereby subjecting the corporations (and the corporate tax preparers) to perjury charges. The debate over the Penalty grew more heated with time, leading to a lawsuit filed in February 2009.

At the center of the firestorm is Cal Rev & Tax Code § 19138. The statute imposes a 20% penalty on any understatement of tax that exceeds \$1 million for any taxable year. n1 The phrase "understatement of tax" is defined as "the amount by which the tax imposed by Part 11 (commencing with Section 23001) [Corporation Tax Law] exceeds the amount of the tax shown on an original return or shown on an amended return filed on or before the original or extended due date of the return for the taxable year." n2 The \$1 million threshold for imposition of the Penalty applies on an aggregate basis for taxpayers that are required or authorized to be included in a combined report under Cal Rev & Tax Code § 25101 or Cal Rev & Tax Code § 25101.15, respectively. n3 The Penalty applies to each taxable year beginning on or after January 1, 2003, where the statute of limitations on assessment has yet to expire for such taxable year and applies in perpetuity for all subsequent taxable years. n4

Taxpayers who wished to avoid the imposition of the Penalty on taxable years for which tax returns had already been filed had the opportunity to file an amended tax return on or before the statutorily prescribed May 31, 2009, deadline. n5 The self-assessed tax shown on an amended tax return filed on or before such date will be treated as the amount of tax shown on the original tax return, thereby mitigating the imposition of the Penalty, at least for those potential tax liabilities of which the taxpayer had knowledge and reported on the amended tax return.

It is important to note that the Penalty is in addition to, not in lieu of, all other penalties imposed under California's Corporation Tax Law. n6 More importantly, however, there are only two statutory exceptions to the imposition of the Penalty. n7 The first is if the understatement of tax is attributable to a change in law that is enacted, promulgated, issued or becomes final after the earlier of (a) the date the taxpayer files the return for the taxable year to which the change applies or (b) the extended due date for the return for the taxable year to which the change applies. n8 The second is if the understatement of tax is attributable to the taxpayer's reasonable reliance on written advice of the FTB in the form of a Chief Counsel legal ruling. n9 There is no reasonable cause exception, nor is there an exception for good faith.

California Taxpayers' Association Brought Suit to Challenge the Validity of the Penalty.

The California Taxpayers' Association ("Cal-Tax") challenged the Penalty in California Superior Court on numerous grounds. n10

For example, Cal-Tax claimed that Section 19138 (Cal Rev & Tax Code § 19138) was in reality a tax, not a penalty, the sole purpose of which was to generate revenue for California's ailing economy, and fast. n11 As a result, Cal-Tax argued, the California Constitution imposed a two-thirds voting requirement in each house of the Legislature. n12 SBX1 28, however, received 22 out of 43 votes in the Senate and 43 out of 80 votes in the Assembly. Neither the Senate vote, nor the Assembly vote, met the two-thirds voting requirement for passage of SBX1 28, if the Penalty was, in actuality, a tax. The suit also challenged the Penalty on substantive due process grounds, arguing that the Penalty's retroactive application was not based upon a "rational legislative purpose" and exceeded a "modest" period. n13 The court rejected these arguments, pointing to the legislative designation and the function of the Penalty with regard to the former and the purpose of encouraging taxpayers who had taken questionable positions to come forward and amend their returns with regard to the latter. n14

Cal-Tax's strongest argument appeared to be that the Penalty precluded both pre-payment and post-payment review upon its exaction by the FTB, therefore denying taxpayers of their procedural due process. n15 The court rejected this argument too, though, stating that when read in harmony with Cal Rev & Tax Code § 19382, the law provides a "post-deprivation remedy in the form of a refund action in which taxpayers may contest the validity of the tax penalty." n16

On May 20, 2009, the Superior Court issued its ruling in the case and denied Cal-Tax's claims in full and expressed its intent to enter declaratory judgment that Section 19138 is constitutional and enforceable on its face. n17 Cal-Tax has yet to appeal the decision.

California Court Decision Leaves Corporate Taxpayers in a Quandary.

In light of the court's decision, corporate taxpayers are left with the daunting task of computing California income tax based on the maximum possible tax liability of *all potential issues*, including troublesome timing, transfer-pricing, unitary combination, business/nonbusiness income, and apportionment issues. Not only does the Penalty provide a perverse incentive to deliberately overstate income or understate a particular deduction, the Penalty places even the most conservative taxpayer in the undesirable position of having to reconsider any and all legally defensible positions which may have been taken and successfully defended but for the existence of the new Penalty. By forcing taxpayers to be overly conservative on meritorious tax positions, the Penalty places corporate tax departments at odds with shareholder interest. Whether these tensions can be reconciled remains to be seen.

To further complicate matters, Cal Rev & Tax Code § 18621 provides that "any return, declaration, statement, or other document required to be made under any provision of Part 10 .., Part 11 .. (commencing with Section 23001), this part, or any other applicable regulation shall contain, or be verified by, a written declaration that is made under the penalties of perjury." How does a taxpayer sign a return under penalty of perjury knowing that but for the Penalty the stated liability would have been different?

With the deadline for filing amended returns under Section 19138 now passed and the money received with these returns now in California's carnivorous coffers, a new push has begun to fix the problem on a going-forward basis. On June 1, 2009, California's Chair of the Assembly Revenue & Taxation Committee amended a proposed bill, AB 697, to limit the Penalty to tax years beginning before January 1, 2008, and to repeal the Penalty as of December 1, 2010. n18

As for now, the Penalty stands. Corporate taxpayers must inevitably arrive at Morton's Fork and make a nearly impossible decision.

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n1 Cal Rev & Tax Code § 19138(a) & (b).

n2 Cal Rev & Tax Code § 19138(b).

n3 Cal Rev & Tax Code § 19138(a)(2).

n4 Cal Rev & Tax Code § 19138(h).

n5 Cal Rev & Tax Code § 19138(b).

n6 Cal Rev & Tax Code § 19138(c).

n7 Cal Rev & Tax Code § 19138(f)(1).

n8 The phrase "change of law" is defined as "a statutory change or an interpretation of law or rule of law by regulation, legal ruling of counsel, with the meaning of subdivision (b) of Section 11340.9 of the Government Code, or a published federal or California court decision." Cal Rev & Tax Code § 19138(f)(2).

n9 Cal Rev & Tax Code § 19138(g).

n10 *California Taxpayers' Association v. Franchise Tax Board*, Sacramento Superior Ct. No. 34-2009-80000168 (filed Feb. 17, 2009).

n11 See Cal-Tax Memorandum in Support of Petition for Writ of Mandate and Verified Complaint, pp. 10 -- 14 (filed Feb. 17, 2009).

n12 See Cal. Const. Art. XIII A, section 3.

n13 See *id.* at pp. 19 -- 20; see also *United States v. Carlton* (1994) 512 U.S. 26, 31-32; *City of Modesto v. National Med., Inc.* (2005) 128 Cal.App.4th 518, 529-530.

n14 *California Taxpayers' Association, supra*, Ruling after Hearing, p. 13 (filed May 20, 2009).

n15 See Cal-Tax Memorandum in Support of Petition for Writ of Mandate and Verified Complaint, pp. 20 -- 21.

n16 Ruling after Hearing at p. 15.

n17 *Id.* at p. 16.

n18 Bill text available at
http://www.leginfo.ca.gov/pub/09-10/bill/asm/ab_0651-0700/ab_697_bill_20090601_amended_sen_v97.html.

RELATED LINKS: For a discussion of related developments, see

- 1-4 Bender's State Taxation: Principles and Practice § 4.06

For more related materials, see

- Lexis CA Tax Practice Insight 6,546

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A Guide to the New 65% Subsidy to Help Pay COBRA Costs

2009 Emerging Issues 3785

The COBRA Health Care Subsidy: A Guide for Employers

By Dorinda DeScherer

June 17, 2009

SUMMARY: The American Recovery and Reinvestment Act of 2009 provides a subsidy for 65% of COBRA continuation coverage. The subsidy must be provided by group health plans subject to the federal COBRA coverage requirements or to similar requirements of state law. The subsidy is available to former employees and their family members who become eligible for coverage after an involuntary termination of employment from September 1, 2008, to December 31, 2009.

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ARTICLE: The COBRA Health Care Subsidy: A Guide for Employers

The COBRA health care continuation coverage rules allow employees who lose their jobs to continue their health coverage under their former employers' plans for up to 18 months. But there's a catch: The plan can charge the full cost for the coverage plus an additional 2% for administrative expenses. And coming up with the necessary premium payments may be difficult or impossible for laid-off employees who are struggling to make ends meet.

The American Recovery and Reinvestment Act of 2009 (P.L. 111-5) provides a subsidy for 65% of the cost of COBRA continuation coverage. The COBRA subsidy is required to be provided by group health plans that are subject to the federal COBRA continuation coverage requirements or to similar requirements under state law. The subsidy is available to former employees and their family members who become eligible for continuation coverage as a result of an involuntary termination of employment from September 1, 2008, through December 31, 2009. The subsidy applies as of the first period of coverage beginning on or after February 17, 2009 (the ARRA enactment date). The premium subsidy lasts for nine months or until the earlier of the date the individual becomes covered by another plan, or Medicare, or the end of the normal COBRA coverage period.

Specifically, the law provides that an "assistance eligible individual" must be treated as having paid in full for COBRA coverage if he or she pays just 35% of the premium [ARRA §3001]. Once that amount has been paid, the employer sponsoring the group health plan is required to make the remaining 65% premium payment for the individual's health coverage or provide coverage if the plan is self-insured.

The employer is not required to bear the ultimate cost for the subsidy. The 65% of the cost borne by the employer

is recouped by means of a credit against the employer's payroll taxes [IRC §6432 as added by ARRA]. Nonetheless, employers may pay a price for the subsidy. According to one survey, 58% of employers expect the subsidy program to increase health care costs due to higher administrative costs and higher usage of continuation coverage.

One way to keep costs under control is to understand exactly how the premium subsidy works. In this commentary, we will look at how the premium subsidy impacts employers.

Covered Group Health Plans

The COBRA subsidy applies to group health plans that are subject to the federal COBRA continuation coverage requirements or to state programs that provide continuation coverage comparable to COBRA continuation coverage. The subsidy also applies to continuation coverage under the Federal Employees Health Benefits Program (FEHBP).

As a general rule, the COBRA continuation coverage requirements apply to any group health plan (including a self-insured plan) maintained by or contributed to by an employer or employee organization to provide health care to employees, former employees, the employer, others associated or formerly associated with the employer in a business relationship, or their families [IRC §§4980B(g)(2), 5000(b)(1)]. However, the COBRA rules provide an exemption from the continuation coverage requirements for employers that normally employed fewer than 20 employees on a typical business day in the preceding year [IRC §4980B]. Moreover, certain types of employer-provided health care arrangements, including long-term care insurance, Archer medical savings accounts (MSAs), certain health flexible spending accounts (FSAs), and on-site first aid clinics are exempt from the continuation coverage requirements. The premium subsidy is available for continuation coverage under any group health plan to which the COBRA continuation coverage requirements apply [IRS Notice 2009-27, Q&A-27--Q&A-29].

The premium subsidy applies to continuation coverage required by state continuation coverage programs, often referred to as state "mini-COBRA" laws, only if the required coverage is comparable to that required by federal COBRA. Comparable state continuation coverage does not include every state law right to continued health coverage, such as a right to continue coverage with no rules that limit the maximum premium that can be charged. To be comparable, the right generally must be to continue coverage substantially similar to that provided under the group health plan at a monthly cost that is based on a specified percentage of the group health plan's cost of providing such coverage. On the other hand, a different period of continuation coverage under a state continuation coverage program does not disqualify the state program from being comparable. For example, the fact that a state continuation coverage program provides only for six months of continuation coverage (instead of 18 months, as required by federal COBRA) will not result in the state program failing to be comparable. Similarly, state programs providing for different qualifying events, different qualified beneficiaries, or different maximum premiums generally will not fail to be comparable solely for those reasons [IRS Notice 2009-27, Q&A-57-Q&A-58].

Except as specifically noted, this commentary will use the term "COBRA continuation coverage" to describe all coverage subject to the premium subsidy requirements.

Assistance Eligible Individuals

The COBRA subsidy must be provided to an assistance eligible individual.

An assistance eligible individual is any individual who (1) became or becomes eligible for COBRA coverage as a result of an involuntary termination of employment during the period from September 1, 2008, through December 31, 2009, (2) who is eligible for COBRA continuation coverage at any time during that period, and (3) who elects continuation coverage [IRS Notice 2009-27, Q&A-10-Q&A-19].

The subsidy is not limited to terminated employees. An assistance eligible individual may be a COBRA qualified beneficiary associated with the related covered employee, such as a dependent child or spouse of an employee. However, the subsidy applies only to *involuntarily terminated* employees and their family members who are qualified

beneficiaries. It does not apply to employees who voluntarily terminate employment or to family members who are COBRA qualified beneficiaries as a result of the voluntary termination, nor does it apply to individuals who are eligible for COBRA coverage as a result of another COBRA-qualifying event (e.g., death of the employee or divorce).

In order to be a qualified beneficiary, an individual must be covered under the group health plan on the day before the involuntary termination (except in the case of a child born to or adopted by a covered employee during a period of COBRA continuation coverage). As under the normal COBRA rules, the qualified beneficiary can independently elect COBRA and can independently receive the COBRA subsidy.

Extended election period. ARRA provides an extended election period for qualified beneficiaries who became eligible for COBRA continuation coverage as a result of an involuntary termination on or after September 1, 2008 and before the date of enactment (February 17, 2009), but did not elect COBRA coverage or elected but dropped the coverage [IRS Notice 2009-27, Q&A-47-Q&A-55].

The extended election period is for 60 days after the qualified beneficiaries are provided notice of the extended election period. The deadline for providing notice of the extended election period was April 18, 2009, consequently some individuals had until mid-June to elect COBRA coverage and qualify for the subsidy.

Under ARRA, the extended election period applies to a group health plan subject to the federal COBRA requirements and to temporary continuation coverage under the FEHBP, but not to state-mandated continuation coverage. However, if a state amends its "mini-COBRA" law to provide for a similar special election and an individual otherwise satisfies the requirements to be an assistance eligible individual, the premium reduction will be available for any resulting continuation coverage

The continuation coverage resulting from an extended election lasts no longer than the original maximum required COBRA coverage period (generally, 18 months from the termination of employment) and begins no earlier than the first period of coverage beginning on or after February 17, 2009.

Expedited review. The law includes an expedited 15-day review process under which an individual may request review of a group health plan's denial of treatment as an assistance eligible individual. In the case of private-sector group health plans subject to the federal COBRA continuation coverage requirements, this review is conducted by the Department of Labor (DOL). The DOL has released Form EBSA 300, *Application to the U.S. Department of Labor for Expedited Review of Denial of COBRA Premium Reduction*, to be used by terminated employees and other qualified beneficiaries to request such review.

In the case of continuation coverage provided through a federal, state or local government plan, or continuation coverage provided pursuant to a state insurance law, the review is conducted by the Department of Health and Human Services Centers for Medicare & Medicaid Services (CMS). Applicants must submit a *Request for Review If You Have Been Denied Premium Assistance* (OMB Control Number 0938-1062 Exp. Date 11/30/2009).

Involuntary Termination of Employment and COBRA Eligibility

One key question that appears to be troubling many employers is what constitutes an involuntary termination of employment that will trigger the COBRA subsidy.

IRS guidance provides that an involuntary termination generally means a severance from employment due to the independent exercise of the unilateral authority *by the employer* where the employee was willing and able to continue working [IRS Notice 2009-27, Q&A-1--Q&A-9].

However, the IRS says that an *employee-initiated* termination for good reason due to an employer action that causes a material negative change in the employment relationship for the employee or a voluntary resignation because of a material change in the employee's work location also count as involuntary terminations. For example, a reduction in

hours would not constitute an involuntary termination even if the employee loses health coverage and becomes eligible for COBRA coverage as a result of the reduction. However, an employee's voluntary resignation in response to a reduction in hours may constitute an involuntary termination if the reduction in hours is a material negative change in the employment relationship for the employee.

On the other hand a reduction in hours to zero will almost always qualify as an involuntary termination. The IRS says an involuntary reduction to zero hours, such as a lay-off, furlough, or other suspension of employment, resulting in a loss of health coverage is an involuntary termination for purposes of the subsidy. Moreover, although work stoppage as the result of a strike is not an involuntary termination, a lockout initiated by the employer would be.

The IRS guidance also indicates that an employee will be considered to be involuntarily terminated if he or she accepts a "buy-out" offer when the employer has indicated that the employee's group will be down-sized at the end of the offer period.

The reason for an employee's involuntary termination of employment is generally irrelevant. The subsidy will generally apply even if the employee is fired for cause. However, for purposes of the general COBRA continuation coverage rules, a termination of employment that is due to *gross misconduct* of the employee is not a qualifying event and the employee and other family members losing health coverage by reason of the employee's termination of employment are not eligible for COBRA continuation coverage.

Practice Tip: In order for the COBRA subsidy to apply, *both* the involuntary termination of the employee's employment and eligibility for COBRA coverage must occur during the period from September 1, 2008 through December 31, 2009. For example, if an employee is terminated sometime before December 31, 2009, but does not lose his or her employer-provided health coverage and become eligible for COBRA until sometime in 2010, the subsidy will not apply.

If an employer extends an employee's health coverage for a period of time following a termination of employment, the date of the loss of coverage will depend on how the employer treats the extended period of health coverage.

Example 1. Adam is involuntarily terminated from employment on November 15, 2009. Adam's employer-provided health coverage would normally terminate on November 30, 2009. However, Adam's severance package includes six months of employer-paid health coverage from December 1, 2009 through May 31, 2010. Adam's employer treats the six months of health coverage as deferring the employee's loss of coverage under the plan. Result: Adam's loss of coverage will not occur until May 31, 2010. Therefore, Adam is not eligible for the COBRA subsidy because the loss of coverage will not occur on or before December 31, 2009.

Example 2. Same facts as Example 1, except that Adam's employer treats the six months of health coverage as a provision of COBRA coverage. Result: Adam is eligible for the subsidy because his loss of coverage is deemed to have occurred on November 30, 2009.

Note: Although Adam would technically qualify as an assistance eligible individual as of November 30, 2009, no actual subsidy would be available until June of 2010 when he must begin paying for COBRA coverage. The subsidy is based on the amount of premium actually charged to the employee for COBRA coverage. Where the employer provides coverage at no cost to the employee, there is no premium charge to which the subsidy applies.

An individual's COBRA eligibility must be triggered by the termination of employment in order to qualify for the subsidy. If COBRA continuation coverage is based on a qualifying event before the termination of employment, the later involuntary termination does not cause a qualified COBRA beneficiary to become eligible for the subsidy.

Example 3. Burton is divorced on April 30, 2009. The divorce results in a loss of health coverage for Burton's ex-wife. Burton's ex-wife is eligible for and timely elects COBRA continuation coverage as a result of the divorce. Following the divorce, Burton is involuntarily terminated and loses health coverage on October 30, 2009. Burton elects

COBRA continuation coverage that begins November 30, 2009. Burton's ex-wife is not eligible for the COBRA subsidy because the qualifying event resulting in her COBRA continuation coverage was not an involuntary termination. Burton, however, is eligible for the subsidy.

Example 4. Cheryl experiences a reduction in hours in March 2009 that does not constitute an involuntary termination. The reduction in hours causes Cheryl to lose health coverage under her employer's plan. Cheryl is eligible for and timely elects COBRA continuation coverage that begins as of April 1, 2009. In November 2009, Cheryl is involuntarily terminated from employment. Cheryl does not become eligible for the COBRA subsidy as a result of the November 2009 involuntary termination because the qualifying event with respect to her COBRA continuation coverage was not the involuntary termination.

A termination and loss of health coverage must qualify the individual for COBRA continuation coverage in order for the subsidy to apply. For example, if an employer that is not subject to the COBRA continuation requirements voluntarily provides continuation coverage to involuntarily terminated employees, those employees are *not* eligible for the subsidy.

Practice Tip: The *election* of COBRA coverage is *not* required to occur during the period from September 1, 2008 through December 31, 2009, as long as the COBRA coverage itself begins during that period.

A qualified beneficiary must be given at least 60 days to elect COBRA coverage, beginning as of the later of the date of the loss of coverage or the date the beneficiary is notified of the right to elect COBRA coverage. Consequently, individuals who lose coverage as a result of a termination of employment in the latter part of 2009 will generally have until sometime in 2010 to make their COBRA elections.

The COBRA Subsidy-Crunching the Numbers

An assistance eligible individual must be treated as having paid in full for COBRA coverage if her or she pays 35 percent of the premium. [ARRA §3001]. Once that amount has been paid, the employer sponsoring the group health plan is required to make the remaining 65% premium payment for the individual's health coverage or provide coverage if the plan is self-insured.

The amount used to calculate the employee's 35 percent share of the premium is the premium amount the employee would otherwise be required to pay for COBRA continuation coverage [IRS Notice 2009-27, Q&A-20--Q&A-26].

Under the COBRA rules, the maximum amount an employer is permitted to charge for COBRA coverage is 102 percent of the "applicable premium"-that is, 100 percent of the cost of coverage for similarly situated individuals plus 2 percent for administrative expenses.

If a person other than the employer pays the premium on behalf of an assistance eligible individual, the individual is nonetheless treated as paying the premium and is entitled to the premium subsidy. Thus, payment by an assistance eligible individual includes payment by another individual paying on behalf of the individual, such as a parent or guardian paying on behalf of a child, or an entity such as a state agency or charity paying on behalf of an individual. However, payment of the premium by the employer will not count as payment by the assistance eligible individual. Moreover, the IRS says that payment of the premium with pre-tax dollars from an employer-provided health reimbursement account (HRA), counts as a payment by the *employer*, not the employee.

If the amount actually charged the assistance eligible individual is less than the maximum COBRA premium, the amount actually charged is used to determine the assistance eligible individual's 35% share and the subsidized amount.

Example 1. David is an assistance eligible individual. David's full premium for COBRA continuation coverage under his former employer's group health plan is \$500 per month. David is entitled to COBRA continuation coverage

upon the timely payment of \$175 (35 percent of \$500). The COBRA subsidy is \$325.

Example 2. Same facts as Example 1, except that David's former employer pays one-half the COBRA premium on David's behalf and David is charged only \$250 per month. David is entitled to COBRA continuation coverage upon the timely payment of \$87.50 (35% of \$250). The COBRA subsidy is \$162.50.

Under the COBRA rules an individual receiving COBRA coverage must have the same rights as active employees to change coverage during an open enrollment period, including the right to add coverage for dependents. However, except in the case of a child who is born or adopted during the COBRA coverage period, a spouse or dependent who was not covered before a qualifying event is not a qualified beneficiary. The subsidy does not apply to any portion of a COBRA premium that is attributable to coverage for an individual who is not a qualified beneficiary because such an individual is not an assistance eligible individual.

When allocating the premium between coverage for an assistance eligible individual and coverage for other individuals, the premium is allocated first to the cost of coverage for the assistance eligible individual. Therefore, if coverage for the other individuals does not add to the overall cost, the subsidy applies to the full amount paid for the coverage. However, if coverage for the other individuals adds to the cost, the incremental cost is not eligible for the subsidy.

Example 3. Edmund, an assistance eligible individual has COBRA coverage for himself and his two dependent children who are also assistance eligible individuals. The COBRA coverage also covers an individual who is not an assistance eligible individual. The premium for COBRA coverage for an individual and two or more dependents is \$1,000 per month. Thus, the premium for coverage of the assistance eligible individuals (Edmund and the two children) would be \$1,000 per month, regardless of the coverage for the other individual. The incremental cost of the coverage for the other individual is \$0. Therefore, the subsidy applies to the entire \$1,000 premium. Edmund is entitled to COBRA coverage upon timely payment of \$350 (35% of \$1,000) and the amount of the subsidy is \$650.

Example 4. Fern has self-only COBRA continuation coverage. The premium for self-only COBRA coverage is \$450 per month. Therefore, Fern must pay \$157.50 (35 percent of \$450) per month and is eligible for a subsidy of \$292.50 (65 percent of \$450) per month. However, during the subsidy period, the plan has an open enrollment period and Fern adds her spouse and dependent child (who are not assistance eligible individuals) to the coverage. The additional coverage raises the premium to \$1,000 per month. The \$550 incremental cost for the additional coverage is not eligible for the subsidy. Therefore, Fern's subsidy remains at \$292.50 (65% of \$450). Fern must pay \$157.50 (35% of \$450) plus \$550 for the additional coverage, or a total of \$707.50.

Optional coverage changes. As a general rule, a COBRA beneficiary is entitled only to continue the coverage he or she had immediately prior to the COBRA qualifying event (except for changes allowed during an open enrollment period). However, under the subsidy rules, an employer may *but is not required* to offer assistance eligible individuals a special opportunity to change coverage in conjunction with electing COBRA coverage.

An assistance eligible individual may elect to enroll in different coverage only if: (1) the employer involved has determined that it will permit assistance eligible individuals to enroll in different coverage; (2) the premium for the different coverage is not more than the premium for coverage in which the individual was enrolled at the time of the termination of employment; (3) the different coverage elected is also offered to active employees of the employer at the time the election is made; and (4) the different coverage isn't limited coverage (e.g. dental or vision coverage).

An assistance eligible individual must make a different coverage election not later than 90 days after the date of notice of the plan enrollment option, which must be provided as part of the notice of COBRA continuation coverage rights (see below). Once an election of different coverage is made, it becomes COBRA continuation coverage, and must be continued for the entire COBRA period unless a change is otherwise permitted under the normal COBRA rules.

Employer Subsidy Reimbursement

The amount of the COBRA premium subsidy (i.e., the 65% of the premium not paid by the COBRA beneficiary) will be reimbursed to the person to whom premiums for COBRA continuation coverage are payable [IRC §6432 as added by ARRA §3001(a)(12)(A)] The mechanism for making the reimbursement is treatment of the amount of the subsidy as a payment of that person's payroll taxes. If the amount treated as paid exceeds the amount of the liability for payroll taxes, the excess will be treated as an overpayment of payroll taxes.

Depending on the situation, the reimbursement may be claimed by the employer, the plan, or the insurer. [IRC §6432(b)] In the case of a plan subject to the federal COBRA coverage rules or a self-insured plan, the reimbursement is claimed by the employer maintaining the plan. In the case of a multiemployer plan, the credit is claimed by the plan itself. In all other cases, the credit is claimed by the insurer providing coverage under the plan.

In the typical case where the employer maintaining the group health plan is eligible for reimbursement, the employer recovers the subsidy provided to assistance eligible individuals by taking the subsidy as a credit on its quarterly Form 941 employment tax return. The employer may provide the subsidy-and take the credit on its employment tax return only after it has received the 35 percent premium payment from the assistance eligible individual [IR 2009-15].

An employer can reduce the amount of its payroll tax deposits to reflect the COBRA subsidy provided to assistance eligible individuals. The amount of the COBRA subsidy an employer provides during a quarter will be treated as having been deposited on the first day of the quarter and applied against the employer's deposit requirements. Therefore, the employer will be treated as having made timely deposits up to the amount of the subsidy during the quarter, regardless of the otherwise applicable due dates for deposits.

Practice Tip: The IRS has made it clear that the credit is not required to be claimed on Form 941 for the quarter in which the subsidy is actually provided; instead, the employer may generally choose to claim the credit on Form 941 for a later quarter in the same calendar year. However, if an employer reduced its payroll tax deposits for a quarter by the amount of subsidy, it must claim the credit for that amount on Form 941 for the quarter for which its payroll tax deposits were reduced. If the subsidy is not claimed for a particular quarter or is miscalculated, the employer can file Form 941-X, *Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund* (Rev. June 2009), to make any necessary adjustments.

When claiming the payroll credit on Form 941, the employer is required to report only the total amount of the COBRA subsidy provided and the number of assistance eligible individuals to whom the subsidy was provided. Note that when counting assistance eligible individuals for this purpose, employers should count only those individuals who paid a reduced COBRA premium during the quarter, even if the reduced premium was for insurance that covered more than one assistance eligible individual. For example, if a former employee paid for coverage for himself, a spouse and two children, the employer should include only *one* individual in the number of assistance eligible individuals. In addition, the IRS says an individual should be reported only once per quarter regardless of whether the individual made monthly or more frequent premium payments during the quarter.

Employers must, however, maintain additional documentation to back up the payroll credit claimed. This documentation includes: (1) Information on the receipt, including dates and amounts, of the required 35% of the premium from each assistance eligible individual. (2) In the case of an insured plan, copies of invoices or other supporting statements from the insurance carrier and proof of timely payment of the full premium for each assistance eligible individual. (3) In the case of a self-insured plan, proof of the premium amount and proof of the coverage provided to each assistance eligible individual. (4) Attestation of involuntary termination, including the date, for each covered employee whose involuntary termination is the basis for eligibility for the subsidy. (5) Proof of each assistance eligible individual's eligibility for and election of COBRA coverage. (6) A record of the Social Security numbers of all covered employees, the amount of the subsidy for each covered employee, and whether the subsidy was for one individual or two or more. (7) Other documents necessary to verify the correct amount of the credit.

Duration of COBRA Subsidy

An assistance eligible individual qualifies for the subsidy for a period of not more than nine months [Notice 2009-27, Q&A-33-Q&A-44].

The subsidy terminates as of the first date an assistance eligible individual becomes eligible for coverage under any other group health plan (other than limited coverage for dental, vision, counseling, or referral services; coverage under a flexible spending arrangement; or coverage at an on-site medical facility maintained by an employer and that consists primarily of first-aid services, prevention and wellness or similar care) or is eligible for Medicare benefits; or the earliest of (a) the date that is nine months after the first day of the first month that the subsidy applies to the individual or (b) the date following the expiration of the maximum period of COBRA continuation coverage.

Termination of the subsidy is triggered by *eligibility* for other health coverage even if the individual does not enroll for such coverage.

Example 1. George has been receiving COBRA coverage subject to the subsidy under his former employer's health plan. George begins employment with a new employer on July 15, 2009 and is eligible to enroll in the new employer's plan with coverage effective August 1. However, George declines the coverage and continues his COBRA coverage. Although the eligibility for other coverage does not terminate George's right to COBRA coverage, the premium subsidy does not apply as of August 1, 2009.

Example 2. Helen and her husband, who are both assistance eligible individuals, have COBRA coverage under the plan of the Helen's former employer. Helen's husband begins employment with a new employer and is eligible to enroll for either self-only or family coverage under the new employer's plan. Helen's husband opts for self-only coverage, while Helen remains covered by COBRA coverage. Although Helen is allowed to continue COBRA coverage, the premium subsidy is no longer available as of the date she became eligible for coverage under the plan of her husband's new employer.

Eligibility for retiree health coverage in lieu of COBRA coverage may or may not affect an individual's eligibility for the subsidy. Eligibility for retiree health coverage will have no effect on the subsidy if the retiree health coverage is offered under the *same* group health plan as the COBRA coverage. However, if an individual is eligible for retiree coverage under a *different* plan the subsidy will not apply.

Practice Tip: Although the subsidy applies only to individuals who qualify as assistance eligible individuals on or before December 31, 2009, the subsidy itself may apply well into 2010. For example, IRS guidance points out that an individual to whom the subsidy first applies on December 1, 2009, can receive the subsidy until August 1, 2010 (assuming the individual does not become eligible for other group health coverage or otherwise lose eligibility for COBRA coverage before that date).

An individual who is no longer eligible for the subsidized COBRA premium because of eligibility for coverage under another group health plan (other than limited coverage) or Medicare must notify the group health plan providing the subsidized COBRA coverage. An assistance eligible individual who fails to provide the required notice must pay a penalty of 110% of the premium subsidy received after termination of eligibility. 6720C(a) as added by ARRA §3001(a)(13)(A)] No penalty will be imposed if failure to provide the required notice was due to reasonable cause and not to willful neglect. [IRC §6720C(b) as added by ARRA §3001(a)(13)(A)]

Income Tax Treatment of COBRA Subsidy

The COBRA premium subsidy is excluded from the gross income of an assistance eligible individual for federal income tax purposes [IRC § 139C as added by ARRA §3001(a)(15)(A)].

However, the law provides a recapture rule for premium assistance provided to higher-income taxpayers. Under

the recapture rule, if (a) premium assistance is provided for any COBRA continuation coverage for the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer during any portion of the tax year, and (b) the taxpayer's modified adjusted gross income (MAGI) for the tax year is more \$145,000 on a single return or \$290,000 on a joint return, the taxpayer's income tax for the tax year will be increased by the amount of the premium assistance.

To avoid recapture, an assistance eligible individual can elect to waive the right to premium assistance.

To waive the subsidy an assistance eligible individual must provide a signed and dated notification-which must make reference to a "permanent waiver"-to the employer or other person entitled to reimbursement for the COBRA subsidy. No notice is required to be given to the IRS or other government agency. If an assistance eligible individual elects to waive the subsidy, the election may not be reversed and the individual may not receive the subsidy in either 2009 or 2010, regardless of income for the year [Notice 2009-27, Q&A-45--46].

On the other hand the IRS notice makes it clear that an employer cannot effectively "waive" the subsidy for an assistance eligible individual by refusing to provide the subsidy because the individual's income is too high. Even if an assistance eligible individual's income is high enough that recapture would apply, COBRA coverage must be provided upon payment of 35% of the premium unless the individual has notified the plan that he or she has elected to waive the subsidy.

Practice Tip: Assistance eligible individuals will apparently be on an "honor system" for purposes of the recapture rule. The IRS has made it clear that no information reporting of the COBRA premium subsidy is required to be provided to an assistance-eligible individual or to the IRS by an employer.

Note: The treatment of the premium subsidy for state tax purposes is determined under state law.

Notice Requirements

The ARRA provides that the general requirement to provide a notice of COBRA continuation coverage rights will not be met unless the notice includes an additional notification about the availability of the COBRA subsidy.] A violation of this additional notice provision will be treated as a violation of the general COBRA notice requirements. The penalty for failure to provide required notice of COBRA continuation rights is \$110 per day.

The additional notification requirement may be met either by amending existing notice forms, or by including a separate document with the notice otherwise required.

The additional notification must include: (1) the forms necessary for establishing eligibility for the premium subsidy; (2) the name, address, and telephone number needed to contact the plan administrator and any other person maintaining relevant information in connection with the premium subsidy; (3) a description of the special election period (if applicable); (4) a description of the obligation of the assistance eligible individual to notify the plan providing continuation coverage of eligibility for subsequent coverage under another group health plan or Medicare, and the penalty for failure to do so; (5) a description, displayed in a prominent manner, of the qualified beneficiary's right to a reduced premium and any conditions on entitlement to the reduced premium; and (6) description of the option of the qualified beneficiary to enroll in different coverage, if permitted by the employer.]

Model notices can be found on the Department of Labor website at <http://www.dol.gov/ebsa/COBRA.html>.

RELATED LINKS: For more discussion of COBRA, see

- Employee Benefits Guide A7:9.08

For more discussion, see

- 2009-1 Federal Tax Legislative Analysis III

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New Guidance on Executive Compensation Limitations

2009 Emerging Issues 3772

Jayne Zanglein on June 2009 Interim Rule on Executive Compensation at TARP Firms

By Jayne Zanglein

June 16, 2009

SUMMARY: On June 9, 2009, the Department of the Treasury issued an interim final rule on TARP Standards for Compensation and Corporate Governance. The rule provides guidance on the executive compensation and corporate governance provisions of the Emergency Economic Stabilization Act of 2008 that apply to entities that receive financial assistance under the Troubled Asset Relief Program (TARP). The June 2009 guidance supersedes the February 2009 guidance.

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ARTICLE: On June 9, 2009, the Department of the Treasury issued an interim final rule on TARP Standards for Compensation and Corporate Governance. 31 CFR 30-1 *et seq.* The rule provides "guidance on the executive compensation and corporate governance provisions of [the Emergency Economic Stabilization Act of 2008, 110 P.L. 343, 12 USCS 5201, et seq. (EESA)] that apply to entities that receive financial assistance under the Troubled Asset Relief Program (TARP)." 31 CFR 30-1 (Summary, at 1). EESA Section 111 makes it mandatory for institutions that receive assistance under TARP to implement certain executive compensation and corporate governance provisions. TARP recipients include many Fortune 100 corporations such as Bank of America, Citigroup, JP Morgan, Morgan Stanley, and Goldman Sachs. Wall Street Journal Online, *Participants in Government Investment Plan* (April 22, 2009).

The Treasury issued a previous guidance in February 2009 on the executive compensation restrictions under EESA. But before the guidance could be implemented, Congress passed the American Recovery and Reinvestment Act of 2009, 111 P.L. 5, which completely modified EESA Section 111. The June 2009 Interim Rule consolidates the executive compensation provisions applicable to TARP recipients and adopts standards, some of which are similar to the February 2009 Interim Guidance. 31 CFR 30-1 (Executive Summary, at 11). The June guidance supersedes the February guidance.

The June guidance includes numerous standards applicable to TARP recipients. TARP recipients include those companies that have received or hold TARP funds, but excludes entities that receive TARP funds under EESA § 109. 31 CFR 30, Q-1 (Definition of TARP Recipient). Q-2 provides details on how long these provisions will continue to apply to TARP recipients.

Each of these standards will be examined below.

1. Compensation Committee

TARP recipients must maintain a Compensation Committee during the TARP Period. 31 CFR 30, Q-4. The "TARP period" means the "period beginning with the TARP recipient's receipt of any financial assistance and ending on the last date upon which any obligation arising from financial assistance remains outstanding (disregarding any warrants to purchase common stock of the TARP recipient that the Treasury may hold)." 31 CFR 30, Q-1 (Definition of TARP Period).

Every six months, the members of the Compensation Committee must: (1) Meet with senior risk officers to "to ensure that the [Senior Executive Officers (SEO)] compensation plans do not encourage SEOs to take unnecessary and excessive risks that threaten the value of the TARP recipient," 31 CFR 30, Q-4(a)(1); (2) Meet with senior risk officers to review "employee compensation plans in light of the risks posed to the TARP recipient by such plans and how to limit such risks," 31 CFR 30, Q-4(a)(2); and (3) Meet to review the entity's employee compensation plans to "ensure that these plans do not encourage the manipulation of reported earnings of the TARP recipient to enhance the compensation of any of the TARP recipient's employees," 31 CFR 30, Q-4(a)(3).

Each year, the Compensation Committee must: (1) Prepare a written report for inclusion in the Compensation Committee Report required by Item 407(e) of Regulation S-K, 31 CFR 30, Q-7(c), analyzing the SEO plans, and explain why they do not encourage unnecessary and excessive risk taking, how these plans encourage long-term value creation, and how these plans discourage financial manipulation designed to increase SEO compensation, 31 CFR 30, Q-4(a)(4). 31 CFR 30, Q-7(b); (2) Certify that they have completed the required compensation reviews, 31 CFR 30, Q-4(a)(5). *See also* 31 C.F.R. § 30, Q-7(a); and (3) Disclose whether it has hired a compensation consultant and any services (consulting or not) that the consultant has provided to the board, including compensation benchmarking, 31 CFR 30, Q-11(c).

If the committee discovers that certain features of SEO compensation plans encourage excessive risk-taking or financial manipulation, the committee must take action to limit these features. 31 CFR 30, Q-5, Q-6.

Similar rules apply to private TARP recipients, 31 CFR 30, Q-4(c). Even TARP recipients who have never had an outstanding TARP obligation must comply with some of these rules. 31 CFR 30, Q-4(d).

2. Clawback Provisions

EESA Section 111(b)(3)(B) requires a TARP recipient to ensure that any bonus payment made to a SEO or the 20 next most highly-compensated employees during the TARP period is subject to "clawback" if the bonus payment was based on materially inaccurate financial statements. A financial statement is "materially inaccurate if an employee knowingly engages in "providing inaccurate information (including knowingly failing to timely correct inaccurate information) relating to those financial statements." 31 CFR 30, Q-8. The Interim Rule clarifies that the TARP recipient must "exercise its clawback rights except to the extent it demonstrates that it is unreasonable to do so," such as when the expenses of recovery outweigh the amount to be recovered. 31 CFR 30, Q-8.

3. Golden Parachutes

EESA Section 111(b)(3)(C) requires a TARP recipient to prohibit any golden parachute payment to an SEO and any of the next five most highly compensated employees during the TARP period. 31 CFR 30, Q-9. Because a golden parachute is treated as being paid at the time of separation and equals the present value of all future payments, the golden parachute deemed to be paid during the TARP period may include payments made after the TARP period ends. 31 CFR 30, Q-8 (a). The Interim Rule also provides examples of the application of this provision. For example, if before the entity became a TARP recipient, an employee separated from service and was entitled to installment payments under a golden parachute, then the installments made after the entity became a TARP recipient are not prohibited. *Id.* at Example 2.

4. Prohibition on Bonuses and Gross-ups

EESA Section 111(b)(3)(D) prohibits a TARP recipient from paying bonuses or allowing bonuses to accrue during the TARP period. The restriction is tiered:

Table 1 Restrictions on Bonuses Paid by TARP Recipients, 31 C.F.R. § 30, Q-10(b)(1).

If the TARP Recipient Receives:

Restrictions Apply to:

Less than \$25 million

The most highly compensated employee

More than \$25 million but less than \$250 million

The 5 most highly compensated employees

More than \$250 million but less than \$500 million

The SEOS and the 10 next most highly compensated employees

More than \$500 million

The SEOs and the 20 next most highly compensated employees

The amount of financial assistance is determined at the end of the recipient's fiscal year and the new limit applies to the next fiscal year. 31 CFR 30, Q-10(b)(2). For the first year, the limit on bonuses does not apply to bonuses awarded or accrued before the entity became a TARP recipient. 31 CFR 30, Q-10(b)(3).

If a former SEO receives a bonus based on time served as a SEO, the bonus will be deemed to have accrued while the employee was an SEO. 31 CFR 30, Q-10(c)(3)(2). The Interim Rule provides examples.

This restriction on bonuses does not apply to "bonus payments required to be paid under a valid employment contract if the employee had a legally binding right under the contract to a bonus payment as of February 11, 2009" as long as the bonus is paid in accordance with the terms of the contract. 31 CFR 30, Q-10(e)(2). The Interim Rule provides examples.

In addition, TARP recipients must disclose perquisites paid to employees listed in the above table if those perquisites are equal to or greater than \$25,000. 31 CFR 30, Q-11(b)(1). The disclosure must include a "narrative description of the amount and nature of these perquisites, the recipient of these perquisites, and a justification for offering these perquisites." *Id.*

This restriction does not apply to long-term restricted stock as long as the "value of this grant may not exceed one third of the employee's annual compensation as determined for that fiscal year." 31 CFR 30, Q-10(e)(1)(i). The recipient does not look back to the prior year to determine compensation. *Id.* For purposes of determining the value of the stock, the long-term stock granted "will only be included in the calculation in the year in which the restricted stock is granted at its total fair market value on the grant date." *Id.* The Interim Rule includes an example.

These rules apply to publicly-traded and private TARP recipients. 31 CFR 30, Q-10(f).

TARP recipients are also prohibited from informally or formally providing gross-ups to the SEOs and the next 10 highest paid employees. 31 CFR 30, Q-11(d).

5. Adoption of Policy on Luxury Expenditures

EESA Section 111(d) requires a TARP recipient to adopt and maintain a policy on excessive or luxury expenditures. 31 CFR 30, Q-12.

6. Requirement for Say on Pay

EESA Section 111(e) requires a TARP recipient to allow a shareholder resolution on executive compensation.

7. Effect of Mergers and Acquisitions

If a TARP recipient is acquired, the purchaser will not be subject to EESA Section 111 simply because of the acquisition, 31 CFR 30, Q-13(a), unless the purpose of the transaction was to evade EESA requirements. 31 CFR 30, Q-13(b).

8. Certification Under EESA Section 111(b)(4)

EESA Section 111(b)(4) requires the principal executive officer and principal financial officer to provide certain certifications. The Interim Rule provides model certifications. 31 CFR 30, Q-15 and Appendices A and B. Persons who provide false or misleading certifications will be subject to criminal prosecution. 31 CFR 30, Q-15(c).

9. Appointment of a Special Master

The Special Master (Kenneth Feinberg) must approve compensation payments and structures for payment to CEOs and most highly compensated employees by TARP recipients who receive exceptional financial assistance. *See* 31 CFR 30, Q-16(a)(3); 31 CFR 30, Q-11(a). Those recipients currently are AIG, Citigroup, Bank of America, General Motors, GMAC, Chrysler and Chrysler Financial. Tom Braithwaite, *US 'Pay Tsar' to Vet Executive Packages*, FT Online (June 10, 2009). In addition, the Special Master must also approve compensation for other employees (such as executive officers or the top 100 highly paid employees) who are not subject to EESA's bonus restrictions and who make less than \$500,000 (excluding long-term restricted stock). 31 CFR 30, Q-11(a). The Special Master has the authority to alter the terms of the recipient's compensation arrangements. 31 CFR 30, Q-11(a).

In addition, the Special Master will review all compensation paid by TARP recipients before February 17, 2009.

At the request of a TARP recipient, the Special Master has authority to issue advisory opinions on whether a compensation structure may violate EESA or TARP. 31 CFR 30, Q-16(a)(4). In making this determination, the Special Master will abide by the following principles:

- "The compensation structure should avoid incentives to take unnecessary or excessive risks that could threaten the value of the TARP recipient." 31 CFR 30, Q-16(b)(1)(i).
- "The compensation structure, and amount payable .. should reflect the need for the TARP recipient to remain a competitive enterprise, to retain and recruit talented employees who will contribute to the TARP recipient's future success, and ultimately to be able to repay TARP obligations." 31 CFR 30, Q-16(b)(1)(ii).
- "The compensation structure should appropriately allocate the components of compensation such as salary, short-term and long-term incentives, as well as the extent to which compensation is provided in cash, equity or other types of compensation such as executive pensions, other benefits, or perquisites, based on the specific role of the employee and other relevant circumstances, including the nature and amount of current compensation, deferred compensation, or other compensation and benefits previously paid or awarded." 31 CFR 30, Q-16(b)(1)(iii).
- "An appropriate portion of the compensation should be performance-based over a relevant performance period." 31 CFR 30, Q-16(b)(1)(iv).
- "The compensation structure, and amount payable .. should be consistent with, and not excessive taking into account,

compensation structures and amounts for persons in similar positions or roles at similar entities that are similarly situated." 31 CFR 30, Q-16(b)(1)(v).

■ "The compensation structure, and amount payable .. should reflect the current or prospective contributions of an employee to the value of the TARP recipient, taking into account multiple factors such as revenue production, specific expertise, compliance with company policy and regulation (including risk management), and corporate leadership, as well as the role the employee may have had with respect to any change in the financial health or competitive position of the TARP recipient." 31 CFR 30, Q-16(b)(1)(vi).

The Special Master also has the authority to issue advisory opinions on his own initiative. *Id.*

10. Effective Date

The Interim Rules became effective on publication in the Federal Register, June 15, 2009.

Implications

The June 2009 Interim Rules should assuage some of the public outcry over executive compensation at TARP firms. In particular, the public should be reassured by the appointment of Kenneth Feinberg as the TARP Special Master. Feinberg is given plenty of flexibility in considering whether an employee's compensation is excessive. Corporate executives and boards of directors should welcome this flexibility.

The Guidance will encourage shareholder activists to propose "Say on Pay" at each of the TARP firms, likely making the 2010 proxy season a particularly volatile one.

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■ 111 P.L. 5

For the full text of the Emergency Economic Stabilization Act of 2008, see

■ 110 P.L. 343

For additional discussion, see

■ LexisNexis Tax Advisor -- Federal Topical § 2B:5.01

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The Perils of the Foreign Bank Account Reporting Rules

2009 Emerging Issues 3726

Muntean on the Perils of the Foreign Bank Account Reporting Rules

By Mark Muntean

June 16, 2009

SUMMARY: In recent years, a major concern of many practitioners involves the Foreign Bank Account Reporting rules. These rules, originally enacted as part of the Bank Secrecy Act and Patriot Act regulations, require individuals and entities with interests in foreign bank accounts to file an annual report detailing their those interests. The consequences of failing to file when required can be severe, and include potential civil and criminal penalties.

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ARTICLE: Foreign Bank Account Reporting: A Very Serious Matter Has Become More Serious

When I was in college, if someone said the word "FBAR," immediately I would think of the bar to which I went after receiving a grade in chemistry or biology. Following September 11, 2001, FBAR has come to take on a whole new meaning. FBAR is the acronym for the Foreign Bank Account Reporting rules and the consequences for the failure to comply with such rules are significantly worse than a bad grade in a science class. See P.L. 107-56, Section 361(b). The FBAR rules are not tax rules; rather, these rules were originally enacted as part of the Bank Secrecy Act ("BSA") and Patriot Act regulations. 31 CFR 103.

Administered by the Internal Revenue Service (IRS), the FBAR rules require persons, individuals or taxpayers (U.S. citizens; U.S. residents, and some foreign persons as discussed below) to file a report stating whether they have a beneficial or financial interest in, or signatory authority over, a financial account held in a foreign country with an aggregate value exceeding \$10,000, at any time during the year. Treasury has delegated administration of these provisions to the IRS. 31 CFR 103.56(g). Pursuant to these rules, a federal income tax return filed by a person subject to these regulations must indicate whether the individual has an interest in a financial account in a foreign country. Such indication is made by checking a box on the IRS Form 1040. If the individual checks the "yes" box on the IRS Form 1040, an FBAR report must be filed. 31 CFR 103.24.

Rules Define Persons with a Financial or Beneficial Interest, or Authority Over Accounts.

As stated above, for tax year 2008 and going forward, the FBAR rules require every person (taxpayer or not) to file a report stating whether they have a beneficial or financial interest in, or signatory authority over, a financial account in a foreign country with an aggregate value exceeding \$10,000 *at any time during the calendar year*. Previously, only

U.S. citizens or residents, domestic partnerships, domestic corporations, and domestic estates and trusts were required to file. The definition of those required to file was expanded to apply as follows.

Aliens and Strangers. Foreign corporations doing business in the U.S. are also considered U.S. persons for purposes of FBAR reporting. Under these rules, a U.S. person is defined as a citizen, resident or person doing business in the U.S. 31 CFR 103.11(z). The definition of United States is broad and includes the 50 states, U.S. possessions and U.S. territories, including Puerto Rico, the Northern Mariana Islands, Guam, American Samoa, and the United States Virgin Islands. 31 CFR 103.11(nn). Thus, U.S. persons are defined to include all persons (including corporations) who are present in the U.S. or doing business in the boarder U.S, whether or not they are residents or nonresidents. Generally, a person is considered to be in, and doing business in, the United States if that person is conducting business within the United States on a regular and continuous basis. Accordingly, many nonresidents and foreign persons who do business in the U.S. must disclose their foreign bank account information.

Persons who are merely visiting the United States, or who sporadically conduct business in the United States, are not in, or doing business in, the United States, for FBAR reporting purposes.

Financial or Beneficial Interest. Any U.S. person who has a financial interest or beneficial interest in a foreign financial account is required to comply with these rules. Moreover, a shareholder, partner, officer of a corporation, member of a limited liability company, or trustee of a trust may be deemed to hold a financial or beneficial interest in a financial account, where:

- (a) Such person is acting as an agent on behalf of the U.S. person,
- (b) With respect to a corporation the U.S. person owns, directly or indirectly, more than 50 percent of the outstanding stock of the corporation,
- (c) With respect to a partnership or limited liability company, the U.S. person has more than a 50 percent profits interest, or
- (d) With respect to a trust, the U.S. person has either (i) a present interest in more than 50 percent of the trust assets or (ii) receives more than 50 percent of the trust income.

Authority. These rules apply without regard to whether a person has actual authority over a particular account. Moreover, an individual exercising authority under a power of attorney, or a trustee exercising authority under a trust agreement, would be deemed to have signature authority. Each of the above persons is subject to the FBAR reporting rules.

Authority includes persons who have the ability to order a distribution or disbursement of funds or other property held in the account. Such definition is broader than mere signature authority. Authority extends to the ability to order distributions by verbal commands or other communication.

CPA and Bank Reporting. According to the IRS Office of Professional Responsibility, compliance with FBAR reporting is part of a practitioner's due diligence obligation, and a failure to timely file a report under the FBAR rules must be disclosed by tax advisors to the Service on IRS Form 8554. Thus, even if individuals or taxpayers fail to report foreign financial accounts, their CPA or tax advisor is required to report such information.

Tax advisors, CPAs, and other tax professionals must comply with the FBAR rules as part of their duties under Circular 230 Section 10.22. The tax advisor must make reasonable inquiries when a client provides information that suggests possible participation in overseas transactions/accounts subject to FBAR requirements. Although a practitioner can rely on information provided by a client in good faith, that practitioner cannot ignore information gleaned from the client's records or information actually known. Moreover, the practitioner must make reasonable inquiries if information appears incorrect or incomplete. Nominal penalties may also apply to a bank or financial institution that negligently

violates any provision of these regulations as well. *31 USC Section 5321(a)(6)*.

Actual Prosecutions. The Department of Justice has begun prosecuting individuals in connection with the failure to disclose foreign financial accounts. See Department of Justice Press Release Dated April 2, 2009 Re: USB Client Charged. In that case, the individual charged is the alleged beneficiary owner of a USB account in the name of a British Virgin Islands ("BVI") corporation in the U.S., not the corporation. This matter is an ongoing prosecution. Notable though is that the prosecution being brought is against the beneficial owner of the BVI corporation. For a prior case, see *Joseph B. Williams III v. Commissioner*, 131 TC No. 6, 2008 U.S. Tax Ct. LEXIS 24 (2008), summary judgment granted *Williams v. Comm'r*, T.C. Memo 2009-81 (T.C. 2009).

Recently, the IRS has used its summons enforcement authority to compel UBS to provide the names and account records of the 53,000 U.S. taxpayers who maintain undisclosed foreign bank accounts. The IRS Commissioner has announced the hiring of a significant number of new agents to investigate offshore accounts and to enforce these rules.

Failure to File FBAR Returns Can Have Serious Consequences.

The filing due date for the FBAR report is June 30th, six months after the close of each calendar year (June 30, 2009 for the 2008 year). Unlike income tax returns, the date the FBAR form is placed in the mail is **not** considered timely filing. The report must be **received** by the IRS on or before June 30th in order to avoid penalties.

Note: Because of the confusion as to who is required to file and the need for additional guidance following the expanded definition of who is required to file, the IRS has temporarily suspended the requirement to file FBARs due on June 30, 2009, for persons who are not citizens, residents, or domestic entities. *Announcement 2009-51*, IRB 2009-25, 6/5/2009. Persons that had previously been required to file an FBAR report on June 30, 2009, must file the current version of Form TD F 90.22-1, and all other FBAR instructions for that form apply. The definition of a United States person that took effect in 2000, which includes U.S. citizens, U.S. residents, and domestic entities, may be used in determining whether a person has an obligation to file.

As mentioned above, the penalties for violating the FBAR rules can be worse than a poke in the eye with a sharp stick. Notable is that the FBAR civil penalties are separate from any applicable federal income tax penalties. These are not tax code penalties. Instead, the FBAR penalties are under the Treasury banking laws of Title 31 of the United States Code (USC), while tax code penalties are found in the IRS rules under Title 26 USC. There is a whole myriad of penalties at play here. The rationale behind so many penalties is that these penalties will increase voluntary compliance, and I think that is true.

The Small Dollar "Not Willful" Civil Penalty. For FBAR forms due on or after June 30, 2005, the IRS may now impose a civil penalty not exceeding \$10,000 on anyone who violates, or causes an individual to violate the FBAR reporting rules. *31 USC Section 5321(a)(5)*. This is not a "willful" penalty in that this penalty does not require the IRS to show that the violation was willful. Tax code penalties may also apply. See *26 USC 7201* and *7206(1)*.

The IRS may waive the civil penalty where (a) such violation was due to reasonable cause, and (b) the amount of the transaction or the balance in the account at the time of the transaction was properly reported. *31 USC 5321(a)(5)(B)*. Authority for what constitutes reasonable cause can be found under a number of tax code sections elsewhere in the tax law. "Properly reported" means that the income in the foreign account was otherwise reported on the individual's tax return. S. Rep. 108-192, P.L. 108-357 (2004). For example, if the individual realized income from a bank account in a foreign country and that interest income was reported on the individual's tax return, notwithstanding the facts that the individual did not check the "yes" box indicating that the individual had an interest in a foreign financial account, the IRS could consider waiving the penalty with a showing of reasonable cause.

The Big Dollar "Willful" Civil Penalty. The civil willful penalty is a penalty equal to the greater of \$100,000 or 50 percent of the amount in a particular transaction or the balance of the account at the time of the violation. *31 USC*

Section 5321(a)(5). There is not a reasonable cause waiver of the penalty as is in the case of the \$10,000 civil penalty discussed above. The statute of limitations on this penalty is six years. *31 USC 5321(b)(1)*. A civil action to recover any penalty assessed under these rules may be commenced within two years from the later of the assessment of the penalty or the date any judgment becomes final in any criminal action under *31 USC 5322* in connection with the same transaction with respect to which the penalty is assessed. *31 USC 5321(b)(1)*.

The "willful" violation requirement requires a showing that on the IRS' part that the individual willfully failed to file with the specific intent to violate the law. The IRS Chief Counsel has gone on record that the willful standard for the civil penalty should be the same as the criminal penalty discussed below. See IRS CCA 200603026, 2005 *IRS CCA LEXIS 83* (Sept 9, 2005).

The Really Big Dollar "Willful" Criminal Penalty. Criminal violations of the FBAR rules may result in a fine capped at \$250,000. *31 U.S.C. 5322(a)*. Where multiple years are involved indicating a pattern of illegal activity, the statute allows for a fine of \$500,000. The statute of limitations for criminal BSA violations is five years. *31 USC 5321(b)*.

To give effect to *Section 5322(a)*'s "willfulness" requirement, the government must prove that in failing to report, the individual knew that the structuring he or she undertook was unlawful, not simply that their purpose was to circumvent the reporting obligation. The Supreme Court has held that it is significant that the omnibus "willfulness" requirement, when applied such provisions requires both knowledge of the reporting requirement and a specific intent to commit the crime or to disobey the law. *Ratzlaf v. United States*, 510 U.S. 135 (1994). This is a difficult burden of proof.

Possible Federal Prison Time. As if all these monetary penalties are not enough, criminal violations of the FBAR rules can result in a sentence of five years in prison, in addition to the penalties discussed above. *31 USC 5322(a)*. As is the case with criminal fines, if there is more than one year involved indicating a pattern of illegal activity the individual can be sentenced to 10 years in federal prison. Where there are multiple accounts in multiple year, it is reasonable to expect the government to seek one felony count for each account for each year. *31 USC 5321(b)*.

The FBAR Rules Apply Not Only to Bank and Investment Accounts, But to Other Financial Accounts as Well.

Normally when the FBAR rules are discussed, individuals view these rules in the context of bank accounts or investment accounts. However, the IRS views these rules as applying to any financial account.

Pensions Plan and Accounts. Obviously, a foreign IRA type account would require reporting under the FBAR rules. However, the Service also takes the position that all pension plans held in accounts in a foreign country must be reported as foreign bank accounts where the account balance exceeds \$10,000. The IRS only allows as an exception for those pension plans that mirror image the U.S. social security system.

This is surprising, especially in the context of superannuation plans. A superannuation contribution by an employer to an employee plan does not vest immediately, and in many cases cannot be accessed by the employee until the employee is 55 years or older. I might agree with the Service that where the employee is (a) fully vested and the employee is over 55, or (b) where the funds can be withdrawn by the employee at any time (even if subject to a penalty) reporting is required. But an unvested amount that does not belong to the employee or cannot be drawn by the employee does not strike me as an account the employee has a present interest in (only a future contingent interest).

That notwithstanding, however, the only advice that can be given, based on the IRS' position is to report all plans, except those that are the same as the U.S social security system. This is due to the fact that the penalties for failing to do so are so steep that there is too much risk both for the taxpayer and the tax advisor to do anything else.

Offshore Insurance Policies. The government is also focusing on offshore insurance policies as foreign financial

accounts. Thus, any person who has a beneficial interest in an offshore insurance policy may be required to report. Also, the cash value in a life insurance policy might be classified as a financial interest in an offshore account.

Some Credit Card Accounts. There is no direct authority as to whether credit card accounts, where an individual merely owes money to a foreign lender are subject to the FBAR filing requirements. Where an individual deposits funds to a foreign credit card account as an advance payment, such that the individual has a credit balance, an argument exists that such an account is a financial account for purposes of the FBAR reporting requirements. In such case, if the credit balance exceeds \$10,000 the FBAR filing may be due. See IRS CCA 200603026 (Sept. 1, 2005).

Voluntary Disclosure Opportunity Exists for Past Violations.

Recently, the IRS Commissioner issued a statement those individuals who voluntarily disclose past FBAR violations will receive a fair settlement. Beginning on March 23, 2009, the IRS commenced a six month amnesty plan.

Amnesty Qualifications. For the voluntary disclosure amnesty to apply, the individual:

- (a) Must have obtained the funds in the account from a legal source;
- (b) Disclose truthfully, timely and completely all information related to the accounts;
- (c) In this regard, timely disclosure means disclosing the accounts to the IRS before the IRS has notified the person of an investigation or examination, or the intent to initiate an investigation or examination;
- (d) No prior third-party whistleblower must have alerted the government to the noncompliance;
- (e) Must be willing to cooperate with the government; and
- (f) Must make a good faith arrangement to pay all taxes and interest in full.

See Internal Revenue Manual 9.5.3.1.2.1. Amended tax returns and the missing FBAR reports would need to be filed as part of the process.

So Here's the Deal. Under the amnesty plan, the individual/taxpayer must agree to pay: (i) all unpaid taxes and interest for the prior six years (if applicable); (ii) the non-willful penalty for all six years (to the extent applicable); and in lieu of all other penalties, and (iii) a single penalty equal to 20 percent of the highest balance amount in the foreign bank accounts. Where the individual/taxpayer has more than one account, it is presumed that a 20 percent penalty will apply to each account.

All Taxpayers Are Created Equal. In the fair settlement, the IRS will set up a framework where the individual will pay all past taxes and interest going back six years; and pay either an accuracy or delinquency penalty on all years involved up to six years. They will also pay a penalty of 20 percent of the amount in the foreign bank accounts in the year with the highest aggregate account or asset value. Just to be clear, this is 20 percent of the highest asset value of an account anytime in the past six years. The IRS is seeking to give taxpayers a certainty that all cases are being handled consistently.

Individuals who voluntarily disclose such information, although will be assessed taxes, interest and penalties, can avoid criminal prosecution. This current program will be in place for six months only, from March 23, 2009 through August 23, 2009. After that time the IRS will re-evaluate their options.

The IRS Commissioner also states that the IRS is seeking to increase its enforcement effort. In cases where the IRS discovers a taxpayer is not reporting offshore assets, the IRS is instructing its agents to fully develop these cases, pursuing both civil and criminal avenues, and consider all available penalties including the maximum penalty for the willful failure to file the FBAR report and the fraud penalty.

Think It Through. Commentators have argued that this voluntary disclosure process is not fair at all, but instead is too severe for taxpayers or other individuals who have failed to report offshore accounts. I would tend to disagree with such commentators.

For example, if, on the one hand, you assume that an individual who (1) failed to file FBAR reports for the last four years; (2) had three foreign accounts with \$100,000 in each account; (3) did not report the interest income or money earned on such accounts, and (4) that the government discovers this individual, then in addition to any taxes and interest owed, the following might result:

- (a) The government could impose the non-willful civil penalty for each year at \$10,000 each year, or \$40,000.
- (b) The government could impose the civil willful penalty (provided that it could meet its burden of proof) equal to \$600,000 (\$100,000 times 50 percent, times three accounts, times four years).
- (c) Criminal violations of the FBAR rules may result in a fine capped at \$500,000 (since multiple years are involved).
- (d) The government could charge, at a minimum, 12 federal felony criminal counts for not disclosing the foreign accounts (three accounts times four years) and not making the FBAR filing.

The total penalties come to \$1.14 million and 12 possible felony counts.

On the other hand, if the amnesty plan is applied to the same facts then in addition to any taxes and interest owed, (i) the non-willful civil penalty for in the amount of \$40,000 would apply; (ii) a single 20 percent penalty equal to \$60,000 for all accounts; and (iii) no jail time. This totals \$80,000 and a clean bill of health. This strikes me as a no brainer, but reasonable minds can differ.

Notwithstanding the foregoing, the IRS is not without some leniency. In situations in which an individual/taxpayer did not (a) open the account (or cause the account to be opened); (b) there has been no activity while the account was controlled by the taxpayer; and (c) all taxes have been paid with respect to the funds in the accounts (meaning the funds are from legal sources) even though the interest or earnings on the funds in the accounts was unreported, the penalty is reduced to five percent. Memorandum for Commissioner, LMSB Division (Mar. 23, 2009).

Pay Close Attention to Amnesty Opportunities.

The IRS amnesty program should not be overlooked. There is some time left in the program, and any individual with this issue in the closet needs to give the opportunity serious thought. Foreign bank reporting is an issue that is only going to get more attention in the future as the current administration escalates their pursuit of offshore noncompliance. The public sees this as a situation in which the rich hide money, and those who are caught in the prosecution of FBAR violations will likely see very little in the way of sympathy.

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How to Avoid Pitfalls Delaying Your Application for 501(c)(3) Tax-Exempt Status

2009 Emerging Issues 3552

Bobbi Halpin on How to Avoid Pitfalls Delaying Your Application for 501(c)(3) Tax-Exempt Status

By Bobbi Halpin

May 31, 2009

SUMMARY: This Emerging Issues Analysis discusses how to avoid the pitfalls that can delay an application for tax-exempt status. Receiving a favorable determination letter from the IRS in response to an application for tax-exempt status means that one can solicit and accept tax-deductible charitable contributions from donors. Review of current case law on the subject provides additional how-to and how-not-to guidance for those seeking tax-exempt status.

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ARTICLE: I. The Application for Tax-Exempt Status Helps a Charitable Business Grow by Allowing Receipt of Tax-Deductible Contributions

The application for tax-exempt status (IRS Form 1023) is an intimidating document that stands between your client and its tax-deductible charitable contributions. If the application is complete and correct, the Internal Revenue Service will process it and issue a favorable determination letter recognizing your client's status as a tax-exempt, IRC § 501(c)(3) charitable organization. Your client is then able to solicit and accept tax-deductible charitable contributions from donors in furtherance of its charitable purposes. However, if your application is not complete, if inadequate information is provided, or if the Service experiences any other problems in processing your application, the application is typically delayed, or worse denied, producing grief for your client and for you.

The application for tax-exempt status is long, complex, repetitive, tedious and time consuming, and may very well determine the success or failure of your client's charitable mission. The complexity of the application produces many potential pitfalls, most of which can be avoided by rigorously following the directions, a thing that is simple in theory but may be difficult in practice. Fortunately, some problems that can cause delay of your application are relatively easy to avoid (e.g., including the proper user fee). Others are more challenging, but can be overcome with some preparation and hard work.

II. Avoid Delays in Processing Application for Tax-Exempt Status

A. Include the Applicable User Fee

The Service indicates that the *number one reason* applications for tax-exempt status are delayed is failure to

include the proper user fee. (See www.irs.gov/charities, Exempt Organization FAQs.)

The Service requires payment of a user fee for processing the application for tax-exempt status. The applicant must include the *correct amount* of the fee. Currently, for initial requests for a determination letter for exempt organizations with actual or expected annual gross receipts of under \$10,000 per year, the fee is \$300. If actual or expected annual gross receipts are \$10,000 or more, the fee is \$750. Group exemption letters require a \$900 fee. *Rev. Proc. 2009-8, 2009-1 I.R.B. 229, § 6.07*. The user fee must accompany Form 8718, "User Fee for Exempt Organization Determination Letter Request," which then must be included with your application for tax-exempt status.

B. Complete All Sections of the Form that Apply to the Organization

The application for tax-exempt status is extremely complex. You must complete all of the sections that apply to the type of organization for which you are requiring tax-exempt status (*e.g.*, school, church, etc.). Carefully review each part of the application. Some sections will apply to all applicants (*e.g.*, Parts I through IX must be completed by every organization), while others will only apply to specific classes of applicants.

Practice Comment: Software eases paperwork burden of completing application for tax-exempt status. Many vendors offer tax and accounting software for tax-exempt organizations. See, *e.g.*, 990accountant.com and practicaltaxsolutions.com. This software can be helpful to ensure that all applicable items on the form are completed. A feature allowing links to digital documents directly from the related section of the form is especially helpful for organizing the application.

C. Adequately Describe the Tax-Exempt Purpose and Activities of the Organization

For each past, present, or planned activity, the application for tax-exempt status must include information that answers the following questions:

- What is the activity?
- Who conducts the activity?
- When is the activity conducted?
- Where is the activity conducted (city and state)?
- How does the activity further your exempt purposes?
- What percentage of your total time is allocated to the activity?
- How is the activity funded? (Must agree with financial data provided elsewhere.)
- Does the organization operate under any alternate names? Include "aka" (also known as) and dba (doing business as).

(See IRS Form 1023 Instructions, Part IV.) Best practice dictates providing highly specific and detailed information regarding the activities engaged in by the organization. While many state organizational documents require only a broad, general description of the organization's activities (*e.g.*, "the organization is created for charitable purposes pursuant to the requirements of IRC § 501(c)(3)"), the application for tax-exempt status requires much more.

Example: Church is a charitable organization created for the purpose of tending to the spiritual needs of the local community. One of Church's activities is providing a weekly religious service, which is officiated by Minister, and which is open to the public. On its application for tax-exempt status, Church described the weekly service as follows:

"In furtherance of its charitable purpose of tending to the religious needs of the local community, Church holds a 1-hour weekly religious service on Sundays at 10:00 am, at the Community Center in Anytown, New York. The service is conducted by Minister, and has an average weekly attendance of 25 parishioners. During the service, Minister offers spiritual guidance and lessons that serve to bring the community closer together. Minister also uses this opportunity to make community announcements, and to request assistance for parishioners or other community members in need of support. The weekly service constitutes approximately 25% of Church's time spent on charitable activities. (Refer to descriptions of additional activities for balance of time spent.) This activity is funded by contributions collected from during the service, which cover the cost of location rental, printed materials, and any refreshments not donated. (Refer

to attached financial statement.) Church is not affiliated with or controlled by any other charitable organization, and does not hold weekly services under any other name."

Note the detail included in the description. The same detail needs to be included *for each activity* engaged in by the organization. Failure to include adequate descriptions of the organization's activities can cause loss of tax-exempt status on a routine compliance check, if the organization is found later to be engaging in activities that are not approved.

Practice Comment: Controversial charitable purpose can delay processing of application. The practitioner must keep in mind that if the organization's tax-exempt purpose is controversial, no matter how charitable it might be, the Service will scrutinize it closely. Naturally, this will increase the time required for processing the application, and may also increase the likelihood of the application being denied. When describing the charitable purpose of the organization, carefully consider the language used. Avoid using highly-charged or unnecessarily provocative language or phrases.

An entity will not qualify for tax-exempt status if it is not created and operated exclusively for charitable purposes. The Service has denied tax-exempt status in the following situations:

- An organization whose stated purpose is to promote Islamic holy war and holy warriors will be denied tax-exempt status. *United States v. Mubayyid*, Docket No. 05-40026, U.S.D.C. D. Mass., March 8, 2007.
- An organization that supports terrorist activities is subject to having its tax-exempt status revoked, despite having been previously recognized as a tax-exempt entity. *Holy Land Found. for Relief & Dev. v. Ashcroft*, 333 F.3d 156 (D.C. Cir. 2003).
- A foundation is not a tax-exempt 501(c)(3) organization where its articles and bylaws claim it operates for charitable purposes, but it promoted itself as a means of "warehousing wealth" tax-free for donors. *New Dynamics Found. v. U.S.*, Docket No. 99-197T, U.S. Ct. Fed. Cl., April 24, 2006; Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

III. What to Do When the Service Requests Additional Information

The application for tax-exempt status has been carefully completed, checked and rechecked, and all attachments have been included, to no avail. The processing has been delayed because the Internal Revenue Service has requested additional information. In such cases, the practitioner should provide the information promptly and with a pleasant attitude, even if:

- *You feel you have already provided the information.* Carefully consider the request for additional information. Does the application really respond to the request? Is there additional information that may help clarify the details you have already included? The practitioner should keep in mind that the application for tax-exempt status requires extremely detailed information regarding the purposes and activities (actual and intended) of the organization. Broad generalizations are not sufficient. *See* section II.C., above.
- *The information relates to events that have not yet occurred.* On some parts of the application the tax-exempt organization may be required to include its best forecast of events, including financial events, which have not yet occurred, sometimes years in advance of such events. The practitioner should extrapolate to the future using any prior or current history as a guide.

Example: A charitable organization has been receiving average charitable donations of \$500 per month, consistently during the first 12 months of its operation. In the application for tax-exempt status, the charitable organization is asked to provide projections of likely revenues using a good faith estimate. Best practice would dictate that the organization's projected gross income not stray too far from the income it has received in the past. A forecasted average income of \$500 per month would not likely be challenged by the Service.

When submitting such forecasts to the Service, practitioners should include the information on which estimates and predictions are based. If the expected or forecasted gross income is substantially different from the amount of income previously received, provide an explanation that describes the expected source of the additional funding or

assets. If, for example, a large donor has promised a major donation to the organization, especially if it is for a specific project, this information should be disclosed in the application for tax-exempt status. Failure to include such information could jeopardize the tax-exempt status of the organization if a routine compliance check later reveals activities not included on the application.

Example: Rebuildit, Inc., is a charitable organization that provides assistance to people who are victims of natural disaster. For the first year of its existence, Rebuildit was primarily an organization that provided the services of its volunteers in rebuilding homes lost or damaged through natural disaster. As such, the organization had so far collected only minimal cash donations to help defray the costs of transporting workers to the relief area. However, at the beginning of its second year, Rebuildit received a written promise from a donor to contribute an 18-wheel tractor trailer to the organization in 6 months, to be used for the purpose of transporting construction supplies donated, or purchased with donated funds, to relief areas. As a result of this promise, Rebuildit plans to step up its fundraising activities so that it can regularly purchase building supplies for use in its charitable activities. In its application for tax-exempt status, Rebuildit must include details of its first year gross income. However, the application should also include (1) a copy of the written promise of a tractor trailer from a donor; (2) details regarding how the tractor trailer will be used; (3) details regarding the fundraising efforts that are expected to be used, and the new fundraising goals or targets. This information should agree with the financial data included on the application (IRS Form 1023, Part IX, Financial Data).

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RELATED LINKS: For further discussion, see

- LexisNexis Tax Advisor -- Federal Topical § 2E:35.02;
- 1-33 Planning Tax-Exempt Organizations 33.syn

For an example of how not to respond to a Service request for additional information, see

- *Exploratory Research, Inc. v. Comm'r*, Docket No. 15082-05X, U.S. Tax Court, April 8, 2008

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Bobbi Halpin is an attorney admitted to practice in New York and Pennsylvania. She is a frequent contributor to various Matthew Bender publications, including *Federal Taxation of Oil and Gas Transactions*; *Federal Income, Gift and Estate Taxation*; *LexisNexis Federal Tax Library*; and *Current Leasing Law and Techniques--Forms*. Ms. Halpin received a J.D. from New York Law School.

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Corporate Deductions for "Reasonable" Compensation

2009 Emerging Issues 3642

Corporate Deductions for "Reasonable" Compensation: The Independent Investor Test v. the Multi-Factor Test

By Dorinda DeScherer

May 22, 2009

SUMMARY: In an important decision concerning a complex topic, the U.S. Court of Appeals for the 7th Circuit upheld the "independent investor" approach to determining whether the compensation paid to a corporation's shareholder-employee is "reasonable" and thus, deductible. In so doing, the Court restated its objection to the often difficult to apply, "multi-factor approach" used by other courts.

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ARTICLE: In a recent decision, the U.S. Court of Appeals for the Seventh Circuit emphatically upheld its "independent investor" approach to determining whether the compensation paid to a corporation's shareholder-employee is "reasonable" and thus, deductible. In so doing, the appeals court restated its objection to the "multi-factor approach" used by other courts, and rejected the way that the Tax Court has applied the independent investor test (*Menard, Inc. v. Comm'r.*, 560 F.3rd 620, 2009 U.S. App. LEXIS 4883, U.S. Ct. App. (7th Cir., 3/10/09)).

Background

The Internal Revenue Code allows a business to deduct from its taxable income a "reasonable allowance for salaries or other compensation for personal services actually rendered" [IRC Sec. 162(a)(1)]. Occasionally the IRS challenges the deduction of a corporate shareholder-employee's salary on the ground that it is really a dividend. A dividend, like salary, is taxable to the recipient, but unlike salary is not deductible from the corporation's taxable income. So by treating a dividend as salary, a corporation has traditionally been able to reduce its income tax liability without increasing the income tax of the recipient.

The traditional tax advantage for salaries was complicated by a 2003 tax law change. For the period 2003 through 2010, dividends are taxed at a lower maximum rate than salaries--15 percent for dividends versus 35 percent for salary [IRC Sec. 1(h)(11)]. This makes the tradeoff more complex; although the corporation avoids tax by treating the dividend as a salary, which is deductible, the employee pays a higher tax. But depending on its tax bracket, the corporation may still save more in tax than the employee pays. In any case, absent Congressional action, the current favorable treatment of dividends expires at the end of 2010 and the traditional advantage for salaries will be restored.

Regardless of the tax advantage of salaries, treating a dividend as salary is unlikely to occur in a publicly held

corporation. If the CEO or other officers or employees of a public company receive dividends called salary beyond what they are entitled to by virtue of owning stock in the corporation, the other shareholders suffer. But in a closely held corporation, the owners might decide to take their dividends in the form of salary in order to avoid the corporate income tax, and there will be no one to complain--except the IRS.

The "easy" case for blocking conversion of dividends into salary is that of a corporation having few shareholders, practically all of whom draw salaries, especially if the corporation does not pay actual dividends and some of the shareholders do no work for the corporation but merely cash a "salary" check [Treas. Reg. Sec. 1.162-7(b)(1)]. The more difficult case, at least from the IRS's standpoint, is that of a CEO who is the controlling shareholder and who receives hefty compensation because he or she is the heart and soul of the corporation. This is the type of situation that the Seventh Circuit faced in its recent *Menard Inc.* case.

Multi-factor Test

IRS regulations define a "reasonable" salary as the amount that "would ordinarily be paid for like services by like enterprises under like circumstances" [Treas. Reg. Sec. 1.162-7(b)(3)]. But this standard is not particularly helpful in determining the reasonableness of a salary in a specific situation. No two corporations are alike and no two chief executive officers are alike.

Historically, federal appeals courts and the Tax Court have adopted *multi-factor tests* to determine reasonableness, with the factors ranging from a handful to almost two dozen in various formulations. By and large, longer lists include elements that, in shorter ones, are grouped together. A long list could include the following:

- Employee's qualifications and training.
- Nature, extent, and scope of the employee's duties.
- Responsibilities and hours involved.
- Size and complexity of the business.
- Results of the employee's efforts.
- Prevailing rates for comparable employees in comparable business.
- Scarcity of other qualified employees.
- Ratio of compensation to gross and net income (before salaries and federal income tax) of the business.
- Salary policy of the employer for other employees.
- Amount of compensation paid to the employee in prior years.
- Employee's responsibility for employer's inception and/or success.
- Time of year the compensation was determined.
- Whether compensation was set by corporate directors.
- Correlation between the stockholder-employees' compensation and stockholdings.
- Corporate dividend history.
- Contingent compensation formulas agreed on prior to the rendition of services and based upon a free bargain between the employer and employee.
- Under-compensation in prior years.
- Compensation paid in accordance with a plan which has been consistently followed.
- Prevailing economic conditions.
- Whether payments were meant as an inducement to remain with the employer.
- Examination of the financial condition of the company after payment of compensation (*Foo, T.C. Memo 1981-61*).

Independent Investor Test

In 1999, the Seventh Circuit Court of Appeals reviewed these multi-factor tests and concluded that they were too vague and too difficult to apply in actual practice to be of much benefit (*Exacto Spring Corp*, 196 F.3d 833, U.S. Ct.

App. (7th Cir., 1999)). The court concluded that multi-factor tests with no weight assigned to any factor are bad enough from the standpoint of providing an objective basis for a judicial decision, but multi-factor tests when none of the factors is concrete are worse, and that is the character of most of the multifactor tests of excessive compensation.

The Seventh Circuit opined that multi-factor tests invite courts to set themselves up as "super personnel departments" for closely held corporations, a role they are unsuited for. The tests allow courts to decide what the taxpayer's employees *should* be paid on the basis of the judges' own ideas of what jobs are comparable, what relation an employee's salary should bear to the corporation's net earnings, what types of businesses should pay abnormally high (or low) salaries, and so forth. The Seventh Circuit believed that judges are not equipped by training or experience to determine the salaries of corporate officers.

In an effort to bring some objectivity to the issue of reasonable compensation, the Seventh Circuit in the *Exacto* case replaced the multi-factor test with the *independent investor test*. This is a presumption that "when ... the investors in his company are obtaining a far higher return than they had any reason to expect, [the owner/employee's] salary is presumptively reasonable." However, the court added that the presumption could be rebutted by evidence that the company's success was the result of extraneous factors, such as an unexpected discovery of oil under the company's land, or evidence that the company intended to pay the owner/employee a disguised dividend rather than salary. Other types of evidence that might rebut the *Exacto* presumption include evidence of a conflict of interest, and the relation between the executive's compensation that is challenged and the compensation of other executives in the company.

The Menard, Inc. Case

The new Seventh Circuit case, *Menard, Inc.*, involved a Wisconsin firm that sells hardware, building supplies, and related products through retail stores scattered throughout the Midwest. It had 138 stores in 1998, the tax year in question, and was the third largest retail home improvement chain in the United States. It was founded by John Menard in 1962, and, at least through 1998, he was the company's chief executive.

John Menard worked 12 to 16 hours a day 6 or 7 days a week, taking only 7 days of vacation a year, working even while spending "personal time" with his family, involving himself in every detail of his firm's operations, and fixing everyone's compensation. Under his management Menards' revenues grew from \$788 million in 1991 to \$3.4 billion in 1998 and the company's taxable income increased from \$59 million to \$315 million. The company's rate of return on shareholders' equity for 1998 was, according to an IRS expert, 18.8 percent-higher than that of either Home Depot or Lowe's, its competitors.

Menard owned all the voting shares in the company and 56 percent of the nonvoting shares, the rest being owned by members of his family, two of whom had senior positions in the company. Like the other executives of Menard, John Menard was paid a modest base salary but participated along with them in a profit-sharing plan. In 1998, his salary was \$157,500 and he received a profit-sharing bonus of \$3,017,100. However, the bulk of Menard's compensation was in the form of a "5% bonus" that yielded him \$17,467,800, as a result of which, his total compensation for the year exceeded \$20 million.

The 5% bonus program (5 percent of the company's net income before income taxes) was adopted in 1973 by the company's board of directors at the suggestion of the company's accounting firm, though there is no indication that the firm suggested a percentage figure rather than just advising the board that Mr. Menard should have his own bonus plan because of his commanding role in the management of the company. The board at the time included a shareholder who was not a member of Menard's family and he voted for the plan, which was still in force in 1998. That shareholder departed, and the board in 1998 consisted of Menard, a younger brother of his who worked for the company, and the company's treasurer.

Tax Court Decision

When the IRS challenged the reasonableness of John Menard's 1998 compensation, the dispute came before the

Tax Court. The Tax Court acknowledged that, under the *Exacto* independent investor test, a presumption had been created of the reasonableness of John Menard's compensation. Hypothetical independent investors in Menard Inc. would have received "a far higher return than they had any reason to expect." However, the Tax Court said that this was not the end of the story.

The Tax Court noted that *Exacto* implicitly provided that compensation of a CEO fixed by an independent board of directors of a publicly traded company is more likely than not to reflect the true marketplace value of the CEO's services and thus represent legitimate compensation for services rendered. The court pointed out that the Seventh Circuit had not addressed the situation where a presumption of reasonableness is created but where the compensation paid by the taxpayer corporation to its CEO substantially exceeds the compensation paid by comparable publicly traded corporations to their CEOs.

The Tax Court said it had to consider evidence of compensation paid to CEOs in comparable companies to determine if the presumption of reasonableness had been rebutted. And the court found that when compared to the compensation of CEOs of the comparable companies, the presumption had been rebutted. Thus, the court was back at square one and had to determine the reasonableness of the compensation.

The Tax Court believed that Menard Inc. *intended* that a portion of the compensation be a disguised dividend rather than compensation for services rendered. John Menard's bonus was profit-based, made in lump sum at year's end, and was subject to reimbursement if disallowed by the IRS. The fact that John Menard significantly contributed to the company's success was not decisive, particularly given the large size of the bonus, the company's complete lack of formal dividend declarations, and fact that Menard, as a shareholder, benefitted from the company's growth regardless of the bonus.

The Tax Court found that Menard's compensation was reasonable to the extent of \$7,066,912 and disallowed Menard Inc.'s compensation deduction in excess of that amount. (*Menard, Inc., T.C. Memo 2004-207, reconsideration denied at T.C. Memo 2005-3, supplemented by 130 T.C. 54*)

Seventh Circuit Decision

In a sharply worded opinion, the Seventh Circuit reversed the Tax Court, holding that the Tax Court's decision was based on "flimsy grounds."

The appeals court said that the 5-percent-of-net-corporate-income bonus did not look at all like a dividend. Dividends generally are specified dollar amounts—so many dollars per share—rather than a percentage of earnings. When earnings fall, dividends may be cut, but they are cut from one fixed amount to another rather than made to vary continuously, as Menard's percentage of earnings did. The appeals court also criticized the Tax Court's use of the year-end timing of the bonus as an indication of a disguised dividend. Bonuses are typically paid in a lump sum at the end of the year.

The Seventh Circuit attacked the Tax Court for being suspicious that the board of directors that approved the 1998 bonus was controlled by Menard. The appeals court said "it could not be otherwise, since he is the only shareholder who is entitled to vote for members of the board of directors, as he owns all the voting shares in the company. The logic of the Tax Court's position is that a one-man corporation cannot pay its CEO (if he is that one man) any salary!"

The appeals court also dismissed the relevance of the reimbursement arrangement between John Menard and the company. "Given the fondness of the IRS and the Tax Court for a 'totality of the circumstances' approach to determining excessive compensation, it was prudent (and incidentally not in Menard's personal financial interest) for the company to require him to reimburse it should the IRS successfully challenge the deduction."

The Seventh Circuit also gave fairly short shrift to comparisons between John Menard's compensation and the compensation paid to CEOs of its competitors. Menard Inc. adopted a high-risk compensation package for John. A risky

compensation structure implies that the executive's salary is likely to vary substantially from year to year--high when the company has a good year, low when it has a bad one. The appeals court emphasized that John Menard's *average* annual income may thus have been considerably less than \$20 million--a possibility the Tax Court ignored. Had the corporation lost money in 1998, Menard's total compensation would have been only \$157,500--"less than the salary of a federal judge"--even if the loss had not been his fault. According to the court, "the 5 percent bonus plan was in effect for a quarter of a century before the IRS pounced; was it just waiting for Menard to have such a great year that the IRS would have a great-looking case?"

Finally, the appeals court took the Tax Court to task for remarking that, because John Menard owned the company, he had all the incentive he needs to work hard, without the spur of a bonus. "In other words, reasonable compensation for Mr. Menard might be zero. How generous of the Tax Court nevertheless to allow Menards to deduct \$7.1 million from its 1998 income for salary for Menard!"

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An Ill Wind Blows Big Number to Big Oil: The Case Against a Windfall Profit Tax

2009 Emerging Issues 3584

Dobiyanski, Pence, and Reed on the Case Against a Windfall Profit Tax on Oil Companies

By Alfreda Dobiyanski, Diana Kay Pence and Randy M. Reed

May 4, 2009

SUMMARY: Oil price spikes over the summer months have driven up the price of gasoline. Consumer complaints have resulted in Congressional hearings. These hearings resulted in a bill to reintroduce a windfall profit tax on oil companies. The authors investigate the current profitability of the five largest oil and gas companies to determine whether excess profitability was evident and this tax would be justified.

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ARTICLE: New Oil Prices Revive Old Argument

An old saying exists that it's an ill wind that blows no good to someone. Oil prices of \$140 per barrel caused much pain at the pump for the American consumer during the summer. At the same time, the big five oil companies (Dutch Royal Shell, ConocoPhillips, Exxon Mobil, British Petroleum, and Chevron) reported record profits in the multi-billions of dollars in the last quarter of 2007 and the first quarter of 2008. During this period of high oil company profits, consumer groups pressured Congress to act to reduce gasoline prices.

In response, Congress held hearings to determine whether to reintroduce a windfall profit tax, last seen in 1988. The windfall profit tax, punitive in nature, was imposed on profits thought to be excessive, unreasonable, or undeserved. During these hearings, Congress questioned top executives from the largest oil companies requesting explanations for their large profits.

During the resulting furor, the proposed legislation was defeated. Now that the hysteria caused by onerous gasoline prices has abated, perhaps we should dispassionately examine the records to see whether a windfall profit tax would have been justified. Decisions are usually better made when not under duress and one never knows when oil prices might rebound to again cloud the decision field.

Windfall Profit Tax History Revisited

The windfall profit tax was commonly thought to be a tax on profits of a particular industry which ensued from sudden windfall gains. In actuality, the tax, enacted in April 2, 1980, under President Carter, was an excise tax imposed on producers. The tax was based on the excess of the sales price of a barrel of crude oil over an adjusted base price and

a severance tax adjustment. n1 The tax was repealed during the Reagan Administration in 1988.

Originally, the windfall profit tax was projected to raise \$320 billion. However, a congressional analysis by Lazzari n2 indicated that only \$80 billion was collected. This amount was reduced to a net tax effect of only \$40 billion due to the deductibility of the tax against corporate income. In addition, the Lazzari study indicated the tax discouraged the domestic oil industry such that oil production fell between 3 and 6 percent. During this same time period, foreign oil imports grew by 8 to 16 percent over its life. McInnes and Nichols n3 reported that the windfall profit tax had a major effect upon oil production in the U.S. As a result, "(T)he tax made the U.S. more dependent on foreign oil and, therefore, more vulnerable to a supply disruption or to a sharp price increase."

New Legislation Suggests Taxation as a Remedy

The proposal considered by Congress in 2007 and 2008 was significantly different than the previous windfall profit legislation. This law would have enacted a 25% tax on any "unreasonable" profits of the largest US oil companies. In addition, more regulation of oil market speculation was proposed as well. The purpose of this measure was to counter the assertions that speculators were creating a false demand spike by hedging their investments with oil futures. Other proposals would have included possible antitrust actions against OPEC countries, as well as making energy price gouging a federal crime.

Even though the energy package was broad in nature, much emphasis was placed on excessive profits and company greed during congressional hearings. However, the price increases of gasoline might have stemmed more from the high cost of oil due to global supply and demand issues, speculation, and currency exchange rates rather than excessive profits. Enacting a tax on the oil companies probably would not overcome the impact of these factors.

Are Current Profits Really Excessive?

The proposed legislation was based on the premise that oil companies were profiteering at the expense of the American consumer. This premise was based on reports of large dollar amounts of profits by the oil companies. The use of absolute dollar profits, as frequently reported by the media, was misleading and did not properly reflect the relative financial status of a company. A better measuring tool would be the net profit margin (profits divided by sales). This statistic more appropriately reflects the financial reality of a company and how well it is performing. Using this statistic, which controls for company size, allows comparison of disparately-sized companies.

The following (Table 1) illustrates the performance of the five major oil companies during the first quarter of 2008 compared to the first quarter of 2007. This information was extracted from their 10-Qs submitted to the Securities and Exchange Commission in 2008. ExxonMobil (Exxon), the industry leader, reported revenues of \$116,854,000,000 in 2008, n4 compared with \$87,223,000,000 in 2007. However, their net profit margin of 9.32% in 2008 was a decrease from 10.64% in 2007. Dutch Royal Shell (Shell), the second company, reported slightly less revenues than Exxon of \$114,302,000,000 in 2008, n5 compared with \$73,480,000,000 in 2007. Like Exxon, Shell reported a smaller net profit margin in 2008 of 8.05% than in 2007 of 10.13%. British Petroleum (BP) reported revenues of \$87,745,000,000 in 2008, n6 compared with \$61,307,000,000 in 2007. Of all five oil companies, they were the only company to show an increase in net profit margin of 8.83% in 2008, as compared with 7.74% in 2007. Chevron reported revenues of \$65,946,000,000 in 2008, n7 compared with \$48,227,000,000 in 2007. Like Exxon and Shell, their net profit margin of 7.84% in 2008 decreased from 9.78% in 2007. ConocoPhillips (CP), the smallest of the five companies, reported revenues of \$56,552,000,000 in 2008, n8 compared with \$42,867,000,000 in 2007. Their net profit margin was 7.32% in 2008 as compared with 8.27% in 2007.

With the exception of BP, performance for each company, based on net profit margins, has declined. Further study of BP's financial statements revealed this increase was not due to profitability from operations. Instead, their increase in net income occurred due to hedging gains on oil futures.

To make a comparison of the profitability of industrial companies, a list of the 74 industrial sector leaders and their

2006 reported financial results was obtained from the Mergent Industry Review n9 (2008). The net profit margin was calculated for each company and then used to rank the companies' profitability (see Table II). Much of the recent media and congressional focus has been on the net profits of Exxon. The performance of Exxon, the industry leader, was compared to 73 other industrial sector leaders (see Table II). Exxon ranked 37th out of the 74 companies with a net profit margin of 10.46%. As a comparison, Mirant reported a net profit margin of 60%.

Conclusion

In times of economic upheaval caused by sudden dramatic increases in prices, it has been common for people to react violently and emotionally to these traumatic events. Such has been the reaction of the American consumer to the recent gasoline price hikes. Congressional leaders have accused oil company executives of price gauging and have threatened them with a windfall profit tax.

This article examined the net profit margins of the five major oil companies to determine whether any evidence of excessive profitability had occurred in the period between the first quarter of 2007 through the first quarter of 2008. Exxon, the industry leader, and three of the other four companies actually demonstrated less profitability as evidenced by the decline in their net profit margin over this period. The one company (BP) reporting an increase in net profit margin did so because of derivative gains, not because of operations profitability. The decline in net profit margin for the industry demonstrated that these companies did not pass all of the increased cost of production on to the American consumer in their elevation of gasoline prices.

In addition, a comparison of company profitability of the industrial sector leaders showed that Exxon ranked 37th out of the 74 companies. These results suggest that oil companies do not have windfall profit that need to be taxed when other industrial sectors have much higher net profit margins. Many of these other sectors reported much higher (50-60%) net profit margins than did oil companies.

In a capitalist economy, where profit maximization is thought to bring about the efficient allocation of resources, the enactment and use of the windfall profit tax to reduce gasoline prices is questionable. There has been no indication that the windfall profit tax would actually lower gasoline prices. Government leaders in favor of the tax suggested that one of the uses of the proceeds could be to return some of the money to consumers. Since the tax would undoubtedly result in higher prices, the consumer would end up with no net gain from such a proposal. Since the only winner would be the government, perhaps a better way of distributing the wealth would be to reduce the gasoline taxes.

TABLE I

Comparison of Oil Company Profitability

1st Qtr. 2008 (000,000)

1st Qtr. 2007 (000,000)

Revenues

Net Income

Net Profit Margin

Revenues

Net Income

Net Profit Margin

ExxonMobil

\$116,854

\$10,890

9.32%

\$87,223

\$9,280

10.64%

Dutch Royal Shell

\$114,302

\$9,201

8.05%

\$73,480

\$7,441

10.13%

British Petroleum

\$87,745

\$7,751

8.83%

\$61,307

\$4,746

7.74%

Chevron

\$65,946

\$5,168

7.84%

\$48,227

\$4,715

9.78%

ConocoPhillips

\$56,552

\$4,139

7.32%

\$42,867

\$3,546

8.27%

TABLE II
Comparison of Company Profitability

Net Profit

Net Profit

Co. Name

Margin

Co. Name

Margin

1

Mirant

60.07%

38

MSC Industrial Direct

10.30%

2

Allied Cap.

54.16%

39

AutoZone

9.65%

3

Equity Residential

53.90%

40

Quest Diagnostics

9.35%

4

InterDigital Communications

46.87%

41

NIKE

9.14%

5

Pfizer

39.98%

42

UPS

8.84%

6

Southern Copper

37.32%

43

NYSE Euronext

8.63%

7

Franklin Resources

28.57%

44

Waste Management

8.60%

8

Microsoft

27.51%

45

VF Corp.

8.58%

9

Paychex Inc.

27.32%

46

Caterpillar

8.52%

10

Coach

25.40%

47

Carlisle

8.38%

11

Cisco Systems

21.00%

48

United Technologies

7.80%

12

Johnson & Johnson

20.73%

49

Parker Hannifin

7.74%

13

Amgen

20.68%

50

Omnicom Group, Inc.

7.59%

14

eBay

18.86%

51

Alexander & Baldwin

7.59%

15

Carnival

18.48%

52

Alcoa

7.40%

16

Starwood Hotels & Res.

17.44%

53

Honeywell

6.64%

17

Gen. Electric Capital

17.39%

54

Lockheed Martin

6.38%

18

Weight Watchers

17.01%

55

Home Depot

6.34%

19

3M

16.80%

56

Newell Rubbermaid

6.21%

20

PepsiCo

16.06%

57

Bright Horizons

5.98%

21

BlackRock

15.38%

58

Davita

5.94%

22

Apollo Group

15.01%

59

Mohawk

5.77%

23

Time Warner

14.82%

60

Williams-Sonoma

5.60%

24

Citigroup

14.70%

61

USG

4.96%

25

Gannett Co.

14.45%

62

The Gap

4.88%

26

McGraw-Hill

14.10%

63

Pulte Homes

4.82%

27

Washington Mutual

13.54%

64

SAIC

4.71%

28

Proctor & Gamble

13.52%

65

Sara Lee

4.10%

29

Disney

13.20%

66

Best Buy

3.83%

30

Goldman Sachs

13.19%

67

Walgreen

3.80%

31

American Int. Group

12.41%

68

Dick's Sporting Goods

3.62%

32

Altria Group

11.86%

69

WalMart

3.24%

33

AT&T

11.67%

70

Nalco Holding

2.75%

34

Peabody Energy

11.43%

71

Manpower, Inc.

2.27%

35

El Paso

11.10%

72

Weyerhaeuser

2.07%

36

VCA Antech

10.73%

73

Kroger

1.69%

37

ExxonMobil

10.46%

74

Global Partners

0.75%

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IRC Section 4965 and Excise Tax Liability of the Manager of a Tax-Exempt Entity

2009 Emerging Issues 3503

David I. Altman on Excise Tax Liability of the Manager of a Tax-Exempt Entity under IRC Section 4965

By David Altman

April 30, 2009

SUMMARY: This Emerging Issues Analysis discusses excise tax liability of the manager of a tax-exempt entity who approves of the entity's participation in a prohibited tax shelter transaction and knows or has reason to know that the transaction is a prohibited tax shelter transaction. Entity managers include officers, directors and trustees, and the tax is \$20,000 for each approval by the manager.

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ARTICLE: If a specified tax-exempt entity engages in a prohibited tax shelter transaction, the entity manager is liable for an excise tax for each approval of such a transaction if the manager knew or had reason to know that the transaction was prohibited. The tax is \$20,000 per approval by the manager. An entity manager is generally a person who has the authority to act for the entity.

The manager of a tax-exempt entity is subject to tax if the manager approves of the entity's participation in a prohibited tax-shelter transaction and knows or has reason to know that the transaction is a prohibited tax shelter transaction. I.R.C. § 4965(a)(2). For this purpose, tax-exempt entities include [I.R.C. § 4965(c); Prop. Treas. Reg. § 53.4965-2.]; (1) all tax-exempt organizations listed in IRC Section 501(c); (2) religious and apostolic organizations [I.R.C. § 501(d).]; (3) entities eligible for charitable contributions (other than the United States) [I.R.C. § 170(c).]; (4) an Indian tribal government [I.R.C. § 7701(a)(40).]; (5) retirement plans, annuity plans, and annuity contracts [I.R.C. § 4979(e)(1), (2), (3).]; (6) a qualified tuition program [I.R.C. § 529.]; (7) an eligible deferred compensation plan maintained by a state, state agency or political subdivision of a state [I.R.C. § 457(b), (e)(1)(A).], or (8) individual retirement accounts and annuities, Archer MSA's, Coverdell education savings accounts, and health savings accounts [I.R.C. § 4973(a).].

For each entity manager, the amount of the tax is \$20,000 for each approval or other act causing participation in the prohibited transaction. I.R.C. § 4965(b)(2). A prohibited tax shelter transaction is any listed transaction and any prohibited reportable transaction. I.R.C. § 4965(e)(1)(A); Prop. Treas. Reg. § 53.4965-3. A listed transaction is a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the IRS as a tax avoidance transaction under IRC Section 6011. I.R.C. §§ 4965(e)(1)(B), 6707A(c)(2).

A prohibited reportable transaction is any confidential transaction or any transaction with contractual protection

which is a reportable transaction. I.R.C. § 4965(e)(1)(C). A reportable transaction is any transaction for which information is required to be included with a return or statement because the transaction is of a type that the IRS determines has potential for tax avoidance or evasion. I.R.C. § 6707A(c)(1). Under proposed regulations, a tax-exempt entity is a party to a prohibited tax shelter transaction if the entity: (1) facilitates a prohibited tax shelter transaction by its tax-exempt, tax indifferent or tax-favored status; (2) enters into a listed transaction and the tax-exempt entity's tax return (including an amended return) reflects a reduction or elimination of its liability for Federal employment, excise or unrelated business income taxes that is derived directly or indirectly from tax consequences or tax strategy described in the published guidance that lists the transaction; or (3) is identified in published guidance, by type, class or role, as a party to a prohibited tax shelter transaction. Prop. Treas. Reg. § 53.4965-4(a); see *Notice 2007-18, 2007-1 C.B. 608*.

The proposed regulations may be relied on even before they become final. Prop. Treas. Reg. § 53.4965-9(b). Published guidance may identify which tax-exempt entities, by type, class or role, will not be treated as a party to a prohibited tax shelter transaction. Prop. Treas. Reg. § 53.4965-4(b).

An entity manager is generally a person who has the authority to act for the entity.

For purposes of the tax on entity managers of tax-exempt entities, an entity manager of a tax-exempt IRC Section 501(c) organization, religious and apostolic organizations, entities eligible for charitable contributions, or an Indian tribal government (non-plan entities): (1) the person with authority or responsibility similar to that exercised by an officer, director, or trustee of an organization; and (2) for any act, the person having authority or responsibility for that act. I.R.C. § 4965(d)(1).

Under proposed regulations, a person is an officer of a non-plan entity if that person is specifically designated as such under the certificate of incorporation, by-laws, or other constitutive documents of the non-plan entity or regularly exercises general authority to make administrative or policy decisions on behalf of the non-plan entity. Prop. Treas. Reg. § 53.4965-5(a)(2). If a person has authority to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, that person does not exercise general authority to make administrative or policy decisions on behalf of the non-plan entity. Prop. Treas. Reg. § 53.4965-5(a)(3). A person regularly exercises general authority to make administrative or policy decisions if, for any prohibited tax shelter transaction, that person has been delegated final authority or responsibility for that transaction by an officer, director, trustee or governing board of the entity. For example, an investment manager is an entity manager for a prohibited tax shelter transaction if the non-plan entity's governing body delegated to the investment manager the final authority to make specified investment decisions and, in the exercise of that authority, the manager committed the entity to the transaction. Prop. Treas. Reg. § 53.4965-5(a)(4).

For an entity that is a retirement plan, a qualified tuition program, a deferred compensation plan, or other type of individual plan or account (plan entities), the person who approves or otherwise causes the entity to be a party to the prohibited tax shelter transaction is the entity manager. I.R.C. § 4965(d)(2). Under proposed regulations, a person is treated as approving or otherwise causing a tax-exempt entity to become a party to a prohibited tax shelter transaction if the person has the authority to commit the entity to the transaction, either individually or as a member of a collective body, and the person exercises that authority. Prop. Treas. Reg. § 53.4965-5(c)(1). If a person shares such authority as a member of a collective body, such as a board of trustees, the person is considered to have exercised that authority if the person voted in favor of the entity becoming a party to the transaction. However, a member of the collective body is not treated as having exercised such authority if he voted against a resolution that constituted approval of the tax-exempt entity to be a party to a prohibited tax shelter transaction, abstained from voting for such approval, or otherwise failed to vote in favor of the approval. Prop. Treas. Reg. § 53.4965-5(c)(2). If a tax-exempt entity that is a party to a prohibited tax shelter transaction is dissolved, liquidated, or merged into a successor entity, an entity manager of the successor is not, solely by reason of the reorganization, treated as approving or otherwise causing the successor entity to become a party to a prohibited tax shelter transaction, if the reorganization of the tax-exempt entity does not result in a material change in the terms of the transaction. A material change includes an extension or renewal of the agreement (other than through the unilateral exercise of an option granted by the agreement) or a more than incidental change to any payment

under the agreement. A change for the sole purpose of substituting the successor entity for the original tax-exempt party is not a material change. Non-exercise of an option generally will not be an act of approving or causing the entity to be a party to the transaction. Prop. Treas. Reg. § 53.4965-5(c)(3).

Proposed regulations provide guidance on whether an entity manager knows or has reason to know that a transaction is a prohibited tax shelter transaction.

An entity manager is not liable to the excise tax if he does not know or have reason to know that a transaction is a prohibited transaction. I.R.C. § 4965(a)(2). Under proposed regulations, this is based on all facts and circumstances. For an entity manager to know or have reason to know that a transaction is a prohibited transaction, the entity manager must have knowledge of sufficient facts that would lead a reasonable person to conclude that the transaction is a prohibited transaction at the time of approving the entity as a party to the transaction. Relevant factors in making this determination include, but are not limited to: (1) the presence of tax shelter indicia; (2) whether the entity manager received a disclosure statement before consummation of the transaction indicating that the transaction may be a prohibited tax shelter transaction; and (3) whether the entity manager made appropriate inquiries into the transaction. Prop. Treas. Reg. § 53.4965-6(b)(1).

Tax shelter indicia include but are not limited to: (1) the transaction is extraordinary for the entity considering prior investment activity; (2) the transaction promises an economic return for the organization that is exceptional considering the amount invested by, the participation of, or the absence of risk to the organization; or (3) the transaction is of significant size relative to the receipts of the entity. Prop. Treas. Reg. § 53.4965-6(b)(2).

Receipt by an entity manager of a statement, in advance of a transaction, that the transaction may be a prohibited tax shelter transaction is relevant in determining whether the entity manager knew or had reason to know that the transaction is a prohibited transaction. However, an entity manager is not treated as knowing or having reason to know that the transaction was a prohibited tax shelter transaction solely because the entity manager receives such a disclosure. Prop. Treas. Reg. § 53.4965-6(b)(3).

What inquiries are appropriate is determined from the facts and circumstances of each case. For example, if one or more tax shelter indicia are present or if an entity manager receives a disclosure statement, an entity manager has a responsibility to inquire further whether the transaction is a prohibited tax shelter transaction. Prop. Treas. Reg. § 53.4965-6(b)(4). An entity manager is not required to obtain the advice of a professional tax advisor to establish that the entity manager made appropriate inquiries. Prop. Treas. Reg. § 53.4965-6(c)(1).

An entity manager may establish that he did not have a reason to know that a transaction was a prohibited tax shelter transaction at the time the tax-exempt entity entered into the transaction if the entity manager reasonably, and in good faith, relied on the written opinion of a professional tax advisor. The entity manager's education, sophistication, and business experience are relevant in determining whether the reliance was reasonable and made in good faith. The following requirements must be met for reliance on a professional tax advisor: (1) the advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances (this requirement is not satisfied if the entity manager fails to disclose a fact that it knows, or reasonably should know, is relevant to determining whether the transaction is a prohibited tax shelter transaction); (2) the advice must not be based on unreasonable factual or legal assumptions and must not unreasonably rely on the representations, statements, findings, or agreements of the entity manager or any other person; and (3) the written opinion of the professional tax advisor must apply the appropriate law to the facts and, based on this analysis, must conclude that the transaction was not a prohibited tax shelter transaction at a more likely than not level of certainty at the time the entity manager approved the transaction.

Meeting the above conditions does not necessarily establish that the entity manager reasonably relied on the opinion in good faith. For example, reliance may not be reasonable or in good faith if the entity manager knew, or reasonably should have known, that the advisor lacked knowledge in the relevant aspects of federal tax law. Prop.

Treas. Reg. § 53.4965-6(c)(2). An entity manager's reliance on a written opinion of a professional tax advisor is not considered reasonable if the advisor is, or is related to a person who is, a material advisor with respect to the transaction in question. Prop. Treas. Reg. § 53.4965-6(c)(3). Whether a person is a material advisor is determined under I.R.C. §§ 6111 and 6112.

An entity manager is not treated as knowing or having reason to know that a transaction is a prohibited tax shelter transaction if the entity enters into the transaction before the date on which the transaction is identified by the IRS as a listed transaction. However, this rule does not apply to any prohibited reportable transaction, which is any confidential transaction or any transaction with contractual protection which is a reportable transaction. A reportable transaction is any transaction for which information is required to be included with a return or statement because the transaction is of a type that the IRS determines has potential for tax avoidance or evasion. Prop. Treas. Reg. § 53.4965-6(d).

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Excise Tax on Tax-Exempt Entities under IRC Section 4965

2009 Emerging Issues 3555

David I. Altman on the Excise Tax on Tax-Exempt Entities Engaged in Prohibited Tax Shelter Transactions under IRC Section 4965

By David Altman

April 30, 2009

SUMMARY: This Emerging Issues Analysis focuses on specified tax-exempt entities which are subject to an excise tax if the entity engages in a prohibited tax shelter transaction. Some tax-exempt entities must pay excise tax on a transaction that becomes a prohibited transaction through IRS designation after the entity enters into it. Proposed regulations provide help in determining the allocation of income.

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ARTICLE: Specified tax-exempt entities are subject to an excise tax if the entity engages in a prohibited tax shelter transaction. The tax is determined by applying the highest corporate tax rate to the greater of the net income attributable to the transaction or 75 percent of the proceeds of the transaction.

Tax-exempt entities are subject to an excise tax if the entity engages in a prohibited tax shelter transaction. For this purpose tax-exempt entities include [I.R.C. § 4965(c); Prop. Treas. Reg. § 53.4965-2.]: (1) all tax-exempt organizations listed in IRC Section 501(c); (2) religious and apostolic organizations [I.R.C. § 501(d).]; (3) entities eligible for charitable contributions (other than the United States) [I.R.C. § 170(c).]; (4) an Indian tribal government [I.R.C. § 7701(a)(40).]; (5) retirement plans, annuity plans, and annuity contracts [I.R.C. § 4979(e)(1), (2), (3).]; (6) a qualified tuition program [I.R.C. § 529.]; (7) an eligible deferred compensation plan maintained by a state, state agency or political subdivision of a state [I.R.C. § 457(b), (e)(1)(A).]; or (8) individual retirement accounts and annuities, Archer MSA's, Coverdell education savings accounts, and health savings accounts [I.R.C. § 4973(a)].

The tax applies to the tax year in which the entity becomes a party to the transaction and any subsequent tax year. I.R.C. § 4965(a)(1)(A). The amount of the excise tax is determined by multiplying the highest corporate tax rate (35 percent) by the greater of [I.R.C. § 4965(b)(1)(A).]: (1) the entity's net income for the tax year that is attributable to the transaction (after taking into account any other excise tax imposed by the Code on the prohibited transaction), or (2) 75 percent of the proceeds received by the entity for the tax year which are attributable to the transaction.

A prohibited tax shelter transaction is any listed transaction and any prohibited reportable transaction. I.R.C. § 4965(e)(1)(A); Prop. Treas. Reg. § 53.4965-3. A listed transaction is a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the IRS as a tax avoidance transaction under IRC Section

6011. I.R.C. §§ 4965(e)(1)(B), 6707A(c)(2). A prohibited reportable transaction is any confidential transaction or any transaction with contractual protection which is a reportable transaction. I.R.C. § 4965(e)(1)(C).

A reportable transaction is any transaction for which information is required to be included with a return or statement because the transaction is of a type that the IRS determines has potential for tax avoidance or evasion. I.R.C. § 6707A(c)(1).

Proposed regulations define some of the key terms used in applying the tax, including when the entity is a party to a prohibited transaction and the amount of net income and proceeds that are attributable to the transaction.

Under proposed regulations, a tax year for tax-exempt entities is the calendar year or fiscal year, as applicable, depending on the basis on which the tax-exempt entity keeps its books for Federal income tax purposes. If a tax-exempt entity has not established a tax year for Federal income tax purposes, the entity's tax year for the purpose of determining the amount and timing of net income and proceeds attributable to a prohibited tax shelter transaction is the annual period the entity uses in keeping its books and records. Prop. Treas. Reg. § 53.4965-7(a)(2).

Under proposed regulations, a tax-exempt entity is a party to a prohibited tax shelter transaction if the entity: (1) facilitates a prohibited tax shelter transaction by its tax-exempt, tax indifferent or tax-favored status; (2) enters into a listed transaction and the tax-exempt entity's tax return (including an amended return) reflects a reduction or elimination of its liability for Federal employment, excise or unrelated business income taxes that is derived directly or indirectly from tax consequences or tax strategy described in the published guidance that lists the transaction; or (3) is identified in published guidance, by type, class or role, as a party to a prohibited tax shelter transaction. Prop. Treas. Reg. § 53.4965-4(a); see *Notice 2007-18*, 2007-1 C.B. 608.

The proposed regulations may be relied on even before they become final. Prop. Treas. Reg. § 53.4965-9(b). Published guidance may identify which tax-exempt entities, by type, class or role, will not be treated as a party to a prohibited tax shelter transaction. Prop. Treas. Reg. § 53.4965-4(b).

Under proposed regulations, the amount and the timing of the net income and proceeds attributable to the prohibited tax shelter transaction is computed in a manner consistent with the substance of the transaction. Prop. Treas. Reg. § 53.4965-8(a). A tax-exempt entity's net income attributable to a prohibited tax shelter transaction is its gross income derived from the transaction reduced by those deductions attributable to the transaction that would be allowed if the tax-exempt entity were treated as a taxable entity. The net income is further reduced by other federal excise tax imposed on the transaction. Prop. Treas. Reg. § 53.4965-8(b)(1). For a tax-exempt entity that facilitates a tax-exempt transaction through its tax exempt status, the proceeds are the gross amount of the tax-exempt entity's consideration for facilitating the transaction, not reduced by any costs or expenses attributable to the transaction. For a tax-exempt entity that enters into a listed transaction, the proceeds are the tax savings purportedly generated by the transaction and claimed by the tax-exempt entity on its tax return. In addition, any amount that is a gift or a contribution to a tax-exempt entity and is attributable to a prohibited tax shelter transaction is treated as proceeds, unreduced by any associated expenses. Prop. Treas. Reg. § 53.4965-8(b)(2).

Excise tax is increased to the greater of 100 percent of the entity's net income or 75 percent of the entity's proceeds from the transaction if the entity knew, or had reason to know, that the transaction was a prohibited transaction.

There is an increased excise tax if a tax-exempt entity knew, or had reason to know, a transaction was a prohibited tax shelter transaction when the entity became a party to the transaction. In that case, the amount of the tax imposed is the greater of: (1) 100 percent of the entity's net income (after taking into account any other excise tax imposed by the Code) attributable to the prohibited tax shelter transaction, or (2) 75 percent of the proceeds received by the entity which are attributable to the prohibited tax shelter transaction. I.R.C. § 4965(b)(1)(B).

The increased tax does not apply to any prohibited tax shelter transaction to which a tax-exempt entity became a party on or before May 17, 2006, which was the date of enactment of the excise tax provision. Under proposed regulations, an entity is treated as knowing or having reason to know if one or more of its entity managers knew or had reason to know that the transaction was a prohibited tax shelter transaction at the time the entity manager approved the entity as, or otherwise caused the entity to be, a party to the transaction. The entity is attributed the knowledge or reason to know of any entity manager with the authority or responsibility similar to an officer, director, or trustee of an organization even if that entity manager does not approve the entity as, or otherwise cause the entity to be, a party to the transaction. Prop. Treas. Reg. § 53.4965-6(a). There is also an excise tax on entity managers who approve of a tax-exempt entity's participation in a prohibited transaction [I.R.C. § 4965(a)(2)]. Discussion of when an entity manager knows or has reason to know that a transaction is a prohibited tax shelter transaction and the excise tax on entity managers is included in another Emerging Issues Analysis. See David I. Altman on Excise Tax Liability of the Manager of a Tax-Exempt Entity under IRC Section 4965 (April 30, 2009).

Some tax-exempt entities must pay excise tax on a transaction that becomes a prohibited transaction through IRS designation after the entity enters into it. The tax is determined by multiplying the highest corporate tax rate by the income from the transaction that is allocable to the period after the IRS designation. Proposed regulations provide help in determining the allocation of income.

Some tax-exempt entities are subject to a tax if they engage in a subsequently listed transaction. These entities include all tax-exempt organizations listed in IRC Section 501(c), religious and apostolic organizations, entities eligible for charitable contributions (other than the United States), and an Indian tribal government. I.R.C. § 7701(a)(40). A subsequently listed transaction is any transaction to which a tax-exempt entity is a party and which the IRS determines to be a listed transaction at any time after the entity has become a party to the transaction. It does not include a transaction which is a prohibited reportable transaction at the time the entity became a party to the transaction. I.R.C. § 4965(e)(2); Prop. Treas. Reg. § 53.4965-3.

The tax on a subsequently listed transaction is determined by multiplying the highest corporate tax rate by the greater of: (1) the entity's net income (after taking into account any other excise tax imposed by the Code on the transaction) for the tax year that is attributable to the transaction and which is properly allocable to the period beginning on the later of the date the transaction is identified by IRS guidance as a listed transaction or the first day of the tax year, or (2) 75 percent of the proceeds received by the entity for the taxable year which are attributable to the transaction and which are properly allocable to the period beginning on the later of the date the transaction is identified by IRS guidance as a listed transaction or the first day of the tax year. I.R.C. § 4965(a)(1).

Under proposed regulations, the tax-exempt entity's income and proceeds attributable to the transaction are allocated between the period before the transaction became listed and the period beginning on the date the transaction became listed. Prop. Treas. Reg. § 53.4965-7(a)(1)(ii)(A). The IRS treats the period beginning on the first day of the listing year and ending on the day immediately preceding the date of the listing, and the period beginning on the date of the listing and ending on the last day of the listing year as short taxable years solely for purposes of allocating net income or proceeds under this excise tax. The entity continues to file tax returns for the full tax year, does not file tax returns for the deemed short tax years and does not otherwise take the short tax years into account for federal tax purposes. Accordingly, the net income or proceeds that are properly allocated to the listing year are treated as allocable to the period ending before the date of the listing (and thus not subject to excise tax) to the extent the net income or proceeds would have been properly taken into account by the tax-exempt entity in the deemed short year ending on the day immediately preceding the date of the listing. Net income or proceeds that are properly allocated to the listing year are treated as allocable beginning on the date of the listing (and thus subject to excise tax) to the extent the income or proceeds would have been properly taken into account by the tax-exempt entity in the short year beginning on the date of the listing. Prop. Treas. Reg. § 53.4965-8(e).

The net income and proceeds attributable to a prohibited tax shelter transaction must be allocated in a manner consistent with the tax-exempt entity's established method of accounting for Federal income tax purposes. If the

tax-exempt entity has not established such a method of accounting, the entity must use the cash method of accounting to determine the amount and timing of net income and proceeds attributable to a prohibited tax shelter transaction. Prop. Treas. Reg. § 53.4965-8(c)(1). If a tax-exempt entity has established a method of accounting other than the cash method, the tax-exempt entity may nevertheless use the cash method of accounting to determine the amount of the net income and proceeds attributable to a subsequently listed transaction and allocable to pre-listing and post-listing periods. Prop. Treas. Reg. § 53.4965-8(c)(2).

The excise tax is reportable on Form 4720 or Form 5330, as applicable to the reporting entity.

The tax imposed on prohibited tax shelter transactions and subsequently listed transactions is in addition to any other tax, addition to tax, or penalty imposed by the Code. I.R.C. § 4965(g). Entities liable for the tax on prohibited tax shelter transactions and subsequently listed transactions must file Form 4720, "Return of Certain Excise Taxes Under Chapters 41 and 42 of the Internal Revenue Code," or Form 5330, "Return of Excise Taxes Related to Employee Benefit Plans." Tax-exempt entities are subject to disclosure requirements; also, taxable parties are subject to disclosure requirements with respect to prohibited tax shelter transactions to which a tax-exempt entity is a party. Form 4720 must be filed on or before the due date, not including extensions, for filing the entity's annual information return. Entities that are not required to file an annual information return must file Form 4720 on or before the 15th day of the fifth month after the end of the entity's tax year.

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How IRC Section 409A Affects Income Recognition

2009 Emerging Issues 3567

The General Effect of IRC Section 409A on the Income-Recognition Doctrines

By Gerald Levinson

April 29, 2009

SUMMARY: Section 409A provides that if a nonqualified deferred compensation plan fails to meet certain restrictions, amounts deferred will be included in gross income in the year of failure, unless amounts are subject to substantial risk of forfeiture or have been included in income. 409A packs a punch. If taxpayer fails to adhere to its restrictions, she is subject to treatment exceeding what she would have faced if she had taken compensation currently.

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ARTICLE: The General Effect of IRC Section 409A on the Income-Recognition Doctrines

This analysis outlines the effect of IRC Section 409A on the various income recognition doctrines that had developed under the cash method of accounting.

After the *Revenue Act of 1978* placed an effective moratorium on the issuance of new regulations or administrative guidance in the field of nonqualified deferred compensation arrangements, taxpayers become more emboldened in their efforts to structure elections with respect to the receipt of deferred compensation. The Joint Committee on Taxation as part of its 2003 investigation into the deferred compensation plans employed by the Enron Corporation, assessed the situation as follows:

[G]iven the lack of statutory rules in this area, the lack of administrative guidance in this area allows taxpayers latitude to create and promote arrangements which push the limit of what is allowed under the law. Because of the lack of rules and guidance in this area, the current state of practice has, to a great extent, evolved from variations of private letter rulings issued by the IRS to various taxpayers. Because there are no clear rules or guidance, taxpayers continue to create new variations of arrangements that, in their basic form, are generally perceived as allowed by the IRS.

As recommended by the Joint Committee, Congress finally repealed section 132 of the *Revenue Act of 1978* through the enactment of IRC Section 409A in the *American Jobs Creation Act of 2004*. Section 409A generally provides that if a nonqualified deferred compensation plan¹ fails to meet certain restrictions imposed under the statute, then all amounts that have been deferred by the taxpayer pursuant to the plan will be included in gross income in the year in which the failure occurs, unless such amounts are subject to a substantial risk of forfeiture or have been previously included in income. In addition, a penalty is levied at the rate of 20% of the amount included, and interest is

charged on amounts that had previously been deferred.

In short, IRC Section 409A packs a punch. If a taxpayer who is subject to IRC Section 409A fails to adhere to its restrictions, she is subject to tax treatment that exceeds what she would have faced had she simply taken her compensation currently.

IRC Section 409A does not supplant the income recognition doctrines under the cash method of accounting. Rather, it supplements them. To the extent a deferred compensation plan does not fall within the scope of the statute, the timing of inclusion of compensation income will continue to be governed by IRC Section 83, the constructive receipt doctrine, and the cash equivalency doctrine.

Nevertheless, the scope of IRC Section 409A is rather broad. It applies to any nonqualified deferred compensation plan' other than a qualified employer plan and a bona fide plan providing vacation leave, sick leave, *etc.* A nonqualified deferred compensation plan' is one that provides for the deferral of compensation,' and a plan generally provides for the deferral of compensation if the service provider has a legally binding right during a taxable year to compensation that .. is or may be payable to (or on behalf) of the service provider in a later taxable year.'

However, meaningful exceptions to IRC Section 409A exist. For instance, the statute generally does not apply to independent contractors. Furthermore, the statute generally does not apply to nonstatutory stock options or stock appreciation rights, providing those options or rights are not discounted at their issuance.

Backstopping the Constructive Receipt Doctrine

For taxpayers and plans that are subject to IRC Section 409A, the primary effect of the statute is to vastly expand the instances of constructive receipt of compensation income. Whereas prior law under Regulations Section 1.451-2 entailed ensuring that the employee's access to the funds was subject to a substantial limitation, IRC Section 409A reverses the field by defining a limited number of events upon which distributions from a plan are permissible. Pursuant to IRC Section 409A(a)(2), distributions may not be made earlier than: (1) the participant's death; (2) the participant's disability; (3) the participant's separation from service (with a required 6-month delay for key employees); (4) a specified time (or pursuant to a fixed schedule) that is established at the date the compensation is deferred; (5) a change in ownership or control of a corporate employer; and (6) the occurrence of an unforeseeable emergency. This list most notably excludes the right of a participant to unilaterally withdraw amounts from the plan by paying the haircut penalty-the source of the greatest perceived abuse of the constructive receipt doctrine.

Section 409A not only strengthens the constructive receipt doctrine as it applies to the acceleration of distributions, it also constrains the period in which the initial deferral election may be made. Whereas many case decisions had given taxpayers some confidence that valid deferral elections could be made at any point prior to the date on which the amounts were due to be paid, IRC Section 409A imposes far more restrictive rules. As a general rule, the election to defer payment of compensation must be made not later than the close of the taxable year preceding the taxable year in which the compensation is earned. The statute thus effectively forecloses the employee's ability to take a wait-and-see approach, as previously had been afforded under prevailing caselaw.

Impact of IRC Section 409A on Deferral Elections by Taxpayers with Part-Year Work Periods

The enactment of Section 409A and absence of immediate guidance relating to 409A's application created considerable confusion among occupations, such as teaching, that commonly employ part-year work periods. In response, and to assuage the fears of affected taxpayers facing the specter of constructive receipt and significant penalties for 409A violations, the IRS released a number of Questions and Answers (Q&As). These Q&As were designed to help explain how Section 409A would apply to arrangements that allowed taxpayers with part-year work periods to elect to defer a portion of their salaries. The IRS acknowledged that, for convenience of reference, the Q&As refer to school districts and their employees, although certain other taxpayers are also covered.

The Q&As explain that, for purposes of Section 409A: (1) school districts are not required to offer their employees an election between being paid over the school year and being paid over a 12-month period; (2) school districts that chose to offer such an election did not have to make any changes prior to 2008 and their employees would not be subject to additional taxes; (3) any changes required for 2008 were likely to be minor.

The following exemplifies how a teacher's ability to have his or her salary spread over 12 months creates deferred compensation:

Generally, deferred compensation arises in an arrangement under which compensation earned in one year is paid in a later year. For example, assume a school year starts Aug. 1, 2008, and ends May 31, 2009 (10 months), and that a teacher earns \$5,400 per month (\$54,000 per year). If the teacher were paid over 10 months, the teacher would receive \$27,000 in 2008 for the five months of August through December, and would receive \$27,000 in 2009 for the five months of January through May. If instead, the teacher were paid over 12 months, the teacher would receive \$4,500 per month. The teacher would receive only \$22,500 in 2008 for the five months of August through December and would receive \$31,500 in 2009 for the seven months of January through July. In this example, \$4,500 that the teacher earned in 2008 is paid in 2009. In other words, the \$4,500 of 2008 pay is deferred until 2009 and the arrangement generally would be considered deferred compensation that is subject to Section 409A.

Section 409A does not require that an employee be provided any election regarding how the employee is paid. For example, a school district may provide that all teachers will have their pay spread over 12 months, without providing any election to the teachers. In that case, the election rules discussed below would not apply and no additional taxes would be imposed under Section 409A.

Section 409A generally establishes deadlines for when employees have to make their elections to defer compensation. The general rule under the law is that an employee who wants to defer payment of compensation to be earned in one year until a later year must make an election to do that not later than the end of the prior year. In other words, if an employee wanted to defer some of his or her salary that would be earned in 2009, the employee would have to make the election not later than Dec. 31, 2008. Congress gave the IRS and Treasury Department authority to provide additional rules for elections, however. Under final Section 409A regulations, special rules allow teachers (or other taxpayers with similar part-year work periods) to make an election to spread their compensation out for up to 12 months, if their employer is willing to give them that choice.

Generally, the regulations require the following: (a) the teacher (or other employee) must give a written (or electronic) election to the employer that notifies the employer that the employee wants to spread out the compensation. (b) The election must be made before the beginning of the work period (for example, before the first day of the school year for which the teacher is paid, which may be before the first day students arrive for class). (c) The election must be irrevocable, so that it can't be changed after the work period begins. (d) The election must state how the compensation is going to be paid if the election is made (for example, ratably over the 12 months starting with the beginning of the school year). (e) No particular form is necessary for the election and it does not have to be filed with the IRS.

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The Saga of the Reserve Primary Fund and Its Tax Consequences

2009 Emerging Issues 3570

Lowenthal, Storrer and McBride on the Saga of the Reserve Primary Fund and Its Tax Consequences

By Franklin Lowenthal, Philip Storrer and Gary McBride

April 29, 2009

SUMMARY: The Reserve Primary Fund had a reputation as a safe, conservative investment vehicle. Thus it sent a shock wave when on September 12, 2008, its value declined from one dollar to 97 cents; no money market fund had done this in the last 14 years. The authors provide background and analyze the tax consequences of these losses, including what they see as the correct tax treatment.

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ARTICLE: The Reserve Primary Fund (hereafter referred to as RPF) had a reputation as a safe, conservative investment vehicle; it was, in fact, the first money market fund.

The Reserve had relationships with many of the nation's leading corporations, endowments, pensions, municipalities and hedge funds, including over 400 financial services firms and over 30% of the Fortune 100 companies. At the close of business on Friday September 12, the holding report of RPF listed assets of \$62.5 billion; 5 billion shares alone were owned by the government of China. Thus it was a shock when, at 4pm EDT Tuesday, September 17, the RPF per share value "broke the buck" by declining in value from one dollar to 97 cents; no money market fund had done this in the last 14 years. This drop was a result of writing down to zero approximately 785 million dollars in commercial paper and floating rate loans of Lehman Brothers which had declared bankruptcy. The news triggered a run on money funds that abated only when the Treasury announced a program to temporarily insure money-market funds. Secretary Paulson offered government insurance to such funds at the close of business on Friday, September 19. The RPF was explicitly excluded from participating in this program because its value had dropped below the one dollar figure prior to that date.

On the morning of Monday, September 15, RPF had paid out \$11.5 billion to investors who redeemed their shares on that date aware that Lehman Brothers had filed for bankruptcy early that day. However, RPF did not have enough cash on hand to meet the redemption requests for another \$29 billion that were made later on September 15 and on September 16 before the announcement at 4PM on September 16 that the Net Asset Value (hereinafter referred to as NAV) of RPF had decline to \$0.97. The fund invoked the seven-day rule under the Investment Company Act of 1940 to delay honoring these redemptions. Instead it sent out confirmations that the redemption request had been received and that the NAV was still \$1.00 at the time that the request was made. The SEC approved six days later on September 22 the RPF request to extend the delay indefinitely.

It is hardly surprising that the events described above have lead to multiple lawsuits being filed against the RPF; one of the principle ones by Ameriprise Financial whose clients had invested about \$1 billion in the fund (another \$2.2 billion was invested through a subsidiary). The lawsuit alleges institutional investors were given advance warning to the detriment of retail investors. The lawsuits may delay the final liquidation of the fund and hence the realization of the loss by the investors.

In the period from October 31, 2008 to April 17, 2009 RPF has made 4 partial distributions to all investors remaining in the Fund, including those who submitted redemption orders that had not been funded and those who have not submitted redemption orders. To date, \$46.1 billion, or approximately 90% of Fund assets as of the close of business on September 15, 2008, has been returned to investors. Approximately \$4.5 billion remains in the Fund, which includes the Lehman Brothers Holdings Inc. securities held in the Fund, which are valued at zero.

Ameriprise Financial and Ameritrade both have promised to contribute up to 3 cents per share to their clients to mitigate their losses. Ameriprise Financial has set aside \$33 million to fund this obligation; this amounts to approximately 3% of the one billion that its own clients had invested in the fund. "Ameriprise Financial expects this commitment to have an impact of approximately 10 cents per share on its third quarter earnings."

Any reimbursement clients of Ameriprise Financial and Ameritrade receive in 2009 to mitigate their loss in RPF will not result in taxable income to the recipient. Rather it will simply reduce the amount of the loss that the taxpayer will be entitled to claim (see below). Even if the taxpayer is unable to fully or partially deduct the loss, the "tax benefit doctrine" would preclude the taxpayer from having to report the reimbursement as taxable income (just as a state tax refund is not taxable income on Federal Form 1040 if the taxpayer did not itemize deductions on Schedule A).

Tax Treatment of the "Loss"

These "losses" must certainly be tax deductible, but the actual tax saving to investors will depend critically on what method will be permitted in deducting these losses. Moreover, we point out that the loss will not be deductible in any matter until it is realized, which is when RPF is fully liquidated and all the funds have been paid to the investors. We analyze three possible scenarios the last of which we see as the correct approach.

(1) Perhaps the most pragmatic method might be to offset the loss against the income earned with respect to the fund. Using this argument, a deduction in the amount of the loss would arguably be deducted directly from gross income. However, in *Rev. Rul. 73-511* n2 the IRS addressed this netting approach in an analogous situation in connection with offsetting interest received on a CD with the penalty paid on early withdrawal of the account balance. In pertinent part, the IRS ruled,

There is no statutory provision for the use of any type of netting rule since the interest paid or credited and the forfeiture incurred represent two separate transactions and are taxable as such. Interest paid to the depositor or credited to his account with no restriction as to withdrawal is includible in his gross income in accordance with his accounting method. This [sic] only relationship between the interest and the forfeiture penalty is the fact that the penalty is calculated by reference to a given amount of interest. . . . n3

However, the authors feel that if Congress can bail-out the banks and allow them ordinary loss treatment (which they did), then why couldn't they bail out the investors in money market funds and give them an ordinary above AGI deduction for their losses in this context.

(2) The second approach is to take a deduction under IRC section 165 (26 USCS § 165) which allows losses to be deducted if the loss arises from a transaction entered into for profit which clearly this would be. n4 The important question is whether the loss would be an ordinary or a capital loss. There is an adverse consequence to each of these treatments.

If the loss is deemed to result from the "sale or exchange of a capital asset," then the deduction claimed by an

individual taxpayer is limited as explained in 3 below.

If the loss is deemed not to be from a "sale or exchange," then the loss would be ordinary. Such loss, since it is not one of the 21 types of deductions specified in IRC section 62(a) (26 USCS § 62A(a)), would be deducted as a miscellaneous itemized deduction, from adjusted gross income, and therefore be subject to the IRS section 67 (26 USCS §67) 2% limitationⁿ⁵ and the IRC section 68 (26 USCS §68) phase out for individual taxpayers with adjusted gross incomes above certain levels.ⁿ⁶ Individuals subject to the dreaded alternative minimum tax effectively lose the deduction entirely.

(3) The most technically defensive method is to treat the loss as a non-business bad debt under IRC section 166. In fact this approach, in the opinion of the authors, is the only correct treatment. This obtains from the debtor-creditor relationship between the taxpayer-creditor and the issuer of the "shares" evidencing the deposit-claim.ⁿ⁷ As indicated in 2 above, IRC section 166 (26 USCS § 166) requires this loss to be treated, by individual taxpayers, as the sale or exchange of a capital asset held for less than one year(i.e. a short term capital loss). As such, the deduction claimed by an individual taxpayer is limited to capital gains plus an extra deduction limited, however to \$3,000 per year.ⁿ⁸ The loss to a corporation is limited to capital gain with no extra \$3,000.ⁿ⁹ An individual taxpayer is allowed to carry over, to succeeding tax years, any unused loss.ⁿ¹⁰ Corporations are generally allowed to carry back, to the 3 preceding years, any unused capital loss and then carry any remaining balance over to succeeding years.ⁿ¹¹

The considerations that are relevant to the decision between a capital loss and an ordinary loss are summarized as follows:

--Is RPF a "security" as defined by IRC Sec 165(g)(2) (26 USCS §1 65(g)(2))? If it is, then such a "worthless" security would be a capital loss per IRC Sec 165(g)(1) (26 USCS § 165(g)(1)). What makes it a security could be an "evidence of indebtedness" issued by a corporation in registered form.

--If not technically a security, then it is some sort of contractual right to be repaid and that full repayment right will have been breached. If so, the loss would be an ordinary loss because there is technically no sale or exchange. But it could be argued that IRC Section 1271 (26 USCS § 1271) which treats an amount received by the holder on retirement of any debt instrument as a sale (capital loss) is the section that applies.

Financial Planning

Generating capital gains by selling other capital assets, such as stocks or bonds, to be offset against this capital loss is often advanced as a wise tax planning technique. This however is not prudent if the capital gains are long term and therefore subject to the lower capital gains rates.ⁿ¹² While this intuitively makes sense the ultimate proof of this depends upon a present value calculation beyond the scope of this article.ⁿ¹³

Recent Developments

On December 18, 2008, the SEC staff recommended that enforcement action for violation of federal securities laws be taken against Chairman and President Bruce Bent and his two sons who are Vice Presidents. The SEC has not acted on this recommendation but generally 90% of such staff recommendations are adopted by the SEC. The RPF has vowed to use its full resources to fight any prosecutions. It is unclear whether it can legally use any of the undistributed assets to this end.

Technical Aspects of the NAV Calculation

NAV is computed from the formula (Assets -- Liabilities) / Shares Outstanding. An investment of \$10,000 increases both assets and outstanding shares by this amount. If the ratio exceeds one due to income earned by the fund, this income net of fund expenses is distributed to investors in the form of new shares. Thus the published NAV should always be one. However, a substantial loss by a fund, such as the \$785 million loss by RPF due to the Lehman Brothers

bankruptcy can lead to an NAV of less than one. Once such a loss is sustained, the NAV will continue to decrease as shares are redeemed by investors, even if the fund sustains no additional losses! For example, a fund with \$100 in assets, no liabilities and 100 outstanding shares has an NAV equal to one. Now a \$2 write down of its assets reduces the NAV to 0.98. If this is followed immediately by 50 shares being redeemed, the NAV becomes .48 / .50 or 0.96. In the case of the RPF on Monday September 15 and Tuesday September 16, redemption requests amounted to approximately \$40 billion. Although only about \$11.5 billion of this total was actually paid, under Rule 2a-7 RPF had to treat the other \$28.5 billion as liabilities and deduct the same amount from outstanding shares. Christopher Condon pointed out that "as soon as someone says they want their money, the fund must treat that as if the cash has already been sent out when calculating the NAV. Thus, by 4 pm on Sept 16, the fund only had about \$23 billion left in net assets. The \$785 million loss took about 3.4 cents off the NAV at that point." If the redemption requests had amounted to \$50 billion, the same \$785 million loss would have reduced the NAV by 6 cents.

Acknowledgement

The authors wish to recognize the outstanding reporting of both Larry Edelman and Christopher Condon at Bloomberg.com that helped us immeasurably in gathering the background material for this article.

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n1 While the investment is described by the issuer using the term "share" with a fixed share price and value of one dollar, and the income with reference thereto described as a "dividend," the "share" is in reality evidence of a debt on the part of the issuer to the investor for the principal sum of the deposit and the obligation to pay interest on that debt. This arrangement is consistently, and we believe correctly, described as a debtor-creditor relationship. See *Rev. Rul. 73-511, 1973-2 C.B. 402*; See also *Centennial Savings Bank FSB v. United States*, 682 F. Supp. 1389, 1391 (N.D.Tex. 1988); *Colonial Savings Assoc. v. Commissioner*, 85 T.C. 855 (1985), aff'd 854 F.2d 1001 (7th Cir. 1988), cert. denied, 489 U.S. 1090, 109 S. Ct. 1556, 103 L. Ed. 2d 859 (1989); *Centennial Savings Bank FSB v. United States*, 887 F.2d 595; 1989 U.S. App. LEXIS 16491; 89-2 U.S. Tax Cas. (CCH) P9612; 64 A.F.T.R.2d (RIA) 5684, (CA-5 11/02/1989); *Colonial Savings Association, et. ux. v. Commissioner of Internal Revenue & Frontier Savings & Loan Association, as Cross-Appellant, v. Commissioner of Internal Revenue*, 854 F.2d 1001; 1988 U.S. App. LEXIS 11575; 88-2 U.S. Tax Cas. (CCH) P9458; 62 A.F.T.R.2d (RIA) 5420, (CA-7, 8/10/1988).

n2 *Rev. Rul. 73-511, 1973-2 C.B. 402.*

n3 See *Centennial Savings Bank FSB v. United States*, 887 F.2d 595; 1989 U.S. App. LEXIS 16491; 89-2 U.S. Tax Cas. (CCH) P9612; 64 A.F.T.R.2d (RIA) 5684, (CA-5 11/02/1989); *Colonial Savings Association, et. ux. v. Commissioner of Internal Revenue & Frontier Savings & Loan Association, as Cross-Appellant, v. Commissioner of Internal Revenue*, 854 F.2d 1001; 1988 U.S. App. LEXIS 11575; 88-2 U.S. Tax Cas. (CCH) P9458; 62 A.F.T.R.2d (RIA) 5420, (CA-7, 8/10/1988), where both the 5th and 7th Circuit appear to accept the conclusion of *Rev. Rul. 73-511*, that netting is not supported by any statutory provision.

Also, IRC section 62(a)(9) (26 USCS § 62(a)(9)) credits the any sort of money on deposit in a financial institution as a transaction entered into "for profit" and references section 165 (26 USCS § 165) as the authority for a loss deduction related thereto. Section 62(a)(9), in pertinent part reads,

(a) General Rule -- For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions: . . .

(9) Penalties forfeited because of premature withdrawal of funds from time savings accounts or deposits -- The deductions allowed by for losses incurred in any transaction entered into for profit, though not connected with a trade or business to the extent that such losses include amounts forfeited to a bank, mutual savings bank, savings and loan association, building and loan association, corporative bank or homestead association as a penalty for premature withdrawal of funds from a time savings account, certificate of deposit, or (emphasis added).

Centennial v. U.S., 887 F.2d 595; 1989 U.S. App. LEXIS 16491, 89-2 U.S.T.C. (CCH) P9612; 64 A.F.T.R.2d (RIA) 5684 (CA-5) 11/02/1989.

n4 This deposit must be a capital asset under IRC section 1221 (26 USCS § 1221), certainly to the vast majority of taxpayers, but the retirement or satisfaction of debt, regardless of the method of satisfaction, is not a "sale or exchange." However, IRC section 166 (26 USCS § 166) does treat the loss, to individual taxpayers, as resulting from the retirement or satisfaction (worthlessness or partial worthlessness) of a debt as if the loss arose in connection with the a sale or exchange of a capital asset held for less than one year(i.e., a short term capital loss).

n5 IRC section 67(a) (26 USCS § 67(a)) allows miscellaneous itemized deductions only if and to the extent that they, in the aggregate, exceed 2% of the individual taxpayer's adjusted gross income.

n6 IRC section 68 (26 USCS § 68) reduces the amount of selected itemized deductions, including section 165 type losses, by 3% of the extent to which the individual taxpayer's adjusted gross income exceeds \$156,400 (\$78,200 for married taxpayers filing separately). These figures are for tax year 2007 and are increased each year by an indexed amount. The 2008 amounts have yet to be announced.

n7 See footnote 1 for a more complete defense of the debtor-creditor characterization.

n8 26 USCS § 1211(b).

n9 26 USCS § 1211(a).

n10 26 USCS § 1212(b).

n11 26 USCS § 1212(a).

n12 Under 26 USCS § 1(h), the capital gains rate for individuals can be as low as 5% but generally is 15%.

n13 See however, Oil, Gas and Energy Quarterly, The Timing of Capital Gains and Losses by Lowenthal and Storrer, March 2000, pp 495-504.

RELATED LINKS: For more information on IRC Sec. 166 treatment of non-business bad debt losses, see
■ Lexis Explanation IRC Sec. 166(d)

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Rules for Tax Advisors Regarding Covered Opinions under Circular 230

2009 Emerging Issues 3553

David I. Altman on Rules for Tax Advisors Regarding Covered Opinions under Circular 230

By David Altman

April 29, 2009

SUMMARY: This Emerging Issues Analysis discusses one of the regulations under Circular 230 governing the circumstances under which tax practitioners can offer advice, called covered opinions, on federal tax issues to their clients. Covered opinions include advice given in transactions that the IRS has determined are tax avoidance transactions or given to an entity that has tax avoidance as its primary or significant purpose.

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ARTICLE: Tax advisors must follow rules for covered opinions when providing federal tax advice to their clients if the opinion comes within specified categories that relate to tax avoidance transactions.

A practitioner who provides a covered opinion must comply with the standards set forth in Circular 230 regarding covered opinions. 31 C.F.R. § 10.35(a). These standards apply to written advice that is rendered after June 20, 2005. 31 C.F.R. § 10.35(g). A covered opinion is written advice, including electronic communications, by a practitioner concerning one or more federal tax issues arising from [31 C.F.R. § 10.35(b)(2)(i)]: (1) a transaction that is the same as or substantially similar to a transaction that the IRS has determined to be a tax avoidance transaction and that is identified by published guidance as a listed transaction. Substantial similarity is determined at the time the opinion is given. The IRS has provided a list of such transactions in *Notice 2004-67, 2004-2 C.B. 600*; (2) any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, that has as its principal purpose the avoidance or evasion of any tax imposed by the Internal Revenue Code (IRC); or (3) any partnership, entity, or plan, a significant purpose of which is the avoidance or evasion of any tax imposed by the IRC if the written advice is: (a) a reliance opinion; (b) a marketed opinion; (c) subject to conditions of confidentiality; or (d) subject to contractual protection.

The principal purpose of an entity or plan is the avoidance or evasion of any tax if that purpose exceeds any other purpose. An entity or plan that claims tax benefits in a manner consistent with the Code and the Congressional purpose does not have tax avoidance or evasion as its principal purpose. However, there may be a significant purpose of avoidance or evasion even when an entity does not have the principal purpose of avoidance or evasion. 31 C.F.R. § 10.35(b)(10).

A reliance opinion is written advice that concludes at a confidence level of more likely than not that one or more

significant federal tax issues would be resolved in the taxpayer's favor. 31 C.F.R. § 10.35(b)(4)(i). A federal tax issue is significant if the IRS has a reasonable basis for a successful challenge and the issue's resolution could have a significant impact on the overall federal tax treatment of the matter addressed in the opinion. 31 C.F.R. § 10.35(b)(3). Written advice for an entity that has a significant tax avoidance purpose is not treated as a reliance opinion if the practitioner prominently discloses in the advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, to avoid penalties that may be imposed on the taxpayer. 31 C.F.R. § 10.35(b)(4)(ii). An item is prominently disclosed if it is readily apparent to a reader of the written advice, which depends on the facts and circumstances surrounding the written advice. At a minimum, to be prominently disclosed, an item must be set forth in a separate section and not in a footnote in a typeface that is the same size or larger than the typeface of any discussion of the facts or law in the written advice. 31 C.F.R. § 10.35(b)(8).

Practice Note: Use of the disclaimers described above is commonplace among practitioners to avoid having their advice treated as reliance opinions. However, the disclaimer makes it impossible for their clients to rely on the advice.

A marketed opinion is written advice if the practitioner knows or has reason to know that the advice will be used or referred to by a person other than the practitioner, or someone else in the practitioner's firm, in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to one or more taxpayers. Written advice for an entity that has a significant tax avoidance purpose is not treated as a marketed opinion if the practitioner prominently discloses in the advice that: (1) the advice was not intended or written by the practitioner to be used, and that it cannot be used by any taxpayer, to avoid penalties that may be imposed on the taxpayer; (2) the advice was written to support the promotion or marketing of the transaction or matter addressed by the written advice; and (3) the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. 31 C.F.R. § 10.35(b)(5).

Written advice is subject to conditions of confidentiality if the practitioner imposes on one or more recipients of the advice a limitation on disclosure of the tax treatment or tax structure of the transaction that protects the confidentiality of that practitioner's tax strategies. A claim that a transaction is proprietary or exclusive is not a limitation on disclosure if the practitioner confirms to all recipients of the advice that there is no limitation on disclosure of the tax treatment or tax structure of the transaction. 31 C.F.R. § 10.35(b)(6).

Written advice is subject to contractual protection if the taxpayer has the right to a full or partial refund of fees paid to the practitioner or his firm if all or a part of the intended tax consequences from the matters addressed in the written advice are not sustained. Contractual protection also exists if the fees paid are contingent on the taxpayer's realization of tax benefits from the transaction. 31 C.F.R. § 10.35(b)(7).

Specified written opinions are specifically excluded from being covered opinions.

A covered opinion does not include written advice provided to a client during the course of an engagement if a practitioner is reasonably expected to provide subsequent written advice to the client that will comply with the requirements for covered opinions. A covered opinion also does not include written advice, other than advice on a listed transaction or transaction having a principal purpose of tax avoidance or evasion, that concerns the qualification of a qualified plan, is a State or local bond opinion, or is included in documents required to be filed with the Securities and Exchange Commission. 31 C.F.R. § 10.35(b)(2)(ii). A State or local bond opinion is written advice regarding a federal tax issue included in any materials delivered to a purchaser of a State or local bond in connection with the issuance of the bond in a public or private offering, including an official statement that concerns only whether the bond is tax-exempt or other issues relating to the status of the bond under the Internal Revenue Code. 31 C.F.R. § 10.35(b)(9).

Written advice prepared for and provided to a taxpayer, solely for use by that taxpayer, after the taxpayer has filed a tax return with the IRS reflecting the tax benefits of the transaction is not a covered opinion. This exception does not apply if the practitioner knows or has reason to know that the written advice will be relied upon by the taxpayer to take a position on a tax return, including an amended return that claims tax benefits not reported on a previously filed return,

filed after the date on which the advice is provided to the taxpayer. Written advice provided to an employer by a practitioner as an employee of that employer solely for purposes of determining the tax liability of the employer is not a covered opinion. Written advice that does not resolve a federal tax issue in the taxpayer's favor is not a covered opinion, unless the advice reaches a conclusion favorable to the taxpayer at any confidence level (e.g., not frivolous, realistic possibility of success, reasonable basis or substantial authority) for that issue.

The regulations specify requirements that must be met by a covered opinion, including factual accuracy, relating the law to the facts and stating a conclusion regarding federal tax issues.

When providing a covered opinion, the practitioner must use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and to determine which facts are relevant. The opinion must identify and consider all facts that the practitioner determines to be relevant. The practitioner must not base the opinion on any unreasonable factual assumptions, including a factual assumption that the practitioner knows or should know is incorrect or incomplete. A factual assumption includes reliance on a projection, financial forecast or appraisal. The opinion must identify in a separate section all factual assumptions relied upon by the practitioner. The practitioner must not base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person. An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete. The opinion must identify in a separate section all factual representations, statements or findings of the taxpayer relied upon by the practitioner. 31 C.F.R. § 10.35(c)(1).

A covered opinion must relate the applicable law, including potentially applicable judicial doctrines, to the relevant facts. The practitioner must not assume the favorable resolution of any significant federal tax issue or otherwise base an opinion on any unreasonable legal assumptions, representations, or conclusions. The opinion must not contain internally inconsistent legal analyses or conclusions. 31 C.F.R. § 10.35(c)(2).

A covered opinion must consider all significant federal tax issues except as discussed below. The opinion must provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail on the merits for each such issue. If the practitioner is unable to reach a conclusion on one or more of those issues, the opinion must state so. The opinion must describe the reasons for the conclusions, including the facts and analysis supporting the conclusions, or describe the reasons that the practitioner is unable to reach a conclusion as to one or more issues. In evaluating the significant federal tax issues addressed in the opinion, the practitioner cannot take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised. A marketed opinion must provide the practitioner's conclusion that the taxpayer will prevail on the merits at a confidence level of at least more likely than not for each significant federal tax issue. If the practitioner cannot reach a more likely than not conclusion for each significant federal tax issue, the practitioner must not provide the marketed opinion. 31 C.F.R. § 10.35(c)(3).

A practitioner may provide a limited scope opinion that considers less than all of the significant federal tax issues if: (1) the practitioner and the taxpayer agree that the scope of the opinion and the taxpayer's potential reliance on the opinion for purposes of avoiding penalties are limited to the federal tax issues addressed in the opinion; (2) the opinion does not concern listed transactions or an entity with the principal purpose of tax avoidance and is not a marketed opinion; and (3) the opinion includes the appropriate disclosures discussed below. 31 C.F.R. § 10.35(c)(3)(v).

A covered opinion must provide the practitioner's overall conclusion as to the likelihood that the federal tax treatment of the transaction or matter is the proper treatment and the reasons for that conclusion. If the practitioner is unable to reach an overall conclusion, the opinion must state that the practitioner is unable to reach an overall conclusion and describe the reasons for the practitioner's inability to reach a conclusion. A marketed opinion must provide the practitioner's overall conclusion that the federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment at a confidence level of at least more likely than not. 31 C.F.R. § 10.35(c)(4).

The practitioner must be knowledgeable in all of the aspects of federal tax law relevant to the covered opinion.

However, the practitioner may rely on the opinion of another practitioner for one or more significant federal tax issues, unless the practitioner knows or should know that the opinion of the other practitioner should not be relied on. If a practitioner relies on the opinion of another practitioner, the relying practitioner's opinion must identify the other opinion and set forth the conclusions reached in the other opinion. The practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion, if any, satisfy the requirements for covered opinions. 31 C.F.R. § 10.35(d).

Covered opinions must also provide disclosures specified by the regulations.

A covered opinion must prominently disclose the existence of: (1) any compensation arrangement, such as a referral fee or a fee-sharing arrangement, between the practitioner or his firm or a member of his firm and any person (other than the client for whom the opinion is prepared) concerning promoting, marketing or recommending the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion, or (2) any referral agreement between the practitioner and a person (other than the client) engaged in promoting, marketing or recommending the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion. 31 C.F.R. § 10.35(e)(1).

A marketed opinion must prominently disclose that: (1) the opinion was written to support the promotion or marketing of the transactions or matters addressed in the opinion; and (2) the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor. 31 C.F.R. § 10.35(e)(2).

A limited scope opinion must prominently disclose that: (1) the opinion is limited to the one or more federal tax issues addressed in the opinion; (2) additional issues may exist that could affect the federal tax treatment of the transaction or matter that is the subject of the opinion and the opinion does not consider or provide a conclusion regarding any additional issues; and (3) for any significant federal tax issues outside the limited scope of the opinion, the opinion was not written, and cannot be used by the taxpayer, to avoid penalties. 31 C.F.R. § 10.35(e)(3).

A covered opinion that does not reach a conclusion at a confidence level of at least more likely than not for a significant federal tax issue must prominently disclose that it does not reach such a conclusion. The opinion must also prominently disclose that for those significant federal tax issues, the opinion was not written, and cannot be used by the taxpayer, to avoid penalties. 31 C.F.R. § 10.35(e)(4).

A practitioner may not provide advice to any person that is contrary to or inconsistent with the disclosures that are required under the above rules. 31 C.F.R. § 10.35(e)(5).

Compliance with covered opinion rules does not mean that opinion is necessarily correct.

An opinion that meets the requirements of the covered opinion rules satisfies the practitioner's responsibilities, but the persuasiveness of the opinion regarding the tax issues in question and the taxpayer's good faith reliance on the opinion are determined separately under the tax law and regulations. 31 C.F.R. § 10.35(f)(1).

Written advice that is not a covered opinion is also subject to standards set forth by Circular 230.

A practitioner who provides written advice that is not a covered opinion must nonetheless comply with a separate rule under Circular 230. 31 C.F.R. § 10.35(f)(2). A practitioner must not give written advice, including electronic communications, concerning one or more federal tax issues if the practitioner: (1) bases the written advice on unreasonable factual or legal assumptions, including assumptions as to future events; (2) unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person; (3) does not consider all relevant facts that the practitioner knows or should know; or (4) in evaluating a federal tax issue, takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

All facts and circumstances are considered in determining whether a practitioner has failed to comply with these rules. For an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner or a member of his firm in promoting, marketing or recommending to one or more taxpayers an entity, investment plan or arrangement that has a significant purpose of avoiding or evading federal taxes, the determination of whether a practitioner has failed to comply with these rules is made under a heightened standard of care. These rules apply to written advice that is rendered after June 20, 2005. 31 C.F.R. § 10.37.

See Juan F. Vasquez, Jr. and Jaime Vasquez, Section 10.35(b)(4)(ii) of Circular 230 Is Invalid (But Just in Case It Is Valid, Please Note That You Cannot Rely on This Article to Avoid the Imposition of Penalties), 7 *Hous. Bus. & Tax L.J.* 293 (2007).

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- Part 5. Federal Tax Practice, Procedure & Controversies, LexisNexis Tax Advisor -- Federal Topical § 5B:4.06;
- 1-4 Tax Controversies: Audits, Investigations, Trials § 4.06

For discussion of whether the definition of covered opinions is adequate, see Isaac J. Roang, Current Development 2005-2006: To Disclaim or Not To Disclaim: IRS Circular 230 Requirements for Written Advice,

- 19 *Geo. J. Legal Ethics* 937 (2006)

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Standards of Practice for Tax Advisors under Circular 230

2009 Emerging Issues 3551

David I. Altman on Standards of Practice for Tax Advisors under Circular 230

By David Altman

April 28, 2009

SUMMARY: This Emerging Issues Analysis discusses Circular 230 and regulations that govern practice before the IRS, some of which address best practices and how tax practitioners should treat their clients. Although these standards are aspirational and violations of these standards will not necessarily be penalized, noncompliance can lead to sanctions, including monetary penalties for the practitioner and possibly even his firm.

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ARTICLE: Tax advisors must follow the best practices in representing their clients regarding federal tax issues.

Treasury regulations promulgated as part of Circular 230 require that tax advisors must provide clients with the highest quality representation concerning federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. Best practices include:

1. Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.
2. Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.
3. Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.
4. Acting fairly and with integrity in practice before the Internal Revenue Service. 31 C.F.R. § 10.33(a).

Tax advisors with responsibility for overseeing a firm's practice of providing advice concerning federal tax issues or of preparing or assisting in the preparation of submissions to the IRS must take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices described above. 31 C.F.R. § 10.33(b).

Practitioners should note that the best practices described above are aspirational. A practitioner who fails to comply with best practices is not subject to discipline under the regulations governing practice before the IRS. T.D. 9165 (2004).

More specific standards of practice govern positions taken on a return or other document submitted to the IRS.

A practitioner may not advise a client to take a frivolous position on a document, affidavit or other paper submitted to the IRS unless the position is not frivolous. 31 C.F.R. § 10.34(b)(1). A position is frivolous if it is patently improper. 31 C.F.R. § 10.34(e)(3) (proposed). In addition, a practitioner may not advise a client to submit a document, affidavit or other paper to the IRS:

the purpose of which is to delay or impede the administration of the Federal tax laws;

that is frivolous; or

that contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation. 31 C.F.R. § 10.34(b)(2).

A practitioner must inform a client of any penalties that are reasonably likely to apply to the client regarding a position taken on a tax return if the practitioner advised the client regarding that position, or the practitioner prepared or signed the tax return. The preparer must also inform the taxpayer of reasonably likely penalties for any other papers submitted to the IRS. The practitioner must inform the client of any opportunity to avoid any of these penalties by disclosure, if relevant, and of the requirements for adequate disclosure. 31 C.F.R. § 10.34(c)(1), 31 C.F.R. § 10.34(c)(2).

The practitioner must be cautioned that the rules on disclosing likely penalties apply even if the practitioner is not subject to a penalty under the Internal Revenue Code regarding the position or document submitted to the IRS. 31 C.F.R. § 10.34(c)(3).

Practitioner may rely on information submitted by client.

A practitioner advising a client to take a position on a tax return or other document submitted to the IRS, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. Practitioners must be cautioned, however, that they may not ignore the implications of information furnished to, or actually known by, them. Furthermore, practitioners must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent, or incomplete. 31 C.F.R. § 10.34(d).

Proposed regulations describe the circumstances under which a preparer may sign a tax return.

Under proposed regulations, a practitioner may not sign a tax return as a preparer unless:

1. the practitioner has a reasonable belief that the tax treatment of each position on the return would more likely than not be sustained on its merits, or
2. there is a reasonable basis for each position and each position is adequately disclosed to the IRS.

Furthermore, a practitioner may not advise a client to take a position on a tax return or prepare the portion of a tax return on which a position is taken unless one of the above two standards is met. 31 C.F.R. § 10.34(a) (proposed). For these purposes, a practitioner is considered to have a reasonable belief that the tax treatment of a position is more likely than not the proper tax treatment if the practitioner analyzes the pertinent facts and authorities, and based on that analysis reasonably concludes, in good faith, that there is a greater than 50 percent likelihood that the tax treatment will be upheld if the IRS challenges it. A position is considered to have a reasonable basis if it is reasonably based on one or

more of the relevant authorities. Reasonable basis is a relatively high standard of tax reporting and is significantly higher than not frivolous or not patently improper. The practitioner must be cautioned that the reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. The possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be settled may not be taken into account. 31 C.F.R. § 10.34(e) (proposed).

The proposed regulations are applicable for returns filed or advice provided on or after the date that final regulations are published in the Federal Register. 31 C.F.R. § 10.34(f) (proposed).

The authorities that may be taken into account in determining whether a position taken on a tax return meets either the more likely than not standard or the reasonable basis test are:

applicable provisions of the Internal Revenue Code and other statutory provisions;

proposed, temporary and final regulations construing the above statutes;

revenue rulings and revenue procedures;

tax treaties and regulations thereunder, and Treasury Department and other official explanations of tax treaties;

court cases;

congressional intent as reflected in committee reports, statements by the bill's managers;

Blue Book explanations of tax legislation prepared by the Joint Committee on Taxation;

private letter rulings and technical advice memoranda issued after October 31, 1976;

actions on decisions and general counsel memoranda issued after March 12, 1981, and general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin;

IRS information or press releases; and

notices, announcements and other administrative pronouncements published by the IRS in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-4(d)(3)(iii).

Conclusions reached in treatises, legal periodicals, legal opinions or opinions rendered by tax professionals are not authority for this purpose. In addition, an authority does not continue to be an authority to the extent it is overruled or modified, implicitly or explicitly, by a body with the power to overrule or modify the earlier authority, such as a court of appeals. However, a Tax Court opinion is not considered to be overruled or modified by a court of appeals to which a taxpayer does not have a right of appeal, unless the Tax Court adopts the holding of the court of appeals. A private letter ruling is not authority if revoked or if inconsistent with a subsequent proposed regulation, revenue ruling or other administrative pronouncement published in the Internal Revenue Bulletin. Treas. Reg. § 1.6662-4(d)(3)(iii).

Practitioners may be penalized for violating the standards in Circular 230.

After notice and opportunity for a proceeding, the Treasury Secretary may suspend or disbar from practice before the IRS, or censure, a representative who violates the rules in Circular 230. In addition, a monetary penalty may be imposed on the practitioner. If the representative was acting on behalf of an employer or any firm, a monetary penalty may be imposed on the employer or firm if it knew, or reasonably should have known, of the conduct giving rise to the penalty. The penalty cannot exceed the gross income derived from the conduct giving rise to the penalty and may be in addition to, or in lieu of, any suspension, disbarment, or censure of the practitioner. 31 U.S.C. § 330(b).

The Senate Committee Report states that it is critical that the Treasury Secretary have the authority to censure tax advisors as well as to impose monetary sanctions against tax advisors because of the important role of tax advisors in our tax system. S. Rep. No. 108-192 (2004). Thus, failure to comply with the return preparation standards described above may have dire consequences for practitioners and their employers or firms.

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- 1-7 Federal Tax Practice and Procedure § 7.01;
- 1-4 Tax Controversies: Audits, Investigations, Trials § 4.06;
- Part 5. Federal Tax Practice, Procedure & Controversies, LexisNexis Tax Advisor -- Federal Topical § 5A:7.syn

For discussion of how law firms may be responsible for violations of the practice standards under Circular 230, see Evan B. Hofmann, Comment: IRS Circular 230 and Professional Discipline for Firms,

- 43 Hous. L. Rev. 1241 (2006)

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The Attorney Work Product Decision in Comcast, a MA Tax Practice Insight

2009 Emerging Issues 3540

Sheldon H. Laskin on Commr v. Comcast and the Attorney Work Product Doctrine, a Massachusetts Tax Practice Insight

By Sheldon Laskin

April 23, 2009

SUMMARY: The Supreme Judicial Court of Massachusetts has denied enforcement of a subpoena issued by the Massachusetts Commissioner of Revenue, ruling that the attorney work product doctrine shields documents from disclosure to the Commissioner when the documents are prepared by an accounting firm at the request of in-house corporate counsel to assist him in structuring a stock divestiture so as to avoid state excise tax on the capital gain.

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ARTICLE: INSIGHT

The Supreme Judicial Court of Massachusetts (SJC) has denied enforcement of a subpoena issued by the Massachusetts Commissioner of Revenue, ruling that the attorney work product doctrine shields documents from disclosure to the Commissioner when the documents are prepared by an accounting firm at the request of in-house corporate counsel to assist him in structuring a stock divestiture so as to avoid state excise tax on the capital gain. *Commissioner of Revenue v. Comcast Corporation & Continental Teleport, Inc.*, 453 Mass. 293; 901 N.E.2d 1185; 2009 Mass. LEXIS 31 (March 3, 2009).

ANALYSIS

The Justice Department required US West, a predecessor in interest to Comcast, to divest its interest in Teleport Communications Group as a condition of acquiring Continental Cablevision.

Comcast arises from the 1996 acquisition of Continental Cablevision, a Massachusetts cable company with headquarters in Boston, by US West, a predecessor in interest to Comcast. Through a wholly owned subsidiary (Continental Teleport, Inc.), Continental Cablevision owned 11.2% of the stock of Teleport Communications Group, Inc. (TCG), a local telecommunications service provider. As a result of the proposed acquisition, the United States Department of Justice filed a civil antitrust action against US West and Continental Cablevision, alleging that the acquisition would lessen competition in the market for dedicated telecommunications services. The action was settled by consent judgment entered on February 28, 1997, pursuant to which US West was required to divest, on or before December 31, 1998, all of its stock in TCG.

US West consulted Arthur Andersen regarding the Massachusetts tax consequences of divestiture.

As the stock sale was likely to have substantial tax consequences for US West, Andrew Ottinger, West's in-house state and local tax counsel, requested the accounting firm of Arthur Andersen to advise him on the Massachusetts tax effects of the divestiture. Mr. Ottinger is an experienced tax litigator but was unfamiliar with Massachusetts tax law.

After Andersen provided US West with a memorandum summarizing its advice, n1 on February 11, 1997 US West formed a new entity, Continental Holding Company, as a Massachusetts corporate trust pursuant to Mass. Gen. Laws, ch. 62 § 8. The same day, Continental Teleport was dissolved and its assets, including the TCG shares, were transferred to Continental Holding. US West subsequently divested itself of the TCG shares in four separate transactions, culminating with the final sale on November 30, 1997.

Continental Holding reported a capital gain of \$495,733,830 from the sale of the TCG shares on its December 31, 1997 federal income tax return. Claiming an exemption as a Massachusetts corporate trust under G.L. c. 62, § 8(b), the company did not file a Massachusetts corporate excise tax return for the same period. Continental Holding was dissolved on February 12, 1999 and its assets transferred to US West's successor.

The Commissioner of Revenue seeks the Andersen memoranda as evidence that the formation of Continental Holding Company lacked business purpose and should be disregarded for tax purposes.

The Commissioner commenced its audit of US West in June 2000. The issue is whether US West had a legitimate business purpose for reorganizing Continental Teleport as a Massachusetts corporate trust at the time of the sale of the TCG stock. If there was no legitimate business purpose for the reorganization, the commissioner may invoke the "step transaction doctrine" so as to look to the substance of the transaction and not its form. *General Mills, Inc. v. Commissioner of Revenue*, 440 Mass. 154, 172, 795 N.E.2d 552 (2003). If the transaction lacked business purpose, the state could disregard the formation of Continental Holding as a Massachusetts business trust and the capital gain realized by US West would be subject to Massachusetts excise tax. During the audit, the Commissioner sought production of the Andersen memoranda as likely to be relevant to the legitimate business purpose issue. Comcast declined to produce them, asserting that both the attorney-client privilege and the work product doctrine shield them from disclosure to the Commissioner. The trial court held that the documents were shielded from disclosure by both the attorney-client privilege and the work product doctrine. The SJC transferred the case to itself on its own motion.

The SJC holds that the Andersen memoranda are not protected by the attorney-client privilege.

First, the SJC reversed the trial court's attorney-client privilege ruling. As the Court noted, the attorney-client privilege applies;

Where legal advice of any kind is sought from a professional legal adviser in his capacity as such, the communications relating to that purpose, made in confidence by the client, are at his instance permanently protected from disclosure by himself or by the legal adviser, except the protection be waived.

Comcast, 453 Mass. 293, 303, (numbering the elements of the privilege omitted). Furthermore, the party asserting the privilege has the burden of establishing that each element of the privilege applies. *Comcast*, 453 Mass. 293, 304. Finally, the privilege is to be narrowly construed, "in part to protect the competing societal interest of the full disclosure of relevant evidence." *Comcast*, 453 Mass. 293, 304.

As an initial matter, the Court disagreed with the Commissioner's assertion that the documents were not protected by the privilege because Comcast had produced no evidence that the communications contained within the documents were confidential. The Court ruled that the relevant inquiry is not whether the content of a document is confidential, but whether the communication of that content was made in confidence -- that is, with the expectation that the communication will not be divulged. *Comcast*, 453 Mass. 293, 304-305. In this case, the Court found that there was no question that Ottinger intended to, and did, keep the communications from Andersen confidential.

However, the Court found that the derivative attorney-client privilege did not apply in this case. The derivative attorney-client privilege was first enunciated in the seminal case of *United States v. Kovel*, 296 F. 2d 918 (2d Cir. 1961). The derivative attorney-client privilege applies where an attorney consults an accountant or other financial expert so that the expert can "translate" or "interpret" the client's financial information for the attorney. In such cases, the privilege is not waived merely because the attorney consulted the expert. *Comcast*, 453 Mass. 293, 307-308. In this case, Ottinger did not consult Andersen so that Andersen could "translate" or "interpret" US West's proposed transaction. Instead, Ottinger consulted Andersen so that Andersen could render advice as to whether the proposed transaction would be subject to Massachusetts tax. The Court ruled this consultation does not come within the *Kovel* rule. Therefore, Ottinger's communication to Andersen waived the attorney-client privilege.

The SJC holds that the Andersen memoranda are protected by the attorney work product doctrine.

The attorney work product doctrine is intended to create a "zone of privacy for strategic litigation planning .. to prevent one party from piggybacking on the adversary's preparation." *Comcast*, 453 Mass. 293, 312, quoting *United States v. Adlman*, 68 F.3d 1495, 1501 (2d Cir. 1995). While the attorney-client privilege shields communications between attorney and client, the work-product doctrine protects an attorney's written materials and mental impressions. *Comcast*, 453 Mass. 293, 312.

In order to establish that the work product doctrine protects the Andersen memoranda from disclosure, the Court ruled that Comcast bore the initial burden of proving that the memoranda were prepared in anticipation of litigation. If Andersen met its burden, the burden would shift to the Commissioner to demonstrate a substantial need for the documents and that she could not obtain their substantial equivalent without undue hardship. *Comcast*, 453 Mass. 293, 315.

The Court ruled that Comcast met its burden of proving that the Andersen memoranda were prepared in anticipation of litigation. The Court first noted that the courts have developed two separate tests to determine whether a document has been prepared in anticipation of litigation. *Comcast*, 453 Mass. 293, 316. The first test requires a showing that the documents were prepared "primarily or exclusively" to assist in litigation. As the Court notes, this would potentially allow disclosure of documents that contain analysis of expected litigation, if their primary, ultimate or exclusive purpose is to assist in making a business decision. The alternative test requires a lower showing that the documents were prepared "because of" actual or expected litigation. The Court adopted the "because of" test and ruled that the Andersen memoranda were prepared because of expected litigation.

The Court rejected the Commissioner's contention that the Andersen memoranda were not prepared "because of" litigation but to avoid the prospect of litigation. The Court determined that the documents constituted an analysis that was prepared to inform a business decision which turned on Andersen's assessment of the likely outcome of litigation expected to result from the transaction. *Comcast*, 453 Mass. 293, 318. The documents therefore constituted "a detailed analysis of Massachusetts tax law," in order to assess the feasibility of the potential restructuring in view of that law and the potential for litigation. In short, the documents would not have been prepared but for the prospect of litigation. *Comcast*, 453 Mass. 293, 318-319.

Finally, the Court held that the Commissioner failed to establish that information substantially similar to that contained in the Andersen memoranda is not available from US West officials. *Comcast*, 453 Mass. 293, 319. For all these reasons, the Court sustained the trial court's ruling that the Andersen memoranda are not disclosable under the attorney work-product doctrine. n2

Counsel should note that the United States Court of Appeals for the First Circuit has voted to rehear the *Textron* case en banc and has withdrawn the panel decision on which the SJC relied in *Comcast*.

Counsel should keep in mind that the SJC relied on the opinion of the United States Court of Appeals for the First Circuit in *United States v. Textron, Inc. & Subsidiaries*, 553 F. 3d 87 (1st Cir. 2009) in ruling that the "because of" test

is the appropriate test for evaluating an assertion of the work product doctrine. n3 In *Textron*, a three judge panel applied the "because of" test in ruling that tax accrual workpapers were prepared "because of" the prospect of litigation, notwithstanding that such workpapers are required in order to meet SEC requirements for outside auditing of publicly traded corporations. However, on March 25, 2009, a majority of the active judges in the First Circuit voted to hear the case en banc. The Court therefore withdrew the panel opinion upon which the SJC relied in *Comcast* and scheduled the case for en banc hearing on June 2, 2009. Counsel is well advised to note that the state of federal law on the application of the work product doctrine to tax audits -- a body of law on which state courts heavily rely -- may be in flux.

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Return to Text

n1 Because the Andersen documents at issue include five draft memoranda as well as the final memorandum, they will hereinafter be referred to as "the Andersen memoranda."

n2 The Court also ruled that the Commissioner had waived its argument that the rules of criminal procedure govern the application of the work product doctrine in this case, rather than the rules of civil procedure. *Comcast*, 453 Mass. 293, 312-313.

n3 In the federal court system, Massachusetts is in the First Circuit.

RELATED LINKS: For more information on Massachusetts discovery requests, see Sean McMahon, Joint Returns and Other Special Situations Concerning Disclosure on Tax Center at

■ Lexis MA Tax P.I. 1,358

To see Sheldon H. Laskin's amicus brief on behalf of the Multistate Tax Commission, submitted in this case, go to
 ■ 2008 MA S. Ct. Briefs LEXIS 144

For more information on work product and the federal summons power, see
 ■ 1-7 Tax Controversies: Audits, Investigations, Trials 7.02

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Commission's amicus brief in support of the Massachusetts Commissioner of Revenue in the Comcast case. Prior to joining the MTC staff in 1998, Mr. Laskin was an Assistant Attorney General for the Maryland Comptroller of the Treasury and litigated state tax cases in the Maryland court system for 8 $\frac{12}{12}$ years. Before joining the Attorney General's office, Mr. Laskin was in private practice, and argued and won a major employment discrimination case in the United States Supreme Court. *Burnett v. Grattan*, 468 U.S. 42 (1984). He also served on the staff of the U.S. Equal Employment Opportunity Commission and Florida Rural Legal Services. He received his BA and JD degrees from Rutgers University and his LL.M. in Taxation from the University of Baltimore, where he currently teaches State and Local Taxation in the Graduate Tax Program. Mr. Laskin has spoken on state and local tax issues at numerous forums, including annual symposia on state and local tax policy sponsored by the Taxation Section of the Maryland State Bar Association and the University of Baltimore Graduate Tax Program, the COST Sales Tax Conference, the CCH State Tax Advisory Board and the New Jersey Institute for Professionals in Taxation One-Day Tax Seminar. He is the author of a series of LexisNexis "Maryland State Tax Service Practice Insights." His law review article, "Only a Name? Trademark Royalties, Nexus and Taxing That Which Enriches" was published in the 2007 issue of the *Akron Tax Journal*. Mr. Laskin was the principal author of the Multistate Tax Commission's amicus brief in support of the Massachusetts Commissioner of Revenue in the Comcast case.

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Tax Credit for Net Increase in New Jobs, a California Tax Practice Insight

2009 Emerging Issues 3529

Troy M. Van Dongen on California Net Jobs Tax Credit, a California Tax Practice Insight

By Troy Van Dongen

April 20, 2009

SUMMARY: Beginning on January 1, 2009, qualified employers may take advantage of a new tax credit in the amount of \$3,000 for each increase in a qualified full-time employee hired during the taxable year as determined on an annual full-time equivalent basis. Any credits not used for the taxable year may be carried forward up to eight years, and the credit is not subject to the temporary 50 percent limitation for business credits.

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ARTICLE: INSIGHT

Although California recently enacted statutes providing a tax credit for the creation of new jobs, because the number of jobs recognized by these statutes is determined on an annualized full-time equivalent basis, the number of new employees that actually are hired in a given year may not equal the number of new jobs eligible for the credit.

ANALYSIS

Beginning on January 1, 2009, qualified employers may take advantage of a new tax credit in the amount of \$3,000 for each increase in a qualified full-time employee hired during the taxable year as determined on an annual full-time equivalent basis. Any credits not used for the taxable year may be carried forward up to eight years, and the credit is not subject to the temporary 50 percent limitation for business credits.

On February 20, 2009, California enacted sections 17053.80 and 23623 of the Revenue and Taxation Code to provide a tax credit for new jobs created by businesses for each tax year beginning on, or after, January 1, 2009. Under the new law, taxpayers with 20 or fewer employees at the end of the preceding tax year may qualify for a new jobs credit against their personal or corporate income taxes for each new qualified employee hired. To qualify, the new employees must work an average of 35 hours or more each week if they are paid on an hourly basis, or they must meet the standards for full-time employment as set forth in section 515 of the Labor Code if the new employees are paid on a salaried basis.

The number of new jobs created by each qualified employer is measured on a net annualized basis by generally subtracting the number of qualified full-time employees in the preceding tax year from the number of qualified full-time

employees in the current tax year. So, if a taxpayer reduced its workforce in the prior tax year, that reduction may have an impact on the number of jobs eligible for the credit. If, however, the taxpayer first commenced doing business in California during the taxable year, then the number of qualified full-time employees employed in the preceding year would be zero, and the number of new qualified employees would generally equal the number of new jobs eligible for the credit unless the new trade or business activity fails to qualify as a new business under the rules set forth in paragraphs (1) through (6) of subdivision (f) of section 17276 of the Revenue and Taxation Code.

Example: Inga owns and operates Bakery located in California. On January 1, 2008, Bakery had 10 full-time employees, all of which were being paid on an hourly basis. Due to decreased business, however, Bakery laid off two of its employees on June 30, 2008, and another employee resigned voluntarily on December 31, 2008. Accordingly, on January 1, 2009, Bakery had just seven employees. In 2009, business picked up, so Bakery hired six new full-time employees on July 1, 2009, which brought its total number of employees up to 13. Assuming that all 13 employees worked full-time for Bakery while employed by the company in 2009, Bakery would only be entitled to a \$3,000 tax credit for that year. Although Bakery hired six new employees in 2009, because the increase is measured on a net annual full-time equivalent basis, the company may only recognize the net increase of one new job for purposes of this credit. (In contrast, if Bakery first commenced doing business on July 1, 2009, and hired six new full-time employees, then it would be entitled to a \$9,000 credit.)

In addition to the fact that the credit is measured on a net annual full-time equivalent basis, practitioners should be aware that the credit may not be claimed for those employees: 1) who also are certified as a qualified employee in an enterprise zone or targeted tax area; 2) who also are certified as a qualified disadvantaged individual in a manufacturing enhancement area; 3) who also are certified as a qualified disadvantaged individual or qualified displaced employee in a local agency military base recovery area; or, 4) whose wages are included in calculating any other credit allowed. And, the total amount of credit available to be claimed by all taxpayers is capped at \$400 million. As such, the credit must be claimed on a timely filed *original* return, that is received on or before the cut-off date set by the Franchise Tax Board.

Taxpayers wanting to take advantage of this credit are advised to check the Franchise Tax Board's website periodically for notice that the cut-off date has been established. If the credit is claimed on a return submitted after the cut-off date, it may be disallowed by the Franchise Tax Board (the disallowance of which is not subject to administrative or judicial review).

Finally, unlike other credits, the new jobs tax credit of section 23623 of the Revenue and Taxation Code is not subject to the temporary 50 percent limitation for business credits set forth in section 23036.2. And, if not fully used in any given tax year, the credit may be carried forward for up to eight years.

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- 1-3 Bender's State Taxation: Principles and Practice § 3.05

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Tax on Joint Ventures with Indian Companies

2009 Emerging Issues 3312

Jyoti Dialani on Tax on Joint Ventures with Indian Companies

By Jyoti Dialani

April 3, 2009

SUMMARY: This commentary analyzes a ruling by the Authority for Advance Rulings in India which could adversely impact foreign companies entering into joint ventures (JVs) with domestic Indian entities. This analysis emphasizes the importance of incorporating the right clauses in, and careful drafting of, JV agreements between foreign and Indian companies, and adopting a cautious approach in the agreement of working terms and conditions in any project.

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ARTICLE: Joint Venture Contracts with Indian Companies Invite Higher Tax Burdens

A recent ruling by the Authority for Advance Rulings (AAR) [An authority constituted by the Central Government under S.245-O of the Act for giving determinations called advanced rulings in relation to a transaction undertaken or proposed to be undertaken by a non-resident applicant on issues pertaining to tax liabilities on proposed transactions.] in India may prove to be a setback for those foreign companies which have established joint ventures (JVs) with Indian companies due to classifying such JV contracts as Association of Persons (AOPs). An AOP has not been specifically defined by the Indian Income-tax Act, 1961 ("the Act"), [For the full text of the Income-tax Act, 1961, see the official website of the Government of India at <http://law.incometaxindia.gov.in/TaxmannDit/DisplayPage/dpage1.aspx>.] but it is treated as a resident of India liable to similar rates of tax as applicable to resident Indian individuals. An AOP is a fictional person created under the Indian law for tax purposes. However, the question whether any arrangement can result in an AOP or not is dependent on the specific facts of each case. This ruling may adversely impact all those companies who have executed joint venture contracts with Indian companies as they may be liable to pay income tax in India at a higher rate of 41 percent. The AAR has held that a joint venture of a foreign company with two Indian companies for executing a contract in India is in the nature of an AOP and receipts of the same are taxable under the provisions of the Act and not as per the provisions of the Double Taxation Avoidance Agreement (DTAA). This decision was given in the case of Geoconsult, a company incorporated in Austria, which had entered into a joint venture contract with two Indian companies, Rites and Secon. The AAR held that as an AOP, the JV should be taxed as per the provisions of the Act and therefore there is no need to decide the taxability of Geoconsult under the provisions of the DTAA. The AAR made an observation that since all the members of the joint venture joined together for a common purpose on their own volition with an intention to earn income to be shared in a common ratio, such a joint venture was an AOP and hence it should be taxed under the Act. The AAR further held that the provisions of the India-Austria DTAA were not applicable to such a joint venture. This ruling has negatively impacted Geoconsult as it has lost the

beneficial provisions of the DTAA. Though rulings delivered by the AAR do not have precedential value like judgments of appellate tribunals and courts, they do hold persuasive value when the income tax authorities decide similar cases. This Emerging Issues Analysis commentary will uncover the highlights of this specific case examining clauses of the contract which led to the AAR interpreting the status of members of the JV as an AOP and reasons provided for holding such a view. This ruling has also driven home the importance of incorporating the right clauses and careful drafting of such contracts between foreign and Indian companies to avoid harsh tax consequences.

Facts of the case

The Austrian company, which was the applicant in the present case, M/s. Geoconsult ZT GMBH, incorporated and registered in Austria, formed a JV with two Indian companies, M/s Rites Ltd. and M/s. Secon Pvt. Ltd. This JV was established to provide specialized project consultancy services. Himachal Pradesh Road and other Infrastructure Development Corporation Ltd. ("HPRIDC") (see <http://himachal.nic.in/hpridc/>), a State Government undertaking in India, awarded a contract to Geoconsult to provide consultancy services for certain phases in development of seven tunnels in the city of Shimla and in other areas of the State of Himachal Pradesh for implementation of the project. Almost all the services were rendered by Geoconsult from Austria and an engineer was deputed by it in India to undertake periodical site visits to coordinate with other members of the JV. In its application before the AAR, Geoconsult's main contention was that it did not have a "fixed place of business or an office" and it also did not perform any substantial activities in India. The employees were also not deputed in India for substantial periods of time. Accordingly, Geoconsult submitted that it did not have a "permanent establishment" (PE) in India within the meaning of Article 5 of the DTAA [The entire text of the India-Austria DTAA can be found at the official website of the Authority for Advance Rulings at http://www.taxmann.net/DirectTaxLaws/cbdt/dta2008/A1_Austria.htm.] between India and Austria and therefore the income received by the JV for the services performed in connection with the agreement fell within the meaning of the term "fees for technical services," subject to tax in India in accordance with Article 12 of the DTAA between India and Austria. The Income-tax authorities opposed the arguments raised by Geoconsult on a submission that the arrangement with the Indian companies was an AOP and to be assessed as such on higher rates applicable to AOPs in India.

Issues for consideration before the AAR

Geoconsult sought the ruling of the AAR on the following questions:

1. Whether Geoconsult can be said to have a permanent establishment (PE) in India within the meaning of the India-Austria DTAA.
2. If Geoconsult is held to have a PE in India, whether the income earned by it under the JV is attributable to such PE and taxable as business profits under Article 7 of the India-Austria DTAA.
3. If it is held that Geoconsult does not have a PE in India, whether the income earned by it under the JV is taxable as fees for technical services under Article 12 of India-Austria DTAA.

Geoconsult's Contentions

Before the AAR, Geoconsult asserted that the income earned by the JV from the consultancy services provided for the projects in India under the agreement fell within the meaning of the term "fees for technical services" taxable in India as per Article 12 of the India-Austria DTAA. Article 12 (4) defines "fees for technical services" as "payments of any amount to any person other than payments to an employee of a person making payments, in consideration for the services of a managerial, technical or consultancy nature, including the provision of services of technical or other personnel." Clause 5 of Article 12 provides that if the recipient of such royalty or fees for technical services, as a resident of one Contracting State, receives such income through a business carried on in the other Contracting State through a PE situated therein, the income will not be considered as either royalty or fees for technical services and

Article 5 shall not apply to such a situation. Nevertheless, if the income is in the nature of business profits, then Article 7 applies, or if the services are in the nature of independent personal services, then Article 14 applies. However, if the income falls within the meaning of the term, "fees for technical services," Article 12 provides that the rate of tax applicable on the gross receipts shall not exceed 10 percent of such royalty or fees. Section 9(1)(vii) of the Act defines the term "fees for technical services" as any lump sum consideration for the rendering of any managerial, technical or consultancy services, and the services provided by the members of the JV to HPRIDC being in the nature of consultancy services as well as technical services, it was submitted that the income arising to Geoconsult from such a JV was deemed to accrue or arise in India and also subject to tax therein. However, as a resident of Austria, Geoconsult was entitled to the benefits of the provisions of India-Austria DTAA. Geoconsult submitted that since the consultancy services provided by it fell within the scope of the definition of "fees for technical services," Article 12(2) of the DTAA which provides for deduction of tax at the rate of 10 percent on the gross fees was applicable to it, subject however to the condition that the recipient does not have a PE in India. Geoconsult further asserted that it had did not have a fixed place of business or an office in India, it did not perform any substantial activities in India, and its employees were not deputed in India for lengthy periods of time. Based on all these arguments, Geoconsult concluded its submissions that it did not have a PE in India within the meaning of Article 5 of the India-Austria DTAA and, therefore, the income earned from the JV could not be taxed as "business profits" but as "fees for technical services" at the rate of 10 percent as Article 12 of the DTAA was applicable to the facts of its case.

The Revenue's Contentions

The Income-tax Department ("the Department") made a contrary submission before the AAR that Geoconsult had, in fact, a PE in India. The reasons given by the Department were that for Geoconsult to carry out the services as provided in the JV, it would have to necessarily carry out geological and technical investigations, field surveys, collection of seismological data and surveys for establishing topographical conditions or constraints on the proposed tunnel alignments. According to the Department, such activities required constant presence and supervision by technical personnel deployed by Geoconsult at the project sites. This implied that personnel stay at the sites in India for long durations. In presenting a detailed examination of the nature of activities to be carried out by Geoconsult under the terms of the JV contract, the Department submitted that Geoconsult played a major role in the entire project as it was the lead partner. Thus, the Department asserted that without presence of a PE in India, Geoconsult could not successfully implement the project. The fact that Geoconsult played an integral role in the JV and the project was further borne out in the contract terms whereby it was entitled to half of the total revenue received from HPRIDC and the other half was to be shared between the other two partners. The Department submitted that Geoconsult had a PE in India within the meaning of Article 5 of the India-Austria DTAA and the amount thus earned by it against its services was attributable to such PE and taxable in India as "profits and gains of business or profession" under Article 7 of the India-Austria DTAA read with section 44DA of the Act at the prevailing rates. Further, the Revenue's main contention was that the status of the JV formed by Geoconsult and its partners ought to be treated as an AOP in accordance with section 2(31)(v) of the Act read with the explanation thereto. Applying the definition of "person" to the facts of the case, the Department pointed out that the JV was a combination of persons forming a joint enterprise with a common purpose and action which were the elements of an AOP, and thus the arrangement in the present case ought to be treated as an AOP.

Concept of Association of Persons under Indian Tax Law: Judicial Opinions

The Indian Income-tax Act, as discussed above, does not define an AOP but it includes the term in the definition of a "person" and hence, it encompasses any combination or arrangement of persons coming together for one common purpose within its ambit of taxable entities. There have been numerous decisions regarding the meaning of AOP. The crux of some of the important rulings is produced below.

In the case of *N.V. Shanmugham & Co. v. Commissioner of Income Tax*, (1971) 81 ITR 310 (SC), the Supreme Court held that "association of persons" as used in section 2(31) means an association in which two or more persons join in a common purpose or common action, and as the words occur in a section which imposes a tax on income, the

association must be one, the object of which is to produce income, profits or gains. In the case of *G. Murugesan & Bros. v. Commissioner of Income Tax*, (1973) 88 ITR 432 (SC), the Supreme Court also held that for forming an "association of persons" the members of the association must join together for the purpose of producing an income. An "association of persons" can be formed only when two or more individuals voluntarily combine together for a certain purpose. Hence, volition on the part of the members of the association is an essential element. In *Estate of Khan Sahib Mohd. Oomer Sahib v. Commissioner of Income Tax*, (1958) 33 ITR 767 (Mad.), the Madras High Court observed that to "associate" is to join in a common purpose or action. "Association" does necessitate the exercise of volition of those who form the association. The exercise of that volition can be by or on behalf of those who form the association. In *Deccan Wine & General Stores v. Commissioner of Income Tax*, (1977) 106 ITR 111 (AP), the Andhra Pradesh High Court held that an association of persons does not mean any and every combination of persons. It is only when they associate themselves in an income-producing activity that they become an association of persons. They must combine to engage in such an activity; the engagement must be pursuant to the combined will of the persons constituting the association; there must be a meeting of the minds, so to speak. In a nutshell, there must be a common design to produce income. If there is no common design, there is no association. Common interest is not enough. Production of income is not enough. This interpretation of the expression "association of persons" flows from the meaning of the word "association." In the case of *Commissioner of Income Tax v. T.V. Suresh Chandran*, (1980) 121 ITR 985 (Ker.), the Kerala High Court observed that "Joining together by the members of the association for the purpose of producing income is requisite for formation of an association of persons. Such coming together or combining is a consensual act and depends upon the volition of the parties. Merely because certain persons are constituted joint owners, such as by inheriting the property of a person on his death, they do not become an association of persons, where in that event, the jointness is the result of operation of law and not of volition of parties. In the case of *Commissioner of Income Tax v. Indira Balkrishna*, (1960) 39 ITR 546 (SC), the Supreme Court observed that the word "associate" means, according to the Oxford Dictionary, "to join in common purpose or to join in an action." Therefore, an association of persons must be one in which two or more persons join in a common purpose or common action and as the word occurs in section 3 of the 1922 Act, [The 1922 Act was the first Income-tax Act to be enacted and in force in India prior to the present Act. History of Income-tax law in India can be found at <http://www.incometaxindia.gov.in/HISTORY/PRE-1922.ASP>.] which imposes a tax on income, profits or gains, the association must be one in which the objective is to produce income, profits or gains.

Technical issue: Status of the JV

During the hearing of the application, the Department emphasized its position of treating the JV as an AOP in accordance with section 2(31)(v) of the Act read with the explanation and argued for the issue to be taken up before the application was heard and decided on merits. The argument was based on the view that the JV had all the elements necessary to be treated as an AOP as it was a combination of persons forming a joint enterprise with a common motive and action. Accordingly, the plea of the Department to decide the technical issue before the merits was accepted by the AAR.

Question framed by Department

The following question was framed for consideration and ruling by the Department before the AAR: Whether, in the factual as well as the legal matrix, the Joint Venture can be treated as an Association of Persons (AOP) in consonance with section 2(31)(v) read with the explanation to section 2 of the Act and liable to be assessed as such under the Income-tax Act.

If the above question was decided against Geoconsult, the other issues raised would be redundant and not considered by the AAR.

Arguments of the Department on AOP status of Geoconsult

The Department drew attention to the JV agreement between the three parties and the fact that the JV displayed all

the necessary elements required to form an AOP such as an "association" for a common purpose, common action and a common management scheme with a common objective to produce profits or gains. The common action or management was the development of tunnels with technical and professional expertise. Another vital point raised was the fact that the parties were jointly and severally responsible for the implementation of the project. The detailed clauses of the JV agreement were analyzed and the fact that each party was allocated different and distinct responsibilities in the project execution with Geoconsult playing a lead role as far as lending expertise and supervision was highlighted. The clause of the JV agreement in which Geoconsult was entitled to 50 percent of the fees earned from the project with the balance distributable between the other two parties also indicated the crucial role played by it in the JV. On the issue of sharing of profits or profit motive, it was submitted that there was a clear distribution of receipts in a specified ratio between the parties and sharing of receipts could be equated with sharing of profits. Hence, profit motive was clearly present in the JV. Regardless of the profit motive, it was further submitted that the requirement of profit motive was no more necessary after the amendment to section 2(31) being the definition of "person." The insertion of the explanation to section 2(31) with effect from April 1, 2000 eliminated the element of profit motive for the existence of an AOP and just common action and management were sufficient to form an AOP. In support of its argument that the necessary elements to constitute an AOP were common purpose, action, management and an objective to produce income, the Department relied on the decisions of the Supreme Court in the cases of *Commissioner of Income Tax vs. Indira Balkrishna, (1960) 39 ITR 546 (SC)*, *Mohamed Noorullah v. Commissioner of Income Tax, (1961) 42 ITR 115 (SC)*, and *G. Murugesan & Bros. v. Commissioner of Income Tax, (1973) 88 ITR 432 (SC)*. It was submitted that all these conditions were clearly satisfied. The Supreme Court's decision in the case of *Income Tax Officer v. Atchiaiah, (1996) 218 ITR 239 (SC)*, was also applied to the case in determining the status of the JV as an AOP. Accordingly, the Department submitted for the JV to be taxed as an AOP at the rate of 41 percent on net basis including Geoconsult's share.

Countersubmissions by Geoconsult

On status as AOP. Geoconsult contended that the JV is not assessable as an AOP as it did not satisfy the essential conditions requisite to be assessed as such. Drawing attention to the clauses in the JV agreement, Geoconsult submitted that there was no sharing of profits but just an allocation of receipts and sharing of revenue as each member of the JV raised separate invoices for their individual services on Geoconsult and their fees were separately and directly credited to their individual bank accounts and not to the JV. Emphasis was made on the fact that there was no sharing of profits between the parties of the JV. It also opposed the argument of common action and management by submitting that the individual scope of work of each member was separately identified and there was no common management but merely coordination between the parties which was essential for successful execution of the project. The crucial element of an AOP -- spirit of partnership or co-venture -- were absent. The main crux of its argument was that since there was no sharing of profits or revenue by the JV as the fees were directly paid to the members and not to the JV, there was no taxable income in the hands of the JV but in the hands of individual parties and there was no question of an existence of an AOP. It was also argued that an AOP implies the joining of parties under a loose arrangement to work under coordination and with cooperation with an objective of earning income, and in the absence of such a motive, the JV cannot be regarded as an AOP. Geoconsult relied on the decision of the AAR in *In re Van Oord ACZ, BV, (2001) 248 ITR 399 (AAR)*, which held that if parties to a contract bear their own profits and losses and agree to execute a specific part of the job, they cannot be assessed as a single entity but in their individual capacities. Geoconsult also relied on the provisions of section 67A and section 86 of the Act and argued that if the decision of the Supreme Court in the case of *Atchiaiah*, above, were literally followed, these provisions would become redundant.

On existence of PE of Geoconsult in India. On the question of existence of PE, Geoconsult submitted that there was no PE in India as the role played by it was limited to liaison and coordination and not actual execution of the project. The fact that there was neither "fixed place of business or office" in India nor any branch or management within the meaning of Article 5 of the India-Austria DTAA makes it conclusive that there was no PE in India. In the absence of PE, the income was not taxable as "business income" but as "fees for technical services" within the meaning of Article 12 of the India-Austria DTAA, taxable at the rate of 10 percent on a gross basis.

Ruling of the AAR on the Status of JV as AOP

The AAR referred to the definition of "Person" in the Act, which includes certain entities within the tax net. Section 4, which is a charging section, imposes a tax earned by a "person" in the relevant previous year. Section 2(31), which defines a "person" is reproduced below.

"Section 2: xx xx xx

Clause(31) 'Person' includes:--

- (i) an individual
- (ii) a Hindu Undivided Family
- (iii) a company
- (iv) a firm
- (v) an association of persons or a body of individuals, whether incorporated or not,
- (vi) a local authority; and
- (vii) every artificial juridical person, not falling within any of the preceding sub-clauses,

*[Explanation -- For the purpose of this clause, an association of persons, or a body of individuals or a local authority, or an artificial juridical person, shall be deemed to be a person whether or not such person or body or authority or Juridical person was formed or established or incorporated with the object of deriving income, or profits, or gains]

* with effect from 1.4.2002 by Finance Act, 2002."

The AAR analyzed the definition of "person" and noted that the term "association of persons" as provided in the definition has a wider scope. Touching upon the legislative history, the AAR made an observation that in the previous Act (i.e., the 1922 Act) the term used was "body of individuals" which was amended in 1939 to replace it with the term "association of persons." Thus, the legislature has made its intention clear by widening the scope of an assessable entity to include not just individuals but any entities like a company, firm, whether incorporated or not. By virtue of this amendment, an association of persons may have companies, firms, joint families, individuals or associations as its members. All these entities, as members of an AOP can be jointly assessed as such under a single entity and not separately. Reference was also made to section 3(42) of the General Clauses Act, as per which a "person" includes any company or association or body of individuals, whether incorporated or not. Further, the explanation inserted in clause 31 to section 2 of the Act effective from April 1, 2002 provides that an association of persons will be deemed to be a person whether or not it is formed with the objective of deriving income. The insertion of this explanation has eliminated the condition of an objective of earning income to formation of an AOP. In other words, an AOP need not have a common objective of earning income or profits to be assessed as such.

Having analyzed various judicial opinions, the AAR summarized the essential elements of an AOP as below.

1. Two or more persons.
2. Voluntary combinations.

3. A common purpose or common action with object to produce profit or gains. [The object to produce profit or gain is no longer a required element to constitute an AOP with the insertion of the explanation to section 2(31) effective from April 1, 2002.]

4. Combination in Joint Enterprise.

5. Some kind of scheme for common management.

To determine whether or not the above elements were present in the JV, the AAR examined various clauses of the JV agreement and summarized the following features of the contract:

1. As per the agreement, the three JV partners had agreed to collaborate and associate themselves with a common design to provide consultancy services to the client, HPRIDC, for implementation of the project for development of tunnels.

2. This collaboration was with a common action and objective to implement and complete the project and to earn income in the wake of consultancy, respectively.

3. The contract was drawn up by Geoconsult, Rites and Secon with HPRIDC and the income earned by the JV was to be credited to the JV and not to individual parties.

4. Although internally each party to the JV was responsible for separate tasks and duties, the three parties were jointly and severally responsible as a JV to the client.

5. The objective of earning income is obvious from the fact that the services rendered by the JV partners to the client generate income to the J.V.

6. All the partners of the J.V. have joined for a common purpose on their own volition to produce income which is shared in certain ratio.

On the applicability of the Supreme Court's decision in the case of Van Oord, above, the AAR held that the case was distinguishable on facts and not applicable to the case as in that case, the agreement clearly mentioned that each of the parties agreed that it was not their intention to carry on business in common with other parties to make a profit and that each party shall bear its own losses and retain all profits arising from the performance of its requisite work package. In the case of Geoconsult, however, there was no such clause in the JV agreement but, in fact, the clauses clearly indicated a meeting of minds coupled with a common design and common purpose producing income. Geoconsult's plea regarding separate bank accounts and bank guarantees provided by the parties was held to be an irrelevant argument by the AAR as the main elements for the formation of an AOP were present. The reliance by Geoconsult on sections 67A and 86 also was held by the AAR to be irrelevant in determining the status of the JV as an AOP as section 67A provides the method of computing a member's share in the income of an AOP or BOI [Body of Individuals.] and section 86 pertains to non-taxability of the income of the members of the AOP computed in the manner set forth in section 67A of the Act. The AAR further held that after the decision of the Apex Court in the case of Atchiaiah, above, section 67A has lost its relevance as the decision provides no option for either the assessee or the Department to assess the individual members as was the case under the 1922 Act.

The AAR's Decision

The AAR held that the JV displayed the necessary characteristics of an AOP and accordingly it was assessable as such at the rate of 41 percent on net basis. In view of the first question being answered in favor of the Department, the other questions posed by Geoconsult were redundant, and thus it was not necessary to answer them. The ruling was delivered in favor of the Department.

Conclusion

The ruling shows that the status of an assessee and an existence of an AOP are determined by the Indian tax authorities by examining the specific details or characteristics applicable to each case and this makes it more important

for companies entering into joint venture agreements with Indian companies to carefully consider necessary elements and clauses of the agreement before executing the same. There is no blanket rule applicable to all joint ventures with Indian companies but the outcome and the status of the JV determining the applicable tax rates depends entirely on the peculiar facts of each case, the agreements, the terms and conditions and workings of the project, etc. Although advance rulings are only binding on the specific applicant with respect to the case, they hold persuasive value. Indian courts and tax authorities take the principles set forth by the AAR into consideration in the process of delivering judgments in other similar cases. Foreign companies seeking to enter into joint ventures with Indian companies are advised to do so after a thorough study of the laws in force and after having carefully worded clauses in their contracts to avoid any disputes and grey areas with the tax authorities, thus leaving no room for doubt in the interpretation and application of the law and treaties.

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Defined Benefit Plan Meltdowns -- Victims of the Current Crisis

2009 Emerging Issues 3464

Defined Benefit Plan Meltdowns -- Victims of the Current Crisis (A Modest Proposal)

By Alvin Lurie

April 3, 2009

SUMMARY: One could have easily mistaken a recent headline in the New York Times as captioning a story on bailing out companies sponsoring qualified retirement plans: "Obama Promises Bid to Overhaul Retirement Spending." But nothing had been heard about one of the largest and most troubled pools of capital in the country, the defined benefit pension plans that suffered huge losses during most of 2008. This is a key issue for the Obama Administration.

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ARTICLE: One could easily have mistaken a recent headline in the *New York Times* as captioning a story on bailing out companies sponsoring qualified retirement plans:

OBAMA PROMISES BID TO OVERHAUL RETIREMENT SPENDING

We had already seen government bailouts for the mortgage insurers (Freddie Mac and Fannie Mae, and for some (e.g., AIG, Merrill Lynch), but not all (Bear Stearns, Lehman Brothers), giant Wall Street financial institutions, and for the major banks by way of direct capital injections and purchases of their subprime mortgage holdings, and then for two of the major American automakers. The queues were already beginning to form for other troubled industries -- even such once-giants of the rust belt as Big Steel -- trying to get on the dole.

But nothing had been heard about one of the largest and most troubled pools of capital in the country, the private defined benefit pension plans that suffered gargantuan losses during most of 2008. Nor had we heard about devastating effects of these losses on the finances (and in many instances the very solvency) of defined benefit plan sponsors and, of course, on the retirees and other participants whose retirement security is so dependent on the pension trust funds. For months, during the fall of 2008 (one can read that as a reference to more than just the autumn season of the year), while the incredible bailout events were playing out, it was curious that so little attention was being paid to the economic health of the pension sector, that so heavily impacted the nation's well-being at large.

There had been relatively low-key requests for relief from organized pension groups to Treasury and IRS, and to the committees of Congress having jurisdiction, principally for reversal or alleviation some of the more oppressive funding rules of the Pension Protection Act of 2006, as well as other requirements of pension law that were proving troublesome in the downspiraling economy. There was keen interest in this regard in the unforgiving operation of the required minimum distribution provisions. But these requests were met with responses ranging from disinterest to

downright apathy from the government offices in the city by the Potomac. Finally, only modest relief was afforded in the clumsily named Worker, Retiree, and Employer Recovery Act, enacted in a hastily convened lame-duck session of the 110th Congress in the waning days of 2008.

It wasn't that the case couldn't be made that pension plans were in deep distress. The effects of the economic conditions on the private pension system have been direct, immediate and devastating. Pension plans were being subject to formal curtailment, complete freezing of benefits, and outright plan termination. These conditions resulted from massive under-funding, which was due to the combination of market losses and diminished contributions. Some diminished contributions were within permissible bounds under ERISA, but in many cases doubtless resulted from impermissible skipping of required plan contributions. These responses were hardly surprising, given the competing demands on shrinking business resources to meet payrolls, avert layoffs, pay suppliers, satisfy loan covenants, forestall bankruptcy, or just stay in business.

Against this background, persons concerned about survival of the private pension system might have wished the *Times* headline quoted above had been attached to an article on an Obama commitment to address head-on the looming crisis for this until-then neglected, although critical, sector of the economy. The article subject matter was no such thing. The "*Obama promise*" in the headline was to curb the problems of the federal government in dealing with the rapidly escalating and unsustainable costs of funding the Medicare and Social Security entitlement programs. Medicare and Social Security are soon to be further burdened by the claims of the newly emerging "Boomer" cohort. This is obviously a major issue to be confronted by the new Administration, but having no bearing on the equally over-arching matter of rescuing the pensions.

The dire financial condition of private pension plans has been widely reported in the trade press. The under-funding of plans of the S&P 500 companies have escalated by over \$200 billion in the past year. One of the country's highly respected economists, Peter Orszag (now director of the Office of Management & Budget), has estimated that the total shrinkage of all plan values in the past 18 months is approaching \$2 trillion! Hard statistics demonstrating the extent of the devastation in the past year is not likely to be known for a year or more. But the well regarded Boston College Center for Retirement Research has found that the aggregate funded status of plans has fallen from 100 percent at the start of 2008 to 75 percent in October. Similar indications emerge from studies of leading benefits consulting firms. Both Mercer and Watson Wyatt Worldwide confirm the 75 percent figure. Mercer places the defined benefit pension plan deficits of the S&P Fifteen Hundred companies at \$409 billion for 2008, down from a surplus of \$60 billion the previous year, and projects that the pension expense of that same group of companies will likely mushroom from \$10 billion in 2008 to \$70 billion this year.

Evidence of the swelling disenchantment with traditional defined benefit plans was readily at hand well before the current financial crisis. A survey by Wyatt several years ago revealed that, where 89 of the 100 largest companies offered defined benefit pension plans in 1985, only 50 provided such plans to new hires in 2002. That number declined to 42 companies offering such plans in 2004, and 37 in 2005. In a separate study of the 627 Fortune One Thousand companies sponsoring defined benefit plans in 2006, Wyatt found that 113 had frozen or terminated their plans, or announced that they were, as of April 2006, compared with 71 in all of 2004. An additional 49 sponsors closed their plans to new hires by that time in 2006, up from 25 sponsors in 2004.

A previous study by the Center for Retirement Research at Boston College added that in the years 2004-2005, 17 large, financially healthy companies, such as Coca-Cola, IBM and Verizon, froze their plans for *all* employees, so no further benefits have accrued for later periods of service. Obviously, thousands upon thousands of other companies, with unfamiliar names, -many with healthy balance sheets, were doing the same thing. There is no doubt that this past year has seen the abandonment of the bulk of remaining traditional DB plan benefits.

It has been estimated that among the S&P 500, in the decade between 1995 and 2005, 70 percent had converted to cash balance plans, as a way of escaping the otherwise inescapable and unpredictable liabilities with which the defined benefit plans had saddled them. A cash balance plan is a hybrid version of the traditional defined benefit design

combined with many characteristics of a defined contribution plan. This trend was halted for several years while an onslaught of litigation erupted in courts around the country, in the wake of a lower court decision in 2003 involving the IBM cash balance plan. In this case, the judge ruled the cash balance design to be inherently and unavoidably age discriminatory. The reversal of that decision three years later by the 7th Circuit Court in 2006, and the ensuing decisions in three other circuit courts that followed the 7th circuit, restored the cash balance plan to favor. But that was before the economic events of 2008, that have doubtless severely tamped enthusiasm for the cash balance design for many of the same reasons already described in regard to traditional defined benefit plans.

Even the 401(k) plan design, which has essentially ousted defined benefit plans as the design of choice for most pension plan sponsors in this country, has not escaped the disenchantment produced by the current recession, but for entirely different reasons than pertain to defined benefit plans. According to the prestigious Employee Benefits Research Institute, there were 56,000 401(k) plans in 2007, with 21.8 million participants and \$1.425 trillion of assets. If we can assume that those assets have suffered the same 40 to 50 percent depreciation that is generally said to have been the approximate rate of decline in values in the market generally, there are 21.8 million participants and their respective families and dependents who on average have lost almost half their retirement assets. Many of these families have lost *all* their savings).

There is no Pension Benefit Guaranty Corporation back-up for any of that. The PBGC program is only for DB plans (traditional DBs and their hybrid variants, the Cash Balance and so-called Pension Equity plans). This vulnerability of the 401(k)-based benefit has provoked a recent chorus of criticism of that vehicle, and some radical proposals for undergirding it with government protections not unlike those provided by Social Security.

It requires no special perspicacity to discern that a radical overhaul of the private pension system, especially the defined benefit branch, will be required if it is to be preserved as a key engine for assuring the retirement security of our workers and their families. Whatever last legs the defined benefit plan design had been balancing on after the "perfect storm" of 2002 have been knocked out from under it with the financial collapse of 2008. What employer of any size -- but certainly if a small business (excepting of course the one- or two-man corporation or family company) -- that has not adopted a defined benefit plan can now be expected to undertake the financial risk underlying a commitment to deliver a defined benefit to the persons in its workforce at an uncertain future time, with no heed to the uncertainties of forces beyond its control. Those steadily shrinking numbers of companies that had in the past adopted such a plan and not yet terminated or frozen it have in recent months been jolted into seriously considering, if not already effectuating, such an action, as they have seen their plans' values cut in half or worse.

The greatest distress in defined benefit circles is due to the funding requirements imposed by the Pension Protection Act. The ostensible purpose of those provisions was to overcome the rampant underfunding of DB plans; but the subtext of the new funding rules -- not acknowledged in public pronouncements explaining the rationale of the legislation -- was to protect the dangerously declining resources of PBGC, a \$23 billion deficit in 2005, compared with a \$10 billion *surplus* just four years before that. This led to a sharp increase in the PBGC premium in 2006, when, as part of the PPA, Congress raised the annual, per participant premium for individual (as distinguished from multiemployer) defined benefit plans from \$19 to \$30, to ameliorate the imbalance at that time between the dollars flowing out of and into the government insurer of failing defined benefit plans. It cannot be doubted that the imbalance will become much more acute in view of the current state of the economy. Some have projected that the Treasury will now have to pour many billions of dollars into PBGC to enable it to satisfy its obligations to participants of terminated, underfunded defined benefit plans.

It is incumbent on government to do everything it can to bolster the viability of the remaining DB plans. The Worker, Retiree, and Employer Recovery Act of 2008, cited above (with the unpronounceable acronym WRERA), provided some welcome relief, (i) by easing the transitional rules for achieving the required 100 percent funding targets introduced by the PPA of 2006 by permitting the targets to be achieved in stages, (ii) by relaxing the required rate of amortization of underfunding, and (iii) by clarifying use of a 2-year "smoothing" method in calculating the plan asset values. as relating to required minimum funding. These new rules will be helpful for diminishing the funding required

in some cases, although they would have been more helpful if a so-called 10 percent "corridor" (i.e., above or below the fair market value of plan assets) that was established in PPA had been liberalized. But the extent of the underfunding in 2008 directly attributable to the economic collapse will still leave many plan sponsors with required plan contributions in 2009 that are unmanageable because well beyond their financial means, unless at the same time freezing plan benefits or cutting jobs (or both). So the relief provided by WRERA, if not quite resembling the rearranging of deck chairs to prepare for a storm, leaves many plans without a life preserver.

Moreover, even freezing a plan does not foreclose funding problems under the PPA, since benefits accrued before the freeze must continue to be funded if they are at that time partially unfunded; so the plan sponsor may still be left with unmanageable pension costs. Substantial layoffs, apart from their effect on the laid-off participants and even on the participants initially spared who work in the shadow of the next layoff -- to say nothing of the cumulative effect on the Nation's unemployment rate -- also may lead to undesirable consequences for the plan, under the so-called partial termination rule under which a significant level of job terminations (often pegged at 20 percent of participants among the pension cognoscenti) is treated as tantamount to a plan termination for purposes of satisfying the qualification requirements of the Internal Revenue Code, with corollary increased plan funding implications.

The well regarded American Benefits Council, which lobbies the tax and labor arms of government on behalf of plan sponsors, is widely respected by government technicians for its thoughtful, understated and rigorously analyzed positions. It is not given to the pursuit of radical changes in the existing pension rules. It typically is content to achieve incremental changes causing as little disturbance as possible to the relevant body of law (and even less disturbance to the government designers and administrators of that law). It is therefore notable that, while the ABC acknowledges that WRERA provided assistance, for the classes of stakeholders named in the title of the statute, in coping with the pension funding crisis brought on by the current severe economic downturn, the Council, in its paper entitled "Legislation Needed To Address Funding Crisis" (January 2, 2009), minces no words in writing, "more relief is desperately needed."

One could go further. This is a rare opportunity to make major changes to the regulation of private (and perhaps public) pension plans. The funding issue is of course paramount for defined benefit plans. But it is almost 35 years since ERISA established the defined benefit/defined contribution classification scheme. In the intervening period many hybrid variants of both designs have evolved which fit uncomfortably within the discrete rules of either category, so the system has strained to operate within that rigid binary divide. We have seen the traditional defined benefit design, which once was the sole foundation for delivery of pensions in this country, and which many today still regard as the safest and most beneficial platform for workers generally, give way to what Professor Zelinsky has perceptively called "the defined contribution paradigm (that) changed America." It is necessary to reexamine how best to provide retirement security for the Americans of the 21st century. It would be presumptuous to lay out the blueprint here for achieving that goal. This is a task best pursued by a bipartisan, high-level Presidential commission. The challenges threatening survival of the existing instrumentalities of pension delivery -- not least the greatly expanding body of government regulation, whose effects are now compounded by the present economic crisis -- give new urgency to the project.

Given the difficulty and enormity of the issues needing research, deliberation and resolution, this would have to be seen as a multi-year project; but discrete pieces of it, such as the funding issue, need not await completion of the entire reform agenda, and could be assigned deadlines to assure their timely completion. Also, a mechanism should be established for keeping Congress apprised of the work product, so that it does not become susceptible to Congressional dismantling once the Commission is discharged.

Such a project could be designed to also yield not just a bailout of the DB plan, but a much overdue simplification of the entire pension regulatory structure, and a stripping out of the excesses and contradictions of the rule-making that have poured out of the principal agencies of oversight -- Treasury, IRS, Labor and PBGC -- over the past third of a century, admittedly much of it in response to continuous legislative accretions to the law since the original enactment of ERISA.

The complexity of the project is not to be minimized; but it is far less so than other more radical changes suggested in recent years that have gained support, e.g., privatization of Social Security, and replacement of the income tax with a national sales tax. It is a big task, and it obviously won't be Job One of the new Administration. But hopefully it will find its way on to the priority list. Pensions are no less a part of our infrastructure in need of repair than the bridges, and roads and energy grids that are to become a feature of the economic revival program of the new Administration.

RELATED LINKS: For additional discussion, see

■ 1-1 Federal Income Taxation of Retirement Plans § 1.02

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The Deduction for Energy Efficient Commercial Buildings under IRC Section 179D

2009 Emerging Issues 3489

David I. Altman on the Deduction for Energy Efficient Commercial Buildings under IRC Section 179D

By David Altman

March 31, 2009

SUMMARY: This Emerging Issues Analysis discusses the deduction allowed for the cost of energy efficient commercial building property placed in service before January 1, 2014. A partial deduction is allowed for energy savings systems that are not part of a plan to reduce the buildings energy consumption by 50 percent if the system reduces energy consumption by 16 2/3 percent or more.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: **There is a deduction allowed for the cost of energy efficient commercial building property placed in service before January 1, 2014.**

The Internal Revenue Code allows a deduction for the cost of energy efficient commercial building property placed in service during a tax year. *I.R.C. § 179D(a)*. However, the amount of the deduction for any building cannot exceed the excess of the product of \$1.80 and the square footage of the building, over the aggregate amount of the deductions taken for energy efficient commercial building property for all prior tax years. *I.R.C. § 179D(b)*. The basis of any property for which the deduction is taken is reduced by the amount of the deduction allowed. *I.R.C. § 179D(e)*. The deduction went into effect for energy efficient commercial building property placed in service after December 31, 2005 and before January 1, 2014. *I.R.C. § 179D(h)*.

Energy efficient commercial building property is property installed as part of the interior lighting systems, the heating, cooling, ventilation, and hot water systems, or the building envelope as part of a plan to reduce the buildings energy consumption by 50 percent or more.

Energy efficient commercial building property is property for which depreciation or amortization is allowable, which is installed on or in any building located in the United States. In addition, the property must be within the scope of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America (as in effect on April 2, 2003). The property must also be installed as part of the interior lighting systems, the heating, cooling, ventilation, and hot water systems, or the building envelope, and must be certified as being installed as part of a plan designed to reduce the total annual energy and power costs for the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more. *I.R.C. § 179D(c)*. The certification process must include procedures for inspection and testing by qualified individuals

to ensure compliance of buildings with energy-savings plans and targets. The procedures must be comparable to the requirements in the Mortgage Industry National Accreditation Procedures for Home Energy Rating Systems. *I.R.C. § 179D(d)(6)*. Each certification must include an explanation to the building owner regarding the energy efficiency features of the building and its projected annual energy costs. *I.R.C. § 179D(d)(5)*.

Partial deduction is allowed for energy savings systems that are not part of a plan to reduce the buildings energy consumption by 50 percent if other energy savings targets are met.

In some circumstances, a partial deduction is allowed. If the full certification requirements are not met, but there is a certification that any of the heating, cooling, ventilation, and hot water systems satisfies the energy-savings targets, the deduction is allowed for the energy efficient commercial building property installed as part of that system, except that the maximum credit is determined by multiplying the square footage of the building by \$.60 instead of by \$1.80. After consulting with the Secretary of Energy, the IRS must establish a target for each system. If these targets were met for all the systems, the building would meet the 50 percent reduction requirements discussed above. *I.R.C. § 179D(d)(1)*. The energy efficiency target is met if the system reduces the total annual energy and power costs for the combined usage of the buildings heating, cooling, ventilation, hot water, and interior lighting systems by 16 2/3 percent or more as compared to a Reference Building that meets the minimum requirements of Standard 90.1-2001. *Notice 2006-52, 2006-1 C.B. 1175, clarified and amplified by Notice 2008-40, 2008-14 I.R.B. 725*. Until the IRS issues final regulations for property that is part of a lighting system, the lighting system target is a reduction in lighting power density of 25 percent (50 percent for a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 (not including additional interior lighting power allowances) of Standard 90.1-2001. However, if, for the lighting system of any building other than a warehouse, the reduction in lighting power density of the lighting system is not at least 40 percent, only the applicable percentage of the amount of partial deduction otherwise allowable is allowed. The applicable percentage is the number of percentage points (not greater than 100) equal to the sum of 50 and the amount which bears the same ratio to 50 as the excess of the reduction of lighting power density of the lighting system over 25 percentage points bears to 15. For example, if the interior lighting systems achieve a reduction in lighting power density of 32.5 percent, the applicable percentage is 75 percent. (50 percent + 50 percent (32.5 25)/15). These rules for lighting systems do not apply to any system (1) the controls and circuiting of which do not comply fully with the mandatory and prescriptive requirements of Standard 90.1-2001 and which do not include provision for bi-level switching in all occupancies except hotel and motel guest rooms, store rooms, restrooms, and public lobbies, or (2) which does not meet the minimum requirements for calculated lighting levels as set forth in the Illuminating Engineering Society of North America Lighting Handbook, Performance and Application (9th Edition, 2000). *I.R.C. § 179d(f)*.

Any calculation of energy savings for purposes of determining qualification for the deduction must be prepared by qualified computer software. Qualified computer software is software for which the software designer has certified that the software meets all procedures and detailed methods for calculating energy and power consumption and costs as required by the IRS. *I.R.C. § 179D(d)(3)*.

The IRS has set forth standards for determining the energy savings from installing interior lighting systems, the heating, cooling, ventilation, and hot water systems.

The IRS has set forth procedures, in lieu of regulations, that allow a taxpayer who owns, or is a lessee of, a commercial building and installs property as part of the commercial buildings interior lighting systems, heating, cooling, ventilation, and hot water systems, or building envelope to obtain a certification that the property satisfies the energy efficiency requirements. The standard used in making this determination is based on the 2005 California Nonresidential Alternative Calculation Method Approval Manual. *I.R.C. § 179D(d)(2); Notice 2006-52, 2006-1 C.B. 1175, clarified and amplified by Notice 2008-40, 2008-14 I.R.B. 725*. The IRS also provides a public list of software programs that must be used in calculating energy and power consumption. Guidance is given to software developers on how they can qualify their software to appear on the list. *Notice 2006-52, 2006-1 C.B. 1175, clarified and amplified by Notice 2008-40, 2008-14 I.R.B. 725*. A list of qualified software programs can be found at http://www1.eere.energy.gov/buildings/qualified_software.html. The IRS has clarified this guidance.

The deduction for energy efficient commercial property installed on a government owned building may be taken by the person responsible for designing that property.

For energy efficient commercial building property installed on or in property owned by a Federal, State, or local government or a political subdivision thereof, the IRS will promulgate a regulation to allow the allocation of the deduction to the person primarily responsible for designing the property in lieu of the owner of such property. *I.R.C. § 179D(d)(4)*. In lieu of regulations, the IRS has set forth guidance under which a designer eligible for a deduction is a person that creates the technical specifications for the installation of energy efficient commercial building property. For example, a designer may include an architect, engineer, contractor, environmental consultant or energy services provider who creates the technical specifications for a new building or an addition to an existing building that incorporates energy efficient commercial building property. A person that installs, repairs, or maintains the property is not a designer. If more than one designer is responsible for creating the technical specifications for the installation of energy efficient commercial building property on or in a government-owned building, the owner of the building must determine which designer is primarily responsible and allocate the full deduction to that designer or, at the owners discretion, allocate the deduction among several designers. *Notice 2008-40, 2008-14 I.R.B. 725*.

Deductions taken for energy efficient commercial building property are subject to recapture under *IRC Section 1245. I.R.C. § 1245(a)(3)(C)*. This means that gains on the sale of the property are treated as ordinary income to the extent of the deduction allowed. Deductions taken for energy efficient commercial building property are not subject to recapture under *IRC Section 1250. I.R.C. § 1250(b)(3)*.

RELATED LINKS: For further discussion, see

- Lexis Explanation IRC Sec. 179D(d)

For discussion of the deduction for energy efficient commercial building property and other related Code provisions, see Richard A. Westin, *Energy and Environmental Tax Changes in the Flood of Recent Federal Revenue Laws and What They Imply*,

- 15 Penn St. Envtl. L. Rev. 171 (2007)

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The Confidentiality Privilege for Federal Tax Practitioners

2009 Emerging Issues 3486

David I. Altman on the Confidentiality Privilege for Federal Tax Practitioners under IRC Section 7525

By David Altman

March 27, 2009

SUMMARY: Congress adopted IRC Section 7525, which specifically extends the common-law attorney-client privilege for communications to federal tax practitioners. This Emerging Issues Analysis, written by David I. Altman, an experienced legal writer on tax issues, explains the circumstances in which the privilege applies to non-attorneys and examines court decisions that interpret the privilege.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Common-law attorney-client privilege generally did not extend to tax practitioners other than attorneys.

Courts have not generally accepted that communications between a taxpayer and his accountant regarding the taxpayer's taxes should be confidential. For example, the U. S. Supreme Court had held that a claim of an accountant-client privilege could not stop enforcement of an IRS summons for tax accrual workpapers prepared by an independent accounting firm during an audit of its clients' finances. The accounting firm argued that the public interest in promoting full disclosure to public accountants, and in turn ensuring the integrity of the securities markets, required protection for the work that independent auditors perform for publicly owned companies. The Court rejected this argument because it found that the IRS summons power under *IRC Section 7602* should not be restricted absent unambiguous directions from Congress to the contrary. The Court also rejected the taxpayer's argument that a work-product immunity for accountants' tax accrual workpapers is an appropriate extension of the attorney work-product doctrine. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

However, there have been some instances when confidentiality has been extended to accountants. In *United States v. Kovel*, 296 F.2d 918 (2d Cir. 1961), an accountant employed by a law firm in connection with its representation of a client under investigation for income tax violations refused to answer questions posed by the U.S. attorney regarding the client's assets. The accountant's claim of privilege was rejected by the trial court, which held him in contempt for failing to answer the questions. The Second Circuit held that given the complexities of modern legal cases, attorneys often need the assistance of an outside professional to effectively represent their clients. Thus, the presence of an accountant, whether hired by the lawyer or by the client, while the client is relating a complicated tax story to the lawyer, does not

destroy the attorney-client privilege. For the privilege to apply, the communication must be made in confidence for the purpose of obtaining legal advice from the lawyer.

Notwithstanding the Kovel courts extension of the privilege to persons assisting in the case hired by the attorneys client, best practice indicates that the attorney should hire any accountant or other professional needed to assist the attorney in preparing a tax case. The attorney is usually better suited than the client to gauge the expertise necessary for adequate preparation of the case. Furthermore, having the attorney do the hiring makes clear that the person hired is entitled to the same confidentiality privilege as the attorney. In a case in which a taxpayer separately retained an accounting firm and a tax attorney, the court held that documents prepared for the taxpayer by the accountant were not privileged in the absence of proof that these documents were prepared to assist the attorney in litigation. *United States v. Brown*, 349 F. Supp. 420 (N.D. Ill. 1972), modified on other grounds, 478 F.2d 1038 (7th Cir. 1973).

Effective for communications made on or after July 22, 1998, the common-law privilege for attorney-client communications is extended to a communication of tax advice between a taxpayer and any federally authorized tax practitioner.

The IRS Restructuring and Reform Act of 1998 added new *IRC Section 7525*, which makes confidential some communications between taxpayers and federally authorized tax practitioners. Pub. L. No. 105-206, § 3411(a) (1998). Section 7525 is effective for communications made on or after July 22, 1998. It provides that, for tax advice, the same common-law protections of confidentiality which apply to a communication between a taxpayer and an attorney also apply to a communication between a taxpayer and any federally authorized tax practitioner to the extent the communication would be considered a privileged communication if it were between a taxpayer and an attorney. *IRC § 7525(a)(1)*. However, this privilege may only be asserted in any noncriminal tax matter before the Internal Revenue Service, and any noncriminal tax proceeding in Federal court brought by or against the United States. *IRC § 7525(a)(2)*. Thus, the practitioner must be cautioned that this privilege cannot be asserted before federal agencies other than the IRS, such as the U.S. Securities and Exchange Commission. It also cannot be asserted in any non-tax proceeding.

Practitioners must also note the limitation of the privilege to circumstances in which the privilege would apply to communications between a taxpayer and an attorney. This limitation has been held to mean that communications between a tax practitioner and a client made regarding the preparation of a tax return are not protected from discovery. *United States v. KPMG LLP*, 237 F. Supp. 2d 35 (D.C. D.C. 2002). The limitation applies even when the person preparing the return is an attorney. *United States v. Frederick*, 182 F.3d 496 (7th Cir. 1999), cert. denied, 528 U.S. 1154 (2000).

Furthermore, the application of the statutory privilege only to communications between the client and the practitioner has been held to mean that the privilege does not apply to the work product of practitioners. *Id.*; *Evergreen Trading, LLC v. United States*, 80 Fed. Cl. 122 (2007).

A federally authorized tax practitioner is any individual who is authorized under Federal law to practice before the IRS. *IRC § 7525(a)(3)(A)*. Persons entitled to practice before the IRS include attorneys, certified public accountants, enrolled agents, enrolled actuaries, and enrolled retirement plan agents. *31 C.F.R. § 10.3*. Tax advice is advice given by an individual regarding a matter which is within the scope of the individuals authority to practice before the IRS. *IRC § 7525(a)(3)(B)*.

Privilege for communications between federally authorized tax practitioners and clients does not apply to communications regarding tax shelters.

The privilege for federally authorized tax practitioners does not apply to any written communication between the practitioner and any person, any director, officer, employee, agent, or representative of the person, or any other person holding a capital or profits interest in the person, if the written communication is in connection with the promotion of the direct or indirect participation of the person in any tax shelter. *IRC § 7525(b)*. A tax shelter is a partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of the partnership, entity, plan, or arrangement is avoiding or evading federal income tax. *IRC § 6662(d)(2)(C)(ii)*. In considering whether his or her communications are protected from disclosure, a practitioner should be aware that the tax shelter exception from confidentiality may apply to written communications to any person, and the term tax shelter has a broad definition.

Before October 22, 2004, the exception from confidentiality for communications regarding tax shelters applied only to written communications between the practitioner and a director, shareholder, officer, or employee, agent, or representative of a corporation in connection with the promotion of the direct or indirect participation of that corporation in any tax shelter. *IRC § 7525(b)*, prior to amendment by Pub. L. No. 108-357, § 813(a) (2004).

Claim of privilege must be supported by privilege log.

When a taxpayer withholds information otherwise discoverable in federal court by claiming that the information is privileged, the taxpayer must expressly make the claim and describe the nature of the documents, communications, or tangible things not produced or disclosed. This document is called a privilege log. The privilege log must enable the court to assess the claim of privilege without revealing the privileged information. This rule applies regardless of whether the claim of privilege is made under Section 7525, under any other provision of law or under common-law rules. *Fed. R. Civ. P. 26(b)(5)*.

RELATED LINKS: For further discussion, see

- LexisNexis Tax Advisor -- Federal Topical § 5B:4.04

For information on how the privilege affects lawyers who practice with non-lawyers, see Michael W. Loudenslager, Cover Me: The Effects of Attorney-Accountant Multidisciplinary Practice on the Protections of the Attorney-Client Privilege,

- 53 Baylor L. Rev. 33 (2001)

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Which "Abusive Transactions" Involve ESOPs?

2009 Emerging Issues 3475

Which "Abusive Transactions" Involve ESOPs?

By Gerald Levinson

March 26, 2009

SUMMARY: ESOPs are subject to various requirements under the IRC that must be met in order for the ESOP to be tax-exempt and to qualify for other tax benefits. Many of the existing arrangements designed to take advantage of S corporation ESOP rules would not only violate Section 409(p), but also violate other requirements of the Code. This Emerging Issues Analysis explains how ESOPs and S corporations can co-exist.

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ARTICLE: Which Abusive Transactions Involve ESOPs?

As part of its ongoing efforts to curb abusive tax shelters, the IRS has identified as listed transactions a number of transactions involving S Corporations (a/k/a small business corporations) and employee stock ownership plans (ESOPs) that involve *IRC Section 409(p)*, certain business structures, and delayed effective dates of certain law provisions. Section 409(p) was enacted to address concerns about ownership structures involving S corporations and ESOPs that concentrate the benefits of the ESOP in a small number of persons. A "listed transaction" is a transaction that is the same as, or substantially similar to, one that the IRS has determined to be a tax avoidance transaction and identified by IRS notice or other form of published guidance. The parties who participate in listed transactions may be required to disclose the transaction as required by the regulations, register the transaction with the IRS, or maintain lists of investors in the transactions and provide the list to the IRS on request. Additionally, if an abusive transaction results in a substantial understatement of income (which occurs when the reported tax is understated by the greater of 10 percent of the tax required to be shown on the return or \$5,000), *IRC Section 6662(a)* imposes a penalty equal to 20 percent of the underpayment. Why are certain arrangements abusive?

According to the Services S Corporation ESOP Guidance [IRS Retirement Plans Community S Corporation ESOP Guidance (Abusive Transactions Involving ESOPs)], in addition to *IRC Section 409(p)*, ESOPs are subject to various requirements under the IRC that must be met in order for the ESOP to be tax-exempt and to qualify for other tax benefits. Many of the existing arrangements designed to take advantage of the S corporation ESOP rules would not only violate Section 409(p) when it becomes effective for these plans, but also violate other requirements of the Code.

In these arrangements, taxpayers attempt to exclude the income of an operating business through the use of a combination of an S corporation and ESOP. In a typical case, an S corporation is created, with the owner of the

operating business as the only employee of the S corporation. The owner of the operating business causes the two entities to enter into an agreement under which the operating business pays a fee to the S corporation in exchange for management or other services. In addition, the S management corporation purports to adopt an ESOP that is treated as the sole shareholder of the S management corporation and in which the owner is the sole participant.

Taxpayers have argued that under this arrangement the operating company may deduct its payments to the S management corporation and the income of the S corporation is passed through to the purported ESOP. They further contend that because the purported ESOP is a tax-exempt entity, the income is not subject to tax until distributed from the plan. The Service has determined, however, that in many of these arrangements, the purported ESOP fails to satisfy the requirements of the Code for a valid ESOP. The following is an example of a typical abusive arrangement:

Example: Individual A is an employee and the sole shareholder of Corporation X, a C corporation (the income of a C Corp. is taxed and this corp. may have an unlimited number of shareholders, while the income of an S Corp. is passed through to individual shareholders that are limited in number to 100). Corporation X is an operating business with a small number of non-excludable employees, some of who are not highly compensated employees (HCEs). Corporation X does not maintain a qualified retirement plan. In 2008, Corporation X has taxable income of \$500,000 and Individual A receives compensation of \$200,000. The compensation is deducted by Corporation X in calculating its taxable income and is included in income by Individual A.

In 2009, Corporation Y, an S corporation, is created, and a trust purported to be an ESOP is established by Corporation Y. All of the stock of Corporation Y stock is contributed to the purported ESOP. Individual A is the sole employee of Corporation Y and the sole participant in the purported ESOP. All the stock of Corporation Y is allocated to the account of A. The purported ESOP provides for full and immediate vesting of all benefits. Although the trust is purported to be an ESOP, it is not operated in accordance with the requirements for tax qualification under Section 401(a).

Also in 2009, Corporation Y enters into an agreement with Corporation X for fees to be paid in exchange for management services provided by Individual A to Corporation X. The principal business of Corporation Y is performing management functions for Corporation X on a regular and continuing basis. In 2009, the fees paid by Corporation X to Corporation Y equal \$700,000. Corporation X deducts the full amount of the fees on its corporate tax return as a business expense and reports no taxable income. The \$700,000 is reported by Corporation Y as income of the tax-exempt ESOP. Similar fees are paid in the years 2010-2013 and are reported as in 2009.

ESOP Requirements

ESOPs are subject to various requirements under the Code which must be met in order for the ESOP to be tax-exempt and to qualify for other tax benefits. For example, an ESOP must satisfy the nondiscrimination rules of section 401(a)(4) and the coverage rules of section 410(b). The nondiscrimination rules of section 401(a)(4) provide that the contributions or benefits provided under a plan may not discriminate in favor of HCEs [highly compensated employees]. An employee is a HCE either by being a 5-percent owner of the employer or by having compensation above a certain level.

Under the coverage rules of *IRC Section 410(b)*, an ESOP must benefit either a certain percentage of the employers non-highly compensated employees (NHCEs) or a classification of employees that does not discriminate in favor of HCEs. For example, an ESOP that provides benefits to an employers HCEs, but does not provide benefits to the employers NHCEs, will fail these coverage rules and fail to be a qualified ESOP. The plan will therefore lose any tax benefits associated with being an ESOP.

Also, in determining whether these nondiscrimination and coverage rules are satisfied, section 414(m) of the Code provides that all employees of the members of an affiliated service group shall be treated as employed by a single employer. In that case, an employee who is a 5-percent owner of any member of the group is a HCE for the group. The

term affiliated service group includes a group of two or more service organizations (e.g. corporations or partnerships whose principal business is the performance of services) where one of these organizations provides services to the other organization(s) in the group and there is a certain level of common ownership between the organizations. See *Rev. Rul. 81-105, 1981-1 CB 256*. In addition, the term also includes a group consisting of (1) an organization whose principal business is performing, on a regular and continuing basis, management functions for another organization (the recipient organization) and (2) the recipient organization (the organization for which such management functions are performed).

Accordingly, where an affiliated service group exists, an ESOP maintained by one of the organizations in that group may violate the coverage and nondiscrimination rules of the Code even if that organizations only employee is covered by the plan. In the example provided above, Corporations X and Y form an affiliated service group because the principal business of Corporation Y is performing, on a regular and continuing basis, management functions for Corporation X. The purported ESOP of Corporation Y violates the coverage rules under section 410(b) because only Individual A is covered by the purported ESOP, and there are other non-excludible employees of Corporations X and Y who are NHCEs. As a 5-percent owner of Corporation Y, A is a HCE with respect to the affiliated service group of Corporations X and Y.

On December 16, 2006, the Treasury Department and IRS issued final regulations [*Treas. Reg. Sec. 1.409(p)-1* (TD 9302)] that prohibit accruals or allocations under an ESOP that holds stock of an S corporation where the ownership interest in the ESOP or in rights to acquire the corporation are so concentrated among 10 percent owners that they hold 50 percent or more of the interests in the corporation.

Practice Tip

An ESOP may prevent a non-allocation year or a prohibited allocation during a nonallocation year by providing that assets (including S corporation securities)-- that have been allocated to the account of a disqualified person-- will be transferred into a separate portion of the plan that is not an ESOP, or to another qualified plan of the employer that is not an ESOP. In the event such a transfer involves S corporation securities, the recipient plan is subject to tax on unrelated business taxable income under *IRC Section 512*. [*Treas. Reg. Sec. 1.409(p)-1* (TD 9302)].

Practice Tip

If an abusive transaction results in a substantial underpayment of income, a taxpayer may be able to avoid or mitigate the application of the 20% substantial-underpayment penalty by filing a qualified amended return after the due date of the return but before the earliest of: The date on which the taxpayer is first contacted by the IRS concerning an examination of the return; the date on which a person that promotes an abusive tax shelter (as described in *IRC Section 6700(a)*) is first contacted by the Service about an examination of an activity described in Section 6700(a), if the taxpayer claimed any tax benefit on the return either directly or indirectly related to the Section 6700 activity; or for certain pass-through items, the date on which the pass-through entity, such as a partnership or S Corporation, is first contacted by the Service in connection with an examination to which the pass-through item relates.

For these purposes, a qualified amended return is an amended return, or a timely request for an administrative adjustment under *IRC Section 6227*. [See *Treas. Reg. Sec. 1.6664-2(c)(3)*; *Notice 2004-38, 2004-21 IRB 949*].

RELATED LINKS: For further discussion, see

- Bender's Federal Income Taxation of Retirement Plans

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Rules Affecting Related Taxpayer Deductions

2009 Emerging Issues 3461

Loss Deduction Disallowance and Deferral of Deductions for Expenses Paid to Related Taxpayers

By Philip Fink

March 25, 2009

SUMMARY: IRC Sections 267(a)(1), (2) prevent related taxpayers from generating tax benefits from transactions that may be sham transactions. Intent is not a requirement. As long as the transaction falls into the definition of a related party transaction, the prohibitions will apply.

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ARTICLE: *IRC Sections 267(a)(1), (2)* prevent related taxpayers from generating tax benefits from transactions that may be sham transactions. Intent is not a requirement. As long as the transaction falls into the definition of a related party transaction, these provisions will apply.

Caveat: These sections pertain only to the tax benefits from claiming a loss or deferring expenses. If a gain is realized in a related party transaction, it would be recognized according to the general rules for gain recognition. In a like manner, if a taxpayer provides a service to a related party, their income would be recognized according to the general rules of income recognition.

IRC Section 267(a)(1) -- Deduction for Losses are Disallowed: Realized losses that result in transactions between related taxpayers are not recognized.

Related Taxpayers: The definition of related taxpayers is very broad. Some of the more important relations include: 1. Members of a family (ancestor, lineal descendent, brother, sister, or spouse); 2. An individual and a corporation if the individual owns (directly or indirectly) more than 50% in value of the outstanding stock; 3. Two corporations that are members of a controlled group (at least 50% owned) of corporations; 4. A fiduciary of a trust and a corporation, more than 50% in value of the outstanding stock of which is directly or indirectly owned by or for the trust or a grantor of the trust; 5. A corporation and a partnership if the same persons own (a) more than 50% in value of the outstanding stock of the corporation and (b) more than 50% of the capital interest or profits in the partnership; 6. An S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation; 7. An S corporation and a C corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.

Example: Beta Corporation is the wholly owned subsidiary of the Alpha

Corporation. Accordingly, they are deemed to be related taxpayers. Alpha sold property to Beta that resulted in a realized loss of \$100,000. Because Alpha owns all of the stock of Beta, and deemed to be related, the loss is disallowed.

Example: The Miller Trust owns 60% of the stock of the Miller Corporation. The trust sells raw land to the corporation for \$70,000. The trust had a basis in the land of \$100,000. The trust has a realized loss of \$30,000, but it can't be recognized since the trust and the corporation are related.

Subsequent Sale by Transferee: In a transaction between related taxpayers where a loss is not recognized, there is a future benefit accorded the transferee. That is, the transferee will be able to reduce the realized gain in a subsequent sale by the amount of the prior disallowed loss. Note that this provision cannot convert a subsequent realized gain into a recognized loss. It can just reduce the subsequent gain to zero.

Example: The American Company and the National Company are both C corporations that are owned entirely by Ruth Sutherland. American sells property to National that results in an unrecognized loss of \$10,000. Subsequently, National sells the property to an unrelated party for a realized gain of \$7,000. National can take advantage of the prior disallowed loss and reduce the gain to zero.

Caveat Some Tax Benefit Wasted: Note in the example above that the realized gain cannot be converted into a recognized loss. Thus, \$3,000 of the prior disallowed loss will not result in any tax benefit.

Caveat Reduction in tax rates under the Obama Administration: Corporate tax rates will probably be reduced in the near term under the Obama Administration. Thus, postponing the tax benefit from the prior disallowed loss may cause the future tax benefit to be reduced if indeed corporate tax rates are decreased.

Constructive Ownership Rule: The constructive ownership rule prevents taxpayers from transferring ownership interests to avoid the disallowance rule. That is, individuals are deemed to own all of the stock of those they are related to. Moreover, stock held by a corporation (or a partnership, estate, or trust) is considered owned proportionately by its shareholders (or partners or beneficiaries).

Example: Mary and her husband each own 30% of Enterprise Corporation. If Mary sells property to the Enterprise Corporation for a realized loss of \$10,000, the loss will not be recognized. In addition to owning 30% of the stock directly, Mary is also deemed to own 30% indirectly through that her husband. Therefore, she is considered to own 60% of Enterprise Corporation.

Permanent Differences: The transferor and the transferee will both have permanent tax differences.

Example: ABC Corp. and XYZ Corp. are part of a controlled group. In 2009, ABC sells property to XYZ that results in a \$25,000 disallowed loss. In 2012, XYZ sells the property to a nonrelated party for a realized gain of \$35,000. Thus, in 2009, ABC has a nonoperating loss of \$10,000 (\$35,000-\$25,000), but not a corresponding loss on its tax return. Then, in 2012, XYZ reports a \$35,000 nonoperating gain on its income statement, but only a \$10,000 gain on its income tax return.

Adjustment for State and Local Income Taxes: Many states do not follow the disallowance rule and/or give the tax benefit on the subsequent sale. In those cases, an adjustment from the federal tax return will be required.

IRC Section 267(a)(2) Deferral of Deductions for Expenses Between Related Taxpayers: A corporation that is on the accrual basis can't take a deduction for an expense incurred with a related cash basis taxpayer until the year that the related taxpayer includes such amount in its gross income. This rule prevents related taxpayers from achieving the best of both worlds. That is, it prevents the accrual-basis payor from taking a deduction in an earlier year, and a cash-basis payee including payment in gross income in a later year.

Example: The Wadsworth Corporation is a calendar-year taxpayer on the accrual basis. It is in the 35% income tax bracket. Its sole shareholder is Marissa, who is in the 35% income tax bracket. Wadsworth accrues a bonus of \$50,000 for Marissa in 2009. The bonus is paid to Marissa on February 10, 2010. Marissa must include her bonus in her gross income in 2010. Since she owns more than 50% of the corporation, Wadsworth must take the deduction in 2010 even though it accrued the expense on its books for 2009.

Tax Planning Opportunities for 2010 and beyond: Future tax legislation may force taxpayers to change the timing of such payments. For instance, there are rumors that the Obama Administration will let the top individual income tax bracket increase to 39.5% from the current, temporary, 35% beginning in 2010. Also, it is suspected that the top corporate tax rate will be reduced from 35% to 33% for tax years beginning in 2010. Accordingly, in the prior example, Wadsworth should consider paying Marissas 2009 bonus in 2009, and not in 2010 (its practice in the past has been to pay the bonus shortly after the end of the year in which it was earned). By making payment in 2009, Marissa will include the income in 2009 when she is only in the 35% tax bracket. Since Marissa will report her 2009 bonus in 2009, Wadsworth can take the corresponding deduction in 2009 while it is in the 35% income tax bracket rather than deducting it in 2010 when it will be in only the 33% income tax bracket.

Related Taxpayers and the Constructive Ownership Rule: The definition of related taxpayers and the application of the constructive ownership rule are the same for deferred expenses as they were for disallowed losses as discussed earlier.

Timing Differences: When there is a deferred expense as a result of this provision, there will be a timing difference on a corporations income tax return for both years involved.

Example: The Beasley Corp. is owned entirely by Tim Beasley. The corporation is a calendar-year, accrual basis taxpayer. Tim is on the cash basis. For 2009, the corporation accrues a \$10,000 bonus for Tim, and pays it to him on February 1, 2010. Then, for 2010, the corporation accrues a \$15,000 bonus for Tim, and pays him on February 2, 2011. Thus, the corporation has a \$10,000 deduction and Tim has to include \$10,000 of income in 2010. However, for financial reporting purposes, the corporation can report the \$10,000 expense in 2009. In 2011, the corporation can take a tax deduction for \$15,000, and Tim must include \$15,000 in his gross income. For financial reporting purposes, the corporation can accrue the \$15,000 expense in 2010, the year that it is accrued.

Adjustment for State and Local Income Taxes: Many states do not follow the deferral rule. In those cases, an adjustment from the federal tax return will be required.

RELATED LINKS: For more information, see

- LexisNexis Tax Advisor--Federal Topical

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The Future of Corporate Charitable Giving

2009 Emerging Issues 3369

Charitable Contributions by Corporations for 2009 and Beyond

By Philip Fink

March 19, 2009

SUMMARY: IRC Section 170(a)(2), (b)(3), (e)(3) lays out the principal rules for charitable contributions made by corporations. These rules, and their interpretation, may be affected by 2009 legislative and other changes.

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ARTICLE: *IRC Section 170(a)(2), (b)(3), (e)(3)* lays out the principal rules for charitable contributions made by corporations. These rules, and their interpretation, may be affected by 2009 legislative and other changes.

Significance of charitable contributions under the Obama Administration: There are some rumors coming out of Washington, D.C. that under the Obama Administration there will be a small reduction in corporate tax rates. In such a tax environment, corporations might be less inclined to make contributions since the tax benefit will be less.

Tax planning: Corporations that have made multi-year pledges to charities might want to consider accelerating their contributions to a year when they will be in a higher tax bracket.

Annual limitation: For any year, corporations can deduct their charitable contributions up to 10 percent of their taxable income. For this purpose, taxable income is calculated without regard to: the charitable contribution deduction; any net operating loss carryback; any capital loss carryback; the dividends received deduction.

Example: The Enterprise Corp. made contributions during 2009 of \$25,000. It had gross income from operations of \$800,000 and operating expenses of \$650,000. In addition, it received dividends (eligible for the dividends received deduction) of \$10,000. The charitable contribution deduction allowed for 2009 is \$16,000, calculated as follows:

gross income from operations

dividend income

less: operating expenses

taxable income

percentage limitation

allowable deduction

\$ 800,000

10,000

-- 650,000

160,000

10%

\$ 16,000

Five-year carryover: If a corporation makes charitable contributions that exceed the 10 percent limit, it is permitted to carry over the excess to the next five years. The amount carried over plus the amount of contributions in future years will be subject to the 10 percent limit in the carryover year. If the total of contributions in a future year exceeds the 10 percent limit, the current contribution in that particular year will be deducted prior to any amount carried forward.

Example: Assume the same facts as in the prior example. In addition, the Enterprise Corp. made contributions in the amount of \$12,000 in 2010, and it had taxable income of \$150,000 in 2010. The amount of the allowable charitable deduction for 2010 is \$15,000 ($\$150,000 \times 10\%$). The \$15,000 deduction is considered to be comprised of the \$12,000 contribution made in 2010, plus \$3,000 carried over from 2009. Since there was a carryover of \$9,000 ($\$25,000 - \$16,000$) from 2009, there will be a carryover of \$6,000 ($\$9,000 - \$3,000$) to 2011. The \$6,000 can be carried over for four more years since it is considered to have come from contributions made in 2009.

Effect of "matching gifts programs": Many corporations have "matching gifts programs" whereby they will contribute an amount (oftentimes, an equal amount) to a charity to which an employee has made a contribution. Since corporations have no control over their employees, those corporations that have these programs may make matching contributions that exceed the 10 percent limit. Hence, it is important for corporations to properly plan for such carryovers.

Timing differences: If the limitation comes into play, corporate taxpayers will have a timing difference. That is, for financial statement purposes, there is no limitation. Thus, in a year when a corporation makes a charitable contribution in excess of the 10 percent limit, it will be able to expense the entire amount of its charitable contributions on its income statement resulting in net income being less than taxable income.

Example: Assume that for 2009, a corporation has \$100,000 of taxable income and makes charitable contributions in the amount of \$12,000. For financial statement purposes, it can expense the entire \$12,000. However, for tax purposes it can deduct only \$10,000 ($\$100,000 \times 10\%$). This creates a negative timing difference of \$2,000 for 2009.

Tax planning: If a corporation had a contribution carryover that was about to expire, it might consider accelerating income or deferring expense in order to use up the carryover.

Method of accounting: Corporations that are on the cash basis method of accounting can deduct their contributions in the year that they are made.

In general, accrual basis taxpayers can deduct only their contributions in the year they are *made*. However, an exception allows corporations to deduct contributions in the year they accrue a deduction even though such a contribution is not made until the following year. To qualify for the exception, two conditions must be met. First, the contribution is made within two and one-half months of the close of the tax year. Second, such contribution must be

authorized by the board of directors by the end of the year in which the corporation made the accrual.

Example: The Milan Corp. is a calendar-year, accrual basis taxpayer. On December 16, 2009, its board of directors authorizes a contribution to a charitable organization. Accordingly, the Milan Corp. accrues the contribution for 2009. It makes the contribution on March 3, 2010. Milan can take the deduction in 2009 because it was paid within two and one-half months of the end of 2009, and it was authorized by the board of directors.

Example: Assume the same facts as in the prior example, except the payment to the charity was not made until March 22, 2010. Even though the contribution was authorized by the board of directors, since the payment was made more than two and one-half months after the end of 2009, it will have to take the deduction on its 2010 tax return.

Special rule for the contribution of inventory, or depreciable or real property: In general, if this type of property is contributed, the amount of the deduction is the adjusted basis of the property. However, a special rule exists if this type of property is contributed for the care of infants, the ill, or the needy. That is, the amount of the contribution is equal to the adjusted basis of the property plus one-half of the unrealized appreciation. It should be noted that a limitation exists such that the amount of the deduction cannot exceed twice the adjusted basis of the property.

Example: The Wadsworth Corp. purchased a parcel of land four years ago for \$200,000. The land was being held for future growth of the company. However, Wadsworth decided that it didn't want to use the land for future growth, so it contributed the land to a local hospital to be used as the site of their new cancer clinic. At the time of the contribution, the property was worth \$240,000. As a result, it can claim a charitable contribution deduction of \$220,000 [$\$200,000 + (\$40,000 \times \frac{1}{2})$].

Example: Assume the same facts as in the prior example except that the land is worth \$700,000 at the time that it is contributed. The adjusted basis of the property plus one-half of the appreciation of the property is \$450,000 [$\$200,000 + (\$500,000 \times \frac{1}{2})$]. However, since that amount is greater than twice the adjusted basis of the contributed property, the amount of the deduction is limited to \$400,000 ($\$200,000 \times 2$).

RELATED LINKS: For additional discussion, see

- LexisNexis Tax Advisor -- Federal Topical 1D:14.10

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Investing in a Down Economy

2009 Emerging Issues 3363

The Future of Investing for Retirement

By Philip Fink

February 10, 2009

SUMMARY: The difficulty of investing for retirement is that no one knows for certain what the tax laws will be during the years that he or she is working and saving for retirement, or what the tax laws will be when he or she retires and starts to withdraw from retirement accounts. And, constant changes to the tax law make things even more difficult.

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ARTICLE: Investing in an uncertain tax environment: The difficulty of investing for retirement is that no one knows for certain what the tax laws will be during the years that he or she is working and saving for retirement, or what the tax laws will be when he or she retires and starts to withdraw from retirement accounts.

State tax environment: Complicating matters is the fact that the state income tax rules vary quite significantly from state to state. So, to a very large extent, the retirement funds that an individual has to spend is dependent on the state where an individual is living at the time that he or she retires. If an individual lives in a high income tax state during his or her working years and contemplates retiring to a state that has no income tax or a low income tax on retirement income, he or she should invest in a traditional IRA or traditional 401(k) plan. As such, he or she would have the best of both worlds a generous tax benefit when making contributions and no tax burden or a low tax burden when redeeming funds from retirement accounts.

Caveat: Individuals should expect the state income tax laws to vary depending on the economic status of the state where they live. In more challenging times, states may become less liberal with respect to the way that they tax retirement income. On the other hand, in good economic times, the taxation, if any, on retirement benefits may become less burdensome. In addition, some states may decide to make the taxation of retirement benefits more liberal in order to attract more retirees to their states.

Potential for a reduced tax rate on distributions from qualified retirement plans under the Obama Administration: There have been suggestions by advisers to President Obama that there should be a reduced rate on retirement income. However, this special rate will probably pertain to low-income and middle-income taxpayers, only. This would certainly favor traditional 401(k) plans and traditional IRA plans over Roth 401(k) plans and Roth IRAs. If such treatment would materialize, the typical scenario would be that as individuals contribute to their retirement plans, they would receive a tax benefit in a relatively high income tax bracket. Then, when they retire and withdraw funds

from their retirement accounts, such withdrawals would be taxed at a lower rate.

Non-qualified deferred compensation plans may be less attractive under the Obama Administration: Under the Obama Administration, non-qualified deferred compensation plans may not be as attractive as they have been in the recent past for high income individuals. Under the Bush Administration, the highest income tax bracket has been 35%. That rate will probably increase to 39.6% under the Obama Administration. However, that increase may not happen until 2010 or beyond due to the current recession.

Tax planning: Those individuals who qualify to take deferred compensation in 2009 or beyond, should consider taking payment in 2009 rather than delaying if they are in the higher income tax brackets. Alternatively, individuals may want to take out a portion of their benefits in 2009, and the remainder at a later time. In the event that rates do not go higher and they don't need those funds, they can delay the tax burden to a tax year when their gross income may be lower. Even if rates do go up, if deferred compensation is received in a year when a taxpayer has an uncharacteristically low amount of income, delaying the receipt of this income would be a prudent strategy.

Example: Susan, a single individual, has typically been in the highest income tax bracket for the last several years earning between \$400,000-\$500,000 a year. Her income is contemplated to be in that range until 2011 when her taxable income will go down to about \$100,000-\$120,000. She is entitled to receive proceeds from a nonqualified deferred compensation plan in the amount of \$50,000. At her election, she can receive that money in 2010 or 2011. Proposals by the Obama administration are to increase the tax rates for the highest two brackets so that the 33% tax rate will be increased to 35%, and the 35% bracket will be increased to 39.6%. However, the other tax brackets would not change. In this situation, she should wait until 2011 to receive the deferred compensation. Even though the tax rates in the highest two brackets will be increased, since she will have a reduced amount of income, she will be in only the 28% tax bracket in 2011.

Example: Assume the same facts as in the prior example, except that she decides to receive her deferred compensation in 2010 rather than 2011. Assuming that the Obama tax increases are effective for 2010, Susan will have to pay 39.6% of taxes on her deferred compensation.

A renewed interest in investing in state and local bonds under the Obama Administration:

If tax rates increase on individuals in the two highest income tax brackets, there will be a greater incentive to invest in state and local bonds rather than in qualified retirement accounts. There are no limitations for investing in these bonds outside of a qualified retirement account and there are no required minimum distributions. Although there is no tax deduction when investing in tax-exempt bonds, there is no inclusion in income, either. Oftentimes, there are fees to maintain a qualified retirement income. Such a fee could be avoided by investing in tax-exempt bonds instead of a qualified retirement account. Many business and professional people do not achieve their full income potential until their 40s or 50s. Thus, there could be many years of contributions when they are in a low income tax bracket. Then, when they retire and start redeeming funds, they will be in a high income tax bracket. Investing in state and local bonds would avoid a negative change in the tax laws.

Attractive investment climate: At the present time, state and local bonds offer a more attractive return compared to taxable bonds. Thus, not only can individuals achieve generous tax-exempt returns with these bonds, but they would avoid the compliance rules associated with a qualified retirement plan.

Impact on the taxation of social security benefits: Whether an individual receives distributions from a qualified retirement plan or tax-exempt interest, both will equally impact the amount of social security benefits that are required to be included in gross income. For high income taxpayers, this is not a critical issue since they typically have to include 85% of their social security benefits in gross income without regard to the receipt of other forms of retirement income.

Moratorium on required minimum distributions for 2009: Recent legislation allows individuals who are 70 years or older to elect to not withdraw the amount of their required minimum distributions for 2009. This is just a one

year reprieve. For individuals who will be in an uncharacteristically higher income tax bracket in 2009, it gives them the option to postpone distributions to future lower income years. It also allows individuals to take advantage of a bounce-back of the securities in these accounts after a devastating year for many securities in 2008.

Caveat preserving a greater amount for the next generation: For those older retirees who have defined contribution plans (eg, 401(k) plans, IRAs, etc.), the moratorium means that there will be a larger amount left over for their heirs. Generally, the withdrawal rates will be less for the younger heirs than the older account owners. Thus, the moratorium will help in further stretching-out the funds in retirement accounts.

Potential of increasing contribution limits in 2009: In order to encourage individuals to save more for their retirement, Congress may increase the contribution limits for various defined contribution plans during 2009. This increase will be in addition to the usual escalation of contribution limits as a result of the increase to the CPI.

Practice Tip: Whether or not there is an increase of the contribution limits, practitioners should remind their clients of the increase as a result of the inflation adjusted contribution limits so their clients can increase the contributions to their 401(k) plans, IRAs, etc.

RELATED LINKS: For further discussion see

- LexisNexis Tax Advisor -- Federal Topical § 1C:7.01

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Effective Use of Corporate Dividends

2009 Emerging Issues 3338

Philip Fink on Effective Use of Dividends Received by Corporations

By Philip Fink

February 3, 2009

SUMMARY: IRC Section 243 allows corporations that receive dividends from domestic taxpaying corporations to claim a deduction for a certain percentage of the dividends they receive. The purpose of this deduction is to prevent triple taxation.

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ARTICLE: Philip Fink on Dividends Received by Corporations

IRC Section 243 allows corporations that receive dividends from domestic taxpaying corporations to claim a deduction for a certain percentage of the dividends they receive. The purpose of this deduction is to prevent a triple taxation.

Example: Assume Bill owns 1,000 shares of the American Corporation. Also, the American Corp. owns 5,000 shares of the National Corporation. The National Corp. pays a dividend to the American Corp., which in turn distributes that dividend (along with some of its earnings) to Bill. If it were not for Section 243, the same income would be taxed at three different levels. That is, the income that the National Corp. earned will be subject to income tax. Next, the dividend received by the American Corp. from the National Corp. would be subject to tax. Finally, the dividend received by Bill is required to be included in his gross income, as well.

Amount of deduction: The amount of the deduction that a corporation is entitled to depends on the percentage ownership in the corporation that is paying the dividend. If the percentage ownership in the payor-corporation is less than 20%, the amount of the deduction is 70% of the dividend received.

If the percentage ownership in the payor-corporation is greater than 20%, but less than 80%, the amount of the deduction is 80% of the dividend received.

If the percentage ownership is 80% or more, and if the corporation receiving the dividend is a member of an affiliated group with the payor-corporation, then the amount of the deduction is 100% of the dividend received.

Example: The Black Corporation owns 10% of the stock of White, Inc. White pays a \$1,000 dividend to the Black Corporation in the current year. Accordingly, Black is entitled to a dividends received deduction of \$700 (\$1,000 x

70%).

Example: The Enterprise Corporation receives a \$5,000 dividend from Universal, Inc. Enterprise owns all of the stock of Universal, and the two corporations are considered to be an affiliated group. Therefore, Enterprise is entitled to a dividends received deduction of \$5,000.

Caveat: It should be noted that the dividend must be included in gross income, and then Enterprise can take a deduction for \$5,000. These items cannot be netted against each other.

Net income limitation: The dividends received deduction is limited to a percentage of the taxable income of the payee-corporation. For this purpose, taxable income is calculated without regard to the dividends received deduction, any net operating loss deduction, and any capital loss carryback to the tax year in question.

Example: The Acme Corporation owns 25% of Eastern Corp. Eastern pays a dividend of \$120,000 to Acme. Acme's gross income from operations is \$2,000,000, and its operating expenses are \$2,100,000. Its allowable dividends received deduction is \$16,000 calculated as follows:

Gross income from operations	
Dividend income	
Less: expenses from operations	
Taxable income before the dividends received deduction	
Applicable percentage	
Allowable dividends received deduction	
\$ 2,000,000	
120,000	
-- 2,100,000	
20,000	
80%	
\$ 16,000	

Caveat: It should be noted that there is no carryover of the amount of the deduction that is not allowed. That is, in the above example, if the income limitation did not apply, the amount of the deduction would have been \$96,000 (\$120,000 x 80%). Since the deduction is limited to \$16,000, the difference of \$80,000 (\$96,000 -- \$16,000) cannot be carried forward.

Tax planning: In the above example, The Acme Corporation should have accelerated income so more of the dividends received deduction could have been used.

Comparing after-tax results: Corporations that have excess cash to invest should compare the after-tax income of dividend paying stocks to fixed income investments.

Example: The North Corp. has \$100,000 of excess cash that it would like to invest. It is in the 35% tax bracket. North has two alternatives: it can invest in a CD that pays 4% interest, or it can invest in the stock of ABC Corp. that

pays a dividend of 3%. Despite the fact that the rate of interest on the CD is greater than the dividend yield on the stock, if North invests in ABC stock, it will yield an additional \$85 on an after-tax basis compared to the investment in the CD:

Income before tax

$\$100,000 \times 4\%$

$\$100,000 \times 3\%$

Dividends received deduction

n/a

$\$3,000 \times .7$

Income subject to tax

Tax rate

Tax

After-tax income

$\$4,000 - \$1,400$

$\$3,000 - 315$

CD

\$ 4,000

n/a

\$ 4,000

35%

\$ 1,400

\$ 2,600

ABC Stock

\$ 3,000

-- 2,100

900

35%

315

\$ 2,685

Caveat: When investing excess cash, income taxes are just one consideration. There are many factors to be taken into account, such as a potential loss of principal. That is, there is a lesser chance of losing principal when investing in a CD, Treasury bill or money market fund.

Holding period: To prevent taxpayers from jumping in and out of a stock in an attempt to take advantage of this rule, the stock must be held for a certain number of days within a particular time frame. That is, to qualify for the deduction, stock has to be held for at least 46 days during the course of a 91-day period. This period begins on the date 45 days before the ex-dividend date of the stock [or the date the right to receive payment arises].

Example: Thomas, Inc. purchases 1,000 shares of XYZ stock on May 23, 2009. The ex-dividend date is May 30, 2009. The applicable holding period to be eligible for the deduction in this case starts on April 15. Thomas sells the stock on June 9, and receives the dividend on July 2. In this case, Thomas is not eligible for the deduction since it held the stock for only 17 days during the required holding period.

Dividends paid by foreign corporations: In general, the dividends received deduction is allowed when the dividend is received from a domestic taxpaying corporation. However, in certain situations, a dividend paid by a foreign corporation will qualify. That is, if a foreign corporation pays a dividend out of accumulated earnings and profits from a time when it was subject to U.S. taxation, the payee corporation will be allowed to take a dividends received deduction.

For 2009 low interest rates on treasury securities make this tax break better than ever: In the first part of 2009, interest rates on most Treasury securities are less than the rate of inflation. Indeed, stocks of many blue chip companies have a dividend yield higher than the interest rate on Treasury securities. Corporations that have an excess amount of cash should consider investing their excess cash in corporations that pay a generous dividend. By doing so, not only will they obtain a greater return on their investment, but they will obtain the generous tax break accorded dividend income.

Meaningfulness of dividends received under the Obama Administration: There are some rumors coming out of Washington D.C. that there will be a small reduction in corporate tax rates. In such a tax environment, the advantage of the dividends received deduction will not be quite as beneficial as in the past.

State income (franchise) taxes: Many states do not allow this deduction. Hence, corporations that qualify for this deduction on their federal tax returns may have to make an upward adjustment to their state taxable income.

RELATED LINKS: For further discussion, see

- LexisNexis Tax Advisor -- Federal Topical § 2B:6.03

For additional tax insights and developments, visit

- LexisNexis Tax Law Center

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Effect of New Pension Legislation in a Down Environment

2009 Emerging Issues 3322

Jayne Zanglein on The Worker, Retiree, and Employer Recovery Act of 2008

By Jayne Zanglein

January 29, 2009

SUMMARY: President Bush signed the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA) into law. The Act provides relief to workers, employers, and retirees affected by the current economic crisis. The Act includes significant retirement security provisions. In addition, the Act includes a vast array of technical corrections to the Pension Protection Act of 2006 (PPA). This analysis examines the Act.

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ARTICLE: President Bush signed the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA) into law on December 23, 2008. The Act provides relief to workers, employers, and retirees affected by the current economic crisis. The Act also includes significant retirement security provisions. In addition, the Act includes a vast array of technical corrections to the Pension Protection Act of 2006 (PPA). This analysis examines the Act, emphasizing the provisions that offer relief to workers.

MAIN ACT PROVISIONS

Temporary Suspension of Minimum Distribution Requirement

Section 201 of WRERA offers relief to employees. *Internal Revenue Code Section 401(a)(9)* requires plans to begin distributions to a worker no later than the April 1st following the year in which the employee reaches age 70.5 or retires. WRERA provides a one-year moratorium on the required minimum distribution rule, a change that is needed as employees choose to defer retirement in a worsening economy.

Planning Tip:

According to the 2008 Retirement Confidence Survey published by the Employee Benefits Research Institute and Matthew Greenwald & Associates, 8% of all workers over age 55 plan to continue working until death or disability and 11% of workers have no planned retirement date. This trend in delaying retirement has caused Congress to waive the minimum distribution requirement for the 2009 calendar year for employees enrolled in defined contribution plans, including Individual Retirement Plans and 457(b) governmental plans.

According to the Technical Explanation of the Act written by the Joint Committee on Taxation, in the case of an individual whose required beginning date is April 1, 2010 (e.g., the individual attained age 70 1/2 in 2009), the first year for which a minimum distribution is required under current law is 2009. Under the provision, no distribution is required for 2009 and, thus, no distribution will be required to be made by April 1, 2010. However, the provision does not change the individual's required beginning date for purposes of determining the required minimum distribution for calendar years after 2009. Thus, for an individual whose required beginning date is April 1, 2010, the required minimum distribution for 2010 will be required to be made no later than the last day of calendar year 2010. If the individual dies on or after April 1, 2010, the required minimum distribution for the individual's beneficiary will be determined using the rule for death on or after the individual's required beginning date. According to a press release issued by the Senate Committee on Finance, this provision allows workers to protect retirement savings so that they can avoid a tax hit when the market is down.

In addition, if in 2009 a plan distributes to a retiree an eligible rollover distribution that, absent the one-year moratorium, would have been a required minimum distribution, then the plan may offer the retiree the option to receive a direct distribution of this amount instead of requiring the retiree to roll over the amount. According to the Technical Explanation, the distribution will not be subject to the normal 20% excise tax. The plan must provide the retiree with a written explanation of the direct rollover requirement.

Minimum Funding Rules

WRERA Section 202 extends the PPAs transitional minimum funding rule for single-employer defined benefit plans for plan years beginning after 2007 and before 2011, even if the plans shortfall amortization base is not zero, as required under previous law. Under the revised rule, when determining whether a plan has a funding shortfall, a plan must consider only the applicable percentage of the funding target, not the plans entire funding target. A plan will not be required to establish a shortfall amortization base for a plan year in which the value of plan assets equals or exceeds the applicable percentage of the plans funding target for the year (92% for 2008, 94% for 2009, and 96% for 2010). Thus, under the revised transition rule, if a plan was funded at 91% for 2008, the funding shortfall for 2008 is 1% and the plan can use the transition rule in 2009, allowing it to fund 94% in 2009 rather than 100% as required by the previous rule.

Modification of Limitation on Benefit Accruals

The PPA requires a single-employer defined benefit plan to comply with funding-based limits on benefits and accruals. For example, if the plans adjusted funding target attainment percentage is less than 60% for a plan year, then all future benefit accruals must cease as of the plans next valuation date. WRERA Section 203 allows plans to look back to 2008 financial conditions by using their 2008 funding status as a base for 2009. The purpose of this provision, according to the Finance Committees press release is to stav[e] off restrictions on benefit accruals as a result of being less than 60% funded.

Delay of Designation of Multiemployer Plans as Being in Endangered or Critical Status

The PPA adopted Code Section 432, which authorizes additional funding rules for multiemployer plans that are in endangered or critical status, effective for plan years beginning after 2007. Section 432 requires an endangered multiemployer plan to adopt a funding improvement plan and requires a plan in critical status to adopt a funding rehabilitation plan. Plans in critical status are also required to make additional contributions and benefit reductions.

WRERA Section 204 provides a temporary delay in the designation of a multiemployer plan as being in endangered or critical status. For plan years beginning from October 1, 2008 to September 30, 2009, a plan may retain its status as non-endangered or non-critical for the upcoming year. Thus, if a plan is not in critical or endangered status for the 2008 plan year, it may retain this status for the 2009 plan year. Furthermore, a plan that is in endangered status for 2008 may retain this status for 2009 rather than being designated as a plan in critical status under prior Section 432.

If, however, the plan elects to keep its endangered or critical status, then the plan is not required to update its funding improvement or rehabilitation plan for the current year.

Temporary Extension of the Funding Improvement and Rehabilitation Plans

WRERA Section 205 allows the plan sponsor for a multi-employer plan to elect, for plan years beginning in 2008 or 2009, to extend the plans funding improvement or rehabilitation plan by three years.

OTHER RETIREMENT SECURITY PROVISIONS

The WRERA also adopted a number of significant revisions to the PPA beyond technical corrections. These revisions are addressed below.

Rules for Determining Minimum Required Contributions for Defined Benefit Plans

The PPA adopted new rules for calculating the minimum required contributions for defined benefit plans. Plan assets can be valued on the basis of averaging. WRERA Section 121 amends ERISA Section 303(g)(3)(B) and Code Section 430 (g)(3)(B) to clarify that under the averaging method, such averaging shall be adjusted for contributions, distributions, and expected earnings (as determined by the plans actuary on the basis of an assumed earnings rate specified by the actuary but not in excess of the third segment rate applicable under subsection (h)(2)(C)(iii)), as specified by the Secretary of the Treasury.

Modification of Interest Rate Assumption for Small Employer Plans

The WRERA amends Code Section 415(b)(2) to clarify that the interest rate assumptions applicable to small employers (i.e. employers with no more than 100 employees who receive at least \$5,000 in compensation from the employer) with respect to annual benefits payable under the plan when converting from a straight life annuity is not less than the greater of 5.5%, or the amount specified in the plan.

Determination of Market Rate of Return for Governmental Plans

The Age Discrimination in Employment Act deems certain hybrid defined benefit plans to be discriminatory unless the plan limits the annual interest credited to participants accounts to a market rate of return. WRERA Section 123

amends ADEA to provide that with respect to a governmental plan, a rate of return established pursuant to a federal, state, or local law, will be treated as a market rate of return and therefore, is a permissible method of crediting interest under ADEA's interest crediting requirement, unless the method violates another section of ADEA. As a result of this amendment, governmental plans will not have to modify their method of crediting interest on DROP accounts as long as the interest rate is authorized by state, federal, local or administrative law.

Treatment of Medical Care Reimbursements from Governmental Plans

WRERA Section 124 amends Code Section 105(b) to add a new provision that states that amounts paid to a taxpayer from an accident or health plan funded by a medical trust in connection with a public retirement plan is not excluded from gross income solely because the plan reimburses health care expenses on behalf of a deceased plan participant's beneficiary. This change was made to comport with *Revenue Ruling 2007-36*. The plan must have provided for the reimbursement on or before January 2008.

Airline Carrier Rules

WRERA Section 125 permits a qualified airline employee to contribute all or a portion of an airline payment amount to a Roth IRA within 180 days of receipt. WRERA Section 126 states that for purposes of determining the minimum required contributions under the special airline funding rules, plan assets may be valued using the valuation methods available to other single employer defined benefit plans. This allows airline carriers to value assets either based on fair market value or the averaging method authorized by Code Section 430(g)(3).

Penalties Related to Failure to File Partnership or S Corporation Returns

WRERA Sections 127 and 128 increase the penalty for failure to file partnership or S corporation returns by \$4 per partner or shareholder.

TECHNICAL CORRECTIONS TO THE PPA

Finally, WRERA contains a number of technical corrections to the PPA, including provisions that:

- Allow underfunded plans to pay a lump sum distribution of \$5,000 or less;
- Lift the combined defined benefit plan/defined contribution plan limit on deductions for the defined benefit plan if the contributions to the defined contribution plan do not exceed 6% of compensation. In addition, if contributions exceed 6%, then the limit applies only to the contributions over 6%;
- Require all plans to allow rollovers from the plan for nonspousal beneficiaries;
- Require a plan to include in its target normal costs all plan expenses expected to be paid with plan assets;
- Exclude from the Roth IRA contribution adjusted gross income limit rollovers from a Roth 401(k) or 403(b) to a Roth IRA;
- Clarify that the tax exclusion for up to \$3,000 per year for qualified retired public safety officers to pay for qualified

health insurance or long-term care applies to coverage provided by self-insured plans.

RELATED LINKS: For additional discussion and analysis, see Benders Federal Income Taxation of Retirement Plans, ■ 1-8 Federal Income Taxation of Retirement Plans § 8.02

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Jayne Zanglein teaches law at Western Carolina University. She is the co-author of the third edition of *ERISA Litigation*, which was published in December 2008. She has practiced employee benefits law for many years and is a frequent speaker on ERISA issues. She specializes in employee benefits law.

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Innocent Spouse Relief: Is Alioto a Change in IRS Position on Equitable Relief?

2009 Emerging Issues 3325

Bobbi Halpin on Innocent Spouse Relief: Does Alioto v. Commissioner Signal a Change in the Services Position Regarding Equitable Relief?

By Bobbi Halpin

January 29, 2009

SUMMARY: This Emerging Issues Analysis discusses the current state of innocent spouse relief and the impact of the prominent case of Alioto v. Commissioner, where the Tax Court vacated its previous dismissal of spousal relief and ruled in plaintiffs favor. The court also chastised the IRS for its refusal to grant the requested relief, finding that it was an abuse of discretion.

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ARTICLE: *Alioto v. Commissioner, T.C. Memo 2008-185: Innocent Spouse Relief (Equitable Relief) Determinations Reviewable by Court*

The widow of former San Francisco Mayor Joseph Alioto fought the Internal Revenue Service for many years, seeking innocent spouse relief (equitable relief) from tax debt for which she was jointly liable with her late husband. Mrs. Alioto conceded that the amount of the debt determined was accurate, and remained unpaid. However, at the time of her late husbands death in 1998. Mrs. Alioto discovered that he had sizeable unpaid debts to various creditors and the Internal Revenue Service, including tax debt attributable to Mayor Aliotos previous marriage. Mrs. Alioto requested innocent spouse relief from the tax debt pursuant to *IRC Section 6015(f)* (equitable relief), which relief was denied by the Service. Subsequent to Mrs. Aliotos request for relief, the Service seized substantial community property assets, including the proceeds from the forced sale of Mrs. Aliotos personal residence, to pay existing tax debt, including tax debt attributable to Mayor Aliotos former marriage.

Slowly but inexorably, the assets and estate of Mayor Alioto were reduced virtually to nothing. Mrs. Alioto, homemaker to the very wealthy attorney and politician for over 20 years, was obliged to accept at will employment that did not provide health insurance coverage for her and her child (who had epilepsy and required medical treatment for the condition). Mrs. Alioto had minimal assets, substantial health care expenses, and was approaching retirement age. It was clear that payment of the delinquent taxes would impose a severe hardship on Mrs. Alioto. Nevertheless, the Tax Court initially refused to review the Services refusal to grant relief on jurisdictional grounds, thereby effectively affirming the Services decision.

However, on rehearing, the Tax Court vacated its previous dismissal [T.C. Memo 2006-199] and ruled in Mrs.

Aliotos favor, finding that she was entitled to the relief sought. The court found, and the Service did not deny, that Mrs. Alioto had satisfied the requirements for the innocent spouse relief safe harbor set out in *Revenue Procedure 2000-15*, 2000-1 C.B. 447, § 4.02. In its holding the court chastised the Service for its refusal to grant the requested relief, finding that it was an abuse of discretion, arbitrary, capricious, and without sound basis in law or fact. [2008 Tax Ct. Memo LEXIS 181, *42]

The petitioner in this case was clearly entitled to relief under the Code and applicable revenue procedure. Yet the Service denied relief for years, and was very nearly able to deny it completely. To understand how and why this happened, it is necessary to peek behind the courts decision.

Why Did the Service Deny Relief to Which Petitioner Was Clearly Entitled?

Earlier decisions of the Tax Court and other courts interpreted the language of *IRC Section 6015* (regarding innocent spouse relief) to mean that the specific relief available under Section 6015(f) (equitable relief) was available only if a deficiency had been determined with respect to the taxes against which relief was sought. *Billings v. C.I.R.*, 127 T.C. 7 (2006); *C.I.R. v. Ewing*, 439 F.3d 1009 (9th Cir. 2006), *pet. for reh'g en banc den.* (May 10, 2006); *Bartman v. C.I.R.*, 446 F.3d (8th Cir. 2006), *pet. for reh'g en banc den.* (Aug. 3, 2006).

Subsequent to the rulings in these cases, the Service issued Counsel Notice 2006-020 (Aug. 25, 2006) to reflect what would be its new litigation posture: all cases for relief brought under *IRC Section 6015(f)* that did not involve the determination of a deficiency were not to be settled; instead, motions for dismissal for lack of jurisdiction were to be made regardless of the facts or merits, since the courts had no jurisdiction to hear such matters.

Practice Comment: The counsel notice did not specify that matters that had not reached the litigation stage were to be handled in a particular way. Keep in mind, however, that as a result of *Billings* and other cases, there was effectively no judicial oversight of the Services rejection of applications for equitable relief under Section 6015(f). Further, it was clear in the *Alioto* case at least that the Service was not applying its own standards for granting relief, as embodied in *Revenue Procedure 2000-15*.

Since, in her case, Mrs. Alioto was requesting relief with respect to tax debt that did not involve a deficiency, the Service routinely moved to dismiss her case, despite the fact that she clearly qualified for relief. The Tax Court, lacking jurisdiction according to its interpretation of the Code, had no choice but to dismiss the matter.

Why Did the Tax Court Change Its Mind?

Following the *Billings* decision, Congress amended *IRC Section 6015* to provide that Service determinations as to whether equitable relief was appropriate were reviewable by the courts even where there was no related deficiency determination. Pub. L. No. 109-432, 109th Cong., 2d Sess., § 408 (Dec. 20, 2006). After this amendment, Mrs. Alioto successfully petitioned the Tax Court to vacate the previous dismissal and reconsider the case.

In its final ruling, the Tax Court did not mention Counsel Notice 2006-020, but revealed its displeasure with the Services treatment of the plaintiff in other ways. The court repeatedly, and in excruciating detail, recited the facts demonstrating Mrs. Aliotos qualification for the relief sought. The court detailed the ways in which Mrs. Alioto satisfied the safe harbor provisions applicable under *Revenue Procedure 2000-15*. In its holding, the court referred to the actions of the Service in denying relief as arbitrary and capricious.

Practice Comment: Practitioners should note that, while the courts may now review the Services denial of innocent spouse relief when no deficiency is determined, the initial posture of the Service has not changed: that is, upon initial application, the Service may routinely deny innocent spouse relief, regardless of the facts. In this regard the position of the Service is the same as it ever was. Because litigation on this issue is likely, it is beneficial for the client to have legal representation early on in the matter.

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Bobbi Halpin is an attorney admitted to practice in New York and Pennsylvania. She is a frequent contributor to various Matthew Bender publications, including *Federal Taxation of Oil and Gas Transactions*; *Federal Income, Gift and Estate Taxation*; *LexisNexis Federal Tax Library*; and *Current Leasing Law and Techniques--Forms*. Ms. Halpin received a J.D. from New York Law School.

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Taxability of Foreign Companies' Fees for Bio-Analytical Services in India

2009 Emerging Issues 3313

Jyoti Dialani on No Tax on Fees for Foreign Companies Rendering Clinical & Bio-Analytical Services in India

By Jyoti Dialani

January 29, 2009

SUMMARY: This Emerging Issues Analysis discusses a recent ruling by the Authority for Advance Rulings (AAR) in India. The AAR provides tax relief to overseas companies engaged in providing research facilities for clinical and bio-analytical studies to Indian companies for developing new drugs if they do not have a Permanent Establishment in India.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE:

No tax on fees earned by overseas bio-research companies in India

Overseas companies rendering clinical and bio-research services in India for the purposes of developing new drugs or generic versions of existing drugs will benefit from a recent view taken by the Authority for Advance Rulings (AAR) in a ruling relating to a Canadian organization providing such services to pharmaceutical companies in India. This ruling has come in response to an application by the Canadian company before the AAR on a question whether the fee received by it from the two Indian pharmaceutical companies against services provided in the nature of conducting clinical and bio-analytical studies is subject to tax in India in accordance with the provisions of the domestic Indian tax law and the India-Canada Double Tax Avoidance Agreement (DTAA). The Canadian company, a contract research organization, had entered into agreements with two pharmaceutical companies in India for undertaking clinical and bio-analytical studies in the process of and for the development of new drugs. It received fees from the Indian companies for those services. Therefore, the vital issue raised before the AAR was on the nature of the income the Canadian company earned as well as the taxability of the same in India, in accordance with the tax treaties between the two countries and the tax law in India. After examining the nature of the services provided and the earnings of the Canadian company against those services, the AAR held the fee to be in the nature of business profits pursuant to Article 7 of the India-Canada DTAA and the same was held to be exempt from tax as the company did not have a permanent establishment (PE) in India. This ruling translates into considerable relief to all those overseas companies rendering similar services in India without having a PE in the country. On the issue of terming the services in the nature of technical services, the AARs view is that so long as there is no transfer of technology or know-how to the recipient of those services, the services cannot be classified as technical in nature. Further ahead, this commentary seeks to examine the specific facts of this case throwing light on the relevant Indian tax provisions as well as the India-Canada DTAA,

which is *pari materia* with the Indo-US DTAA, n3 therefore making this ruling applicable also to U.S. companies in similar business contracts with Indian companies.

Facts of the case

The application before the AAR in the case under discussion was filed by a company incorporated in Canada called Anapharm, Inc. (Anapharm), a company engaged in research based activities of a clinical and bio-analytical nature. The company has clients in the pharmaceutical industry all over the world with whom it enters into specific research services contracts aimed at assisting these companies in their objective of developing new drugs or generic versions of existing drugs in the market. Anapharm had entered into such contracts with some Indian pharmaceutical companies, namely, Sandoz and Ranbaxy, among others. According to the terms of its contracts, Anapharm carried out evaluations on the prospects of bioequivalence and the comparable bioavailability of new generic drugs in relation to the drugs preexisting in the markets. In the process of carrying out its activities, it had devised various methods and protocols for carrying out the evaluation work in conformity with international regulations. The reports produced by it were also acceptable to the regulatory authorities, including U.S. Food and Drug Administration (FDA). Before the AAR, while detailing the facts, Anapharm mentioned that all the methods/protocols developed by it belonged to it and were its exclusive property and that they were not given to its clients. The clients were also not given any technical plan or research process. The clients were merely furnished with final reports or deductions arrived at from the evaluations. Further, it was also clarified that the methods and protocols employed for one client could not be used for another in their drugs evaluations as they were entirely product specific. For each new drug, a fresh evaluation was required. Once the evaluation report was completed and provided by Anapharm, the clients would submit the same for approval to the regulatory bodies to market the new generic drugs. In lieu of these services, Anapharm would earn fees from the pharmaceutical companies.

Issue for consideration before the AAR

Based on the above facts, Anapharm filed an application before the AAR for an answer as to whether the fee received by Anapharm from Indian pharmaceutical companies on account of undertaking clinical and bio-analytical studies in terms of the agreements entered into with the said companies is subject to tax in India in accordance with the provisions of the Income Tax Act, 1961 n4 and Double Taxation Avoidance Agreement between India and Canada.

Submissions by Anapharm

Before the AAR, Anapharm submitted that it was a tax resident of Canada in terms of the treaty Canada had with India for avoidance of double taxation. On the income earned from India, it was pointed out that the fees received by it from the Indian companies were not fees for included services within the meaning of Article 12 of the India-Canada DTAA as the provision clarifies that any payment received in consideration of any technical or consultancy services can be classified as fees for included services only where such services make available technical knowledge, know-how, skill, experience or amount to the development and transfer of a technical plan or design. On the meaning of make available it was emphasized that technology can be considered to have been made available only when the other party is able to apply the technology by itself. It was further submitted that since the services rendered by it to its Indian clients did not satisfy the test of make available within the meaning of Article 12 of the DTAA, there was no transfer of any technical know-how or skills, plans or designs to the Indian pharmaceutical companies and, therefore, the fees did not constitute fees for included services under the DTAA. According to Anapharm, the fees earned by it from the Indian companies could only be categorized under business profits not taxable in India within the meaning of Article 7 read with Article 5 of the DTAA due to the absence of a permanent establishment (PE) in India.

Arguments raised by the revenue authorities

The revenue authorities contended that the fees earned by Anapharm was in fact not tax exempt in India as it fell

within the meaning of the definitions of fees for technical services as provided in section 9 of the Income Tax Act, 1961 (the Act) and fees for included services in Article 12 (4) of the India-Canada DTAA. In support of the contentions, certain clauses of the agreements of Anapharm with the pharmaceutical companies were highlighted which, according to the revenue authorities, led to an inference that the nature of the services rendered by it clearly fell within the definitions above. Some salient features of the services surfacing from the agreements were pointed out as follows:

- All data developed in the course of the study was agreed to be the sole and exclusive property of the Indian company to be used by them for any purpose, consistent with the provision of the agreement, including submissions to regulatory bodies for approvals.
- The Indian company was entitled to all rights in any invention, technology, know-how or other intellectual property directly and solely resulting from the provision of the services and Anapharm was not entitled to any such right.
- The Indian company was granted ownership rights to tested samples, test compounds and also patents arising from the research project.
- The Indian company was entitled to receive copies of all reports in the standard form and also entitled to use the results freely.

Based on the terms of the agreement and the nature of rights emanating from a reading of the agreements, the revenue authorities argued that since Anapharm was rendering technical expertise of a very high order likely to result in invention, know-how, patent or other intellectual property over which Sandoz and Ranbaxy would have full ownership. Therefore, according to the revenue authorities, it was not just a case of simply providing the final results of analysis to the Indian pharmaceutical companies and being more of a technical and complex nature, they fell within the definition of the term fees for technical services pursuant to section 9 of the Act and fees for included services within the meaning of Article 12 (4) of DTAA. It was also submitted that the income could be classified as royalty income under Article 12 of the India-Canada DTAA. Based on this argument, it was submitted by the revenue authorities that fees paid by the Indian companies to Anapharm would be taxable in India and therefore also subject to withholding tax under section 195 of the Act.

Analysis by the AAR

The AAR examined in detail the relevant provisions, section 9 of the Act and Article 12 of the DTAA, to determine their applicability on the facts of the case and the consequent taxability of the receipts in the hands of Anapharm. It was observed that there was a slight difference between the definitions of fee for technical/included services provided in both, section 9 and Article 12 as the requirement of paragraph 4(b) in Article 12 was absent in section 9. Section 9 merely required the rendering of technical services whereas Article 12 required the making available of technical knowledge, experience, etc., to the other party. Going further, the AAR went into the question of whether the services rendered by Anapharm to both the companies amounted to making available the technical knowledge, skills, expertise, know-how or processes by analyzing the clauses of both the agreements of Anapharm with the companies. Firstly, the AAR examined the facts of the case and the nature of services rendered by Anapharm to each of the two companies by understanding the services mentioned in the clauses of both agreements. Secondly, to understand the meaning of the expression make available, since the DTAA had not defined it anywhere, the AAR looked to the Indo-US DTAA, which was *pari materia* with the India-Canada DTAA and had a protocol annexed to the main body of the DTAA which was signed along with the convention. The protocol, which declared itself as an integral part of the convention, had a memorandum of understanding (MOU) which was intended to provide guidance to the taxpayers and authorities of both countries in interpreting Article 12 concerning the scope of included services. The MOU had provided the following clarification to Paragraph 4(b) of Article 12:

Paragraph 4(b) of article 12 refers to technical or consultancy services that make available to the person acquiring the service technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design to such person (For this purpose, the person acquiring the service shall be deemed to include an agent nominee, or transferee of such person.) This category is narrower than the category

described in paragraph 4(a) because it excludes any service that does not make technology available to the person acquiring the service. Generally speaking, technology will be considered make available when the person acquiring the service is enabled to apply the technology. The fact that the provision of the service may require technical input by the person providing the service does not per se mean that technical knowledge, skills, etc., are made available to the person purchasing the service, within the meaning of paragraph 4(b). Similarly, the use of a product which embodies technology shall not per se be considered to make the technology available.

Although the MOU did not refer to the India-Canada DTAA, the AARs view was that it was a valuable guide to understand the import of the expression make available. From a reading of this MOU, the AAR inferred that the mere provision of technical services was not sufficient to attract Article 12(4)(b). It was an additional requirement that the service provider should also make his technical knowledge, experience, skill, and know-how, etc., known to the recipient of the service to equip him to independently perform the technical function in future, without the help of the service provider. Accordingly, the AAR held that a payment of consideration would be regarded as a fee for technical/included services only if the twin test of rendering services and making technical knowledge available at the same time was satisfied. As to the nature of services rendered by Anapharm, the AAR observed that they were bio-analytical services which were very sophisticated and complex. However, since they were not revealed to its clients, namely Sandoz and Ranbaxy, and the methods of conducting those tests or the inputs were also not revealed which would otherwise enable them to carry out those tests themselves in future, it could not be said that the information and skills were made available to the recipients in compliance with the royalty provision in Article 12 of the DTAA. Further, the mere fact that the tests in question were highly technical in nature would not make a difference. Also, Anapharm had filed an affidavit which affirmed that only final results and a conclusion derived from data of bioequivalence tests were provided to the two companies.

However, clinical procedure and analytical methods, which were its proprietary items, were not transferred, assigned or handed over to any client. The agreement with Ranbaxy provided that Ranbaxy would be the owner of the tested samples and test compounds which would be made available to it by Anapharm after expiry of three months. The AAR noted that merely handing over tested samples and test compounds could not be equated with making technology, know-how, etc., available to Ranbaxy. The agreement also granted ownership rights to Ranbaxy with respect to all intellectual property resulting from the services and this, according to the AAR, also does not mean making available by Anapharm its technical expertise, know-how, etc., to Ranbaxy. Also that it was only natural that Ranbaxy, which has developed the generic drug should enjoy the intellectual property rights. Since the analytical test has not contributed to the development of a new generic drug and it had only shown whether that drug was as efficacious as the reference drug and there was a significant difference between the two, the AAR observed that a mere acquisition of knowledge of testing methods does not result in knowledge of the development of a new drug.

On the question regarding the fees as royalty income within the meaning of Article 12 of the India-Canada DTAA, the AAR studied the definitions of royalty by both, Article 12(3) of the DTAA as well Article 12(2) of the OECD Model Convention. Paragraph (3) of Article 12 of the DTAA states that royalty is payment of consideration for the use of, or the right to use any, copyright, patent, secret formula, process, information concerning industrial, commercial or scientific experience. Paragraph (2) of Article 12 of OECD Model Convention also defines royalty in a manner similar to paragraph (3) of Article 12 of DTAA.

The AAR also made a reference to the OECD commentary which states that information concerning industrial, commercial or scientific experience alludes to the concept of know-how which is all the concealed technical information that is necessary for the industrial reproduction of a product or process directly. Know-how represents what a manufacturer cannot know from mere examination of the product and mere progress of the technique. The commentary further states that a know-how contract differs from contracts for the provision of services, in which one party undertakes to use the customary skills of his calling to execute the work himself for the other party. It was observed that payments made under the latter contract generally come in the category of business income. Applying

these definitions to the facts of the case, the AAR held that the agreements of Anapharm fell in the latter category, as it used its experience and skill itself in conducting the bioequivalence tests, and provided only the final report containing conclusions, to the companies. The information concerning scientific or commercial experience of Anapharm or relating to the method, procedure or protocol used in conducting bioequivalence tests was not imparted to the pharmaceutical companies and the consideration was not paid for that purpose. Merely on the basis of the final report, the pharmaceutical companies would not be able to find out what method, procedure or protocol was used in conducting the tests. Further, the test reports being drug specific, the material furnished by Anapharm could not help the companies to facilitate further research and development of new drugs.

Conclusion of the AAR

Having perused the two agreements in detail, the AAR concluded that in the absence of any provision entitling the Indian companies to know the details of the analytical methods and procedures employed by Anapharm in carrying out the bioequivalence tests, it cannot be held that any skills or technical know-how or expertise were made available to the companies by Anapharm so as to apply the provisions of Article 12 of the DTAA classifying the fees as royalty. Based on the factual details and the analysis of agreements, law and provisions of the India-Canada and Indo-US DTAA, the AARs view was that the fees received by Anapharm were to be treated as business income and not royalty income. Consequently, in view of Article 7 read with Article 5 of DTAA, it was held that such income is taxable in India only if the assessee has a PE in this country. Since Anapharm had denied the existence of any PE in India and there was nothing on record to indicate anything to the contrary, the AAR held that the existence of PE in India also could not be inferred. Thus, the fees paid by the two Indian pharmaceutical companies to Anapharm in respect of bioequivalence tests conducted by it were held by the AAR to be in the nature of business profits under Article 7 of the DTAA and the same was also held not taxable in India as Anapharm did not have a PE in the country.

Impact of the ruling

Although rulings by the AAR are not binding precedents, they do have persuasive value in cases before judicial authorities and hence, though not a path breaking decision, it does provide a ray of hope to all those companies based overseas which engage in rendering similar services to companies in India insofar as their income is not royalty or fees for technical services, which will depend on the specific facts of each case. Their entire income received from such services will be exempt under Indian tax law provided they do not have permanent establishments in India.

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n1 An authority constituted by the Central Government under S. 245-O of the Act for giving determinations called advanced rulings in relation to a transaction undertaken or proposed to be undertaken by a non-resident applicant on issues pertaining to tax liabilities on proposed transactions.

n2 Complete text of the treaty can be found at the official website of the AAR at http://www.taxmann.net/DirectTaxLaws/cbdt/dta2008/A1_Canada.htm.

n3 Complete text of the treaty can be found at the official website of the AAR at http://www.taxmann.net/DirectTaxLaws/cbdt/dta2008/A1_Usa.htm.

n4 The official link to the Government of India, Ministry of Finance website containing the updated Income Tax Act, 1961 is <http://law.incometaxindia.gov.in/TaxmannDit/DisplayPage/dpage1.aspx>.

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Jyoti Dialani is a qualified Solicitor, England & Wales, enrolled with the Law Society, London and a Licensed Attorney in the Bombay High Court, India. Attached to Morgan Walker Solicitors LLP, London, she specializes in Direct Taxes. Previously, she was practicing as a Counsel in Direct Tax Litigation in Mumbai for eight years. She is a Master in Laws from Bombay University and a Solicitor from the Supreme Court of England and Wales, London. She has been actively involved in professional associations in India such as the Chamber of Tax Consultants and All India Federation of Tax Practitioners as a member of various committees. She has authored a book on Indian Contract Law and has several articles in reputable journals to her credit.

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The Tax Axe on Cross-Border Deals in India -- A Perspective

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Jyoti Dialani on the Tax Axe on Cross-Border Deals in India -- A Perspective

By Jyoti Dialani

October 21, 2008

SUMMARY: Recently the Income-tax Department in India has focused on foreign companies involved in acquiring companies by purchasing controlling stakes in Indian companies by foreign companies usually routed through tax havens such as Mauritius, Cyprus and the Cayman Islands. This commentary looks at developments in a few offshore cases and the viewpoints of the Department and the taxpayer, who in this case is the foreign investor in India.

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ARTICLE: Over the last 15 years, with the advent of economic liberalization, India has witnessed a massive paradigm shift in various spheres, with promising potential to drive the country among the leading global economies. With a burgeoning growth of talent and skills, India is seen as a major source of skilled professionals. One of the key contributors to this steady uphill climb has been the shift in economic policies from the archaic closed door policies to the current platform characterized by more transparent and liberal rules and procedures, which has led to a tremendous growth in Indian capital markets and industry fuelled largely by foreign investments.

Over the years, foreign players have entered the Indian markets in sectors of technology, telecom, manufacture, service industry and consumer durables and appliances, to name a few arenas, and it has been a mutually beneficial journey to India as well as the investing countries. It is in this progressive climate that certain leading foreign players are facing slight stumbling blocks due to the recent turn of events resulting from the actions taken by the Income-tax Department. Although the impact is not so severe as to create a negative influence on the overall investor confidence, it has certainly caused some minor hiccups in the investor circles due to projected huge demands of tax running into billions of dollars collectively on the current group of players who seem to have a feeling of treading on shaky ground so far as their tax liabilities in India are concerned.

Lately the Income-tax Department has turned its gaze on certain transactions involving foreign companies having an impact on Indian markets regardless of the absence of any Indian company in such deals. It has cast its net wide recently, slapping notices on several companies who are party to cross-border mergers and acquisitions. Foreign companies which have executed contracts with regard to any business interests in India are facing action from the Department in the form of enquiry notices calling for detailed records and information and even notices of tax demands resulting in a plethora of legal action against such notices and demands.

This commentary will unravel the details of individual cases of foreign companies which seem to be sailing in similar waters and try to present the current position with respect to each of such companies which will detail the facts and subtle lines of distinction between them against the standing legal position.

Vodafone UK Hutchison Hong Kong deal

In May 2007, telecom giant Vodafone International Holdings BV (Vodafone), a Netherlands-based company, headquartered in London, bought CPG Investments Ltd. (CPG), a 100 percent subsidiary of Hutchison Telecommunications International Ltd. (Hutch), a mobile phone services unit of Hong Kong-based company, Hutchison Whampoa Ltd. CPG, which owns eight companies in Mauritius, was a company registered in the Cayman Islands having a majority stake in Hutch-Essar, an Indian company. The transactions of Vodafone's acquisition of CPG from Hutch resulted in Vodafone acquiring a majority stake of 67% in Hutch-Essar for a total consideration of over 11 billion dollars. This acquisition by Vodafone of the direct majority holding in Hutch-Essar came under the Income-tax Departments lens. In August 2007, the Department served a show cause notice on Vodafone-Essar for a probable capital gains tax demand amounting to about 1.7 billion dollars resulting from the transaction. In the notice, the Department asked Vodafone-Essar to show reasons why it should not be treated as an agent of the non-resident company, Hutch, under section 163 of the Income-tax Act, 1961ⁿ¹ (the Act). The tax authorities are claiming capital gains under section 9(1)(i) of the Act as they are of the view that the transaction involved a transfer of an Indian asset for which approval of the Foreign Investment Promotion Boardⁿ² (FIPB) was sought. Vodafone-Essar has submitted to the tax authorities that the transaction having been structured through Mauritius would not attract tax in India as the country has a double taxation avoidance agreement (DTAA) with Mauritius. However, the authorities hold a view that since Hutch's wholly owned subsidiary, CPG Investments, which was bought out by Vodafone as a part of the deal, is based in the Cayman Islands, the transaction can be brought within the tax net in India.

Analysis of the relevant provisions of the Income-tax Act, 1961

Section 160 of the Act defines a representative assessee as follows:

Representative assessee.

160. (1) For the purposes of this Act, representative assessee means

(i) in respect of the income of a non-resident specified in sub-section (1) of section 9, the agent of the non-resident, including a person who is treated as an agent under section 163.

Section 161 sets forth the liability of a representative assessee.

Section 163 defines agent in relation to a non-resident. The relevant part of the definition is as follows:

Who may be regarded as agent.

163. (1) For the purposes of this Act, agent, in relation to a non-resident, includes any person in India

(a) who is employed by or on behalf of the non-resident; or

(b) *who has any business connection with the non-resident; or*

(c) *from or through whom the non-resident is in receipt of any income, whether directly or indirectly; or*

(d) who is the trustee of the non-resident;

and includes also any other person who, whether a resident or non-resident, has acquired by means of a transfer, a capital asset in India. [emphasis added]

Therefore, a person who has a business connection with a non-resident or who is in receipt of any income, directly or indirectly, from a non-resident is stated to be an agent of such a non-resident for the purposes of classification as a representative assessee.

Taking the above relevant provisions into consideration, the Department has sought to attract provisions of section 201 to the case of Vodafone-Essar. Section 201 of the Act has been amended in this years budget with retrospective effect from June 1, 2002, which seeks to clarify that a person required to deduct tax at source but failing to do so will be deemed to be an assessee in default. In other words, the person who is responsible to deduct tax at source from a person but fails to do so and pay the Income-tax Department will be deemed an assessee in default, and will then take the place of the payee from whom such tax was not deducted. Such a person will be liable to pay the tax as the liability of the payee shifts on the latter.

The relevant part of section 201 post amendment is as follows:

Consequences of failure to deduct or pay.

201. (1) Where any person, including the principal officer of a company,

(a) *who is required to deduct any sum in accordance with the provisions of this Act;* or

(b) * * * ,

does not deduct, or does not pay, or after so deducting fails to pay, the whole or any part of the tax, as required by or under this Act, then, such person, shall, without prejudice to any other consequences which he may incur, be ***deemed to be an assessee in default in respect of such tax:*** [emphasis added]

Before the amendment, only a certain category of persons required to deduct tax under the Act were covered under section 201 as assessee in default. With the amendment taking effect, section 201 has included all such persons who are required to deduct tax under the Act.

How the Income-tax Department has sought to invoke provisions of section 201 on Vodafone

By virtue of the amendment to section 201, Vodafone, as the buyer of shares in Hutch-Essar, is liable to deduct tax at source from the consideration paid to the seller. However, since Vodafone has failed to do so, with section 201 being retrospectively amended, it brings Vodafone within its ambit as assessee in default due to non-deduction of tax at source from the consideration paid to Hutch-Essar, the Indian company, which is liable to pay capital gains tax in India on the gains made in the transaction. Income tax authorities are claiming capital gains under Section 9(1)(i) of the Act since their view is that the transaction involved the transfer of an Indian asset for which approval of the FIPB was sought.

The relevant part of section 9(1)(i) is as follows:

Income deemed to accrue or arise in India.

9. (1) The following incomes shall be deemed to accrue or arise in India:

(i) all income accruing or arising, whether directly or indirectly, through or from any ***business connection*** in India, or through or from any property in India, or through or from any asset or source of income in India, or ***through the transfer of a capital asset situate in India.*** [emphasis added]

The Income-tax Departments position is that Vodafone ought to have deducted tax at source under section 195 of the Act.

The relevant part of section 195 is as follows:

Other sums.

195. [(1) Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest or any other sum chargeable under the provisions of this Act (not being income chargeable under the head Salaries) shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income tax thereon at the rates in force:

Thus, section 195 of the Income-tax Act, 1961 casts an obligation on a person responsible for paying any sum which is chargeable to tax in India to a non-resident to deduct income tax at source at the time of payment or credit. This liability to deduct tax applies to non-residents as well as residents. Thus, a non-resident purchaser (the payer) is liable to deduct the tax at source from the consideration paid to the seller if the transaction is liable to tax in India. Based on this principle, the liability for deduction of tax is on the transferee company. The tax liability in substance lies on the seller due to capital gains, which in the given case is Hutch but since the Department could not initiate process against the company in Hong Kong, the notice was issued to Vodafone-Essar (buyer) for recovery of the tax amount.

Subsequent developments

Faced with a potential tax demand of 1.7 billion dollars, Vodafone-Essar sought to have the show cause notice quashed by filing a writ petition before the Bombay High Court with a prayer to also grant an injunction to seek a stay on further proceedings on recovery by the Income-tax Department. In its writ before the Court, Vodafone-Essar raised a plea that as the buyer of the shares; it was not liable to pay taxes in India. It was the contention of Vodafone-Essar that it is the seller who is liable to capital gains tax. The writ petition challenging the income tax notice was based on the following grounds:

i) The sale of Indian company Hutch-Essar shares by the Hong Kong-based Hutch to Vodafone was a transaction that took place outside India and, therefore, the Indian tax authorities have no *locus standi* on the deal as any gain on the sale of shares cannot be considered to have accrued in India.

ii) Vodafone-Essar has no tax liability in India on account of the deal as it was the buyer and not the seller of the shares and, hence, there was no question of capital gains tax liability.

Another basis for its contention was that since the transaction between Hutch and Vodafone was structured through Mauritius, it would not be subject to tax in India as India and Mauritius have a treaty to avoid double taxation. On the other hand, the Income-tax Department, in the proceedings, took a stand that the profit accruing to Hutch in the sale of its Indian stake to Vodafone was generated in India. Another argument advanced by it was that as most of the assets in the deal were based in India and because, under Indian tax law, buyers have to withhold capital gains tax liabilities and pay them to the government, as the purchaser in the deal, Vodafone was under an obligation under the law to pay the withholding tax in India before paying the consideration to Hutch. Also, the Income-tax Departments view was that since the subsidiary was owned by Hutch, i.e., CGP, which was acquired by Vodafone as a part of the deal was based in the Cayman Islands, it was taxable in India. Accordingly, the Income-tax Department asserted that Vodafone-Essar should be treated as an agent of the non-resident Hutch under section 163 of the Act. It emphasized the liability of Vodafone-Essar as payer in the transaction inasmuch as the liability of a payer and payee is different and hence, as

payer, it ought to have deducted tax at source before making the payment to Hutch to have the same deposited with the Government.

Amendment of section 201

In the background of the case, the amendment to section 201 of the Act, made with retrospective effect from 2002, has assumed vital importance. As per the amended law, the buyer of the shares is also liable to pay taxes in India. Therefore, *prima facie*, the amendment, if applicable to the facts of the given case, will go against Vodafone-Essar, who is the buyer in the deal. This amendment, by virtue of its retrospective operation, will effectively weaken the stand taken by the company that even if the deal is taxable, Vodafone-Essar, being the buyer, is not under an obligation to pay tax in India.

Current status of the case

The writ petition filed by Vodafone-Essar was admitted by the Bombay High Court with stay on further proceedings against it by the Department pending final disposal of the writ. In the course of the hearing, the Division Bench observed that the deal, as claimed by Vodafone-Essar, was not just a simple case of a transfer of shares between two foreign companies. It highlighted the fact that the sale of shares was with the approval of FIPB, which was subject to compliance with Indian laws and regulations, including the Indian tax laws. Having made the observation, the Court admitted the petition to determine the maintainability and merits of the case. It also continued the stay granted to Vodafone-Essar pending the final disposal with no requirement on Vodafone-Essar to file any further documentation at that point. The case was scheduled for a final hearing on March 11, and during the hearing the Vodafone-Essar lawyers indicated their intention to challenge the retrospective operation of the amendment proposed to section 201 of the Act by the Finance Bill of 2008 after passage of the bill, as it would have a strong impact on the case. The amendment to the provision was in fact incorporated in the budget proposal after the writ petition against the notices issued by the Income-tax Department was filed by Vodafone-Essar before the Court. The Bench's view was that if Vodafone intended to challenge any new provisions in the finance bill, conducting the hearing prior to passage of the bill would not serve any purpose and, hence, giving directions to Vodafone-Essar to amend the petition with fresh pleas, the next hearing date was adjourned until June 23, 2008, i.e., after the bill becomes law, which would ensure a comprehensive hearing addressing all issues.

Analysis

It is believed by some professionals that by taking the action against Vodafone-Essar, the Income-tax Department in India is attempting to lift the corporate veil, which is a measure usually adopted in cases of fraud and legal violation. It is felt that since Hutch, the Hong Kong-based company, had not paid any tax on the deal, the amendment in the law would ensure that Vodafone, the buyer, pays the tax. If Vodafone-Essar is held to be an agent of Hutch by the Bombay High Court, then in the view of some tax experts, the Income-tax Department can proceed to assess it as the agent for recovery of various tax liabilities on transactions of the non-resident Hutch. Some experts also hold a view that since the amendment is introduced in this year with a retrospective effect, it in a way vindicates Vodafone-Essar's position that under the pre-amended law, there was no obligation on it to pay any tax to the Indian tax authority. The final outcome of the writ petition is being watched closely by foreign investors as it will have a significant impact on foreign companies plans to acquire Indian firms.

Other foreign investors facing tax probes

Vedanta-Sesa Goa deal. Close on the heels of the Vodafone-Hutch transaction, the Income-tax Department has turned its attention to the acquisition of India's largest private iron ore exporter, Sesa Goa, by a UK-based mining company, Vedanta Resources. The total consideration for the acquisition is about 981 million dollars. The action taken by the Department is a notice served on Sesa Goa under section 133 (6) of the Act, seeking details of its acquisition by Vedanta Resources.

The relevant part of the provision reads as follows:

Power to call for information.

133. The Assessing Officer, the Deputy Commissioner (Appeals), the Joint Commissioner or the Commissioner (Appeals) may, for the purposes of this Act, * * *

6) require any person, including a banking company or any officer thereof, to furnish information in relation to such points or matters, or to furnish statements of accounts and affairs verified in the manner specified by the Assessing Officer, the Deputy Commissioner (Appeals), the Joint Commissioner or the Commissioner (Appeals), giving information in relation to such points or matters as, in the opinion of the Assessing Officer, the Deputy Commissioner (Appeals), the Joint Commissioner or the Commissioner (Appeals), will be useful for, or relevant to, any enquiry or proceeding under this Act:

The provision empowers the Department to call for information in relation to any case or transaction, which in the opinion of the assessing authorities will be relevant to or necessary to continue proceedings under the Act. The section thus gives wide powers to the assessing authorities to secure information and details pertaining to cases where they have reason to believe that income has escaped assessment of tax.

This notice enables the Department to strengthen its case against an assessee who it believes has been a party to any transaction which has resulted in non-payment or short payment of taxes.

In April 2007, Vedanta Resources acquired a majority stake of 51% in Sesa Goa from an offshore company called Mitsui. The transaction took effect with Vedanta acquiring 100% of a UK-based company called Finsider International, a company having controlling stakes over Mitsui's interests in Sesa Goa. The company had subsequently also made an open offer to acquire 20% of shareholding in Sesa Goa from its retail shareholders. From the trend and pattern of actions taken by the Department, it is evident that the authorities have been issuing notices and seeking information on the transfer of shares of companies situated outside India having subsidiaries in India, where transactions concerning such companies due to a change in the overseas shareholding result in a change in the effective ownership interests in the Indian subsidiaries as well without actually changing the shareholding pattern.

AT&T-Tata deal. On March 28, 2008, the Income-tax Department raised a tax demand of Rs 45 crore (about 11.25 million dollars) on an Indian company, Tata Industries Ltd. (Tata), on a transaction of its acquisition of stakes in an Indian company, Idea Cellular, from a US company, AT&T. Tata had acquired the stake through a purchase of shares of AT&T Cellular Services Mauritius Pvt Ltd. (AT&T Cellular), a company owned by AT&T, USA, incorporated and registered in Mauritius on September 28, 2005, for a total consideration of about 165 million dollars. Idea Cellular was proportionately held by the two Indian business groups, namely, Tatas and Birlas, and AT&T Cellular. AT&T US sold interest in its Indian arm, Idea Cellular, by selling shares of its Mauritian subsidiary, AT&T Cellular, to the Tatas. However, since AT&T Cellular was jointly held by two US companies, Cingular Wireless Services, Inc. and MMM Holding LLC, the Tatas had to sign the deal with these two US companies for acquiring the shares of AT&T Cellular. After the exit of AT&T, the Income-tax Department proceeded to investigate the transaction and treated it as one between an Indian company and a US company. Like in the case of Vodafone, the Income-tax

Department also treated Tata as an agent under section 163 of the Act and held it to be an assessee in default under section 201 of the Act for failure to deduct tax at source while making payment of the consideration to the two US-based companies. The Department's view is that AT&T US is taxable on the transaction on the grounds that the Mauritian entity is merely a conduit enabling the main transaction as its sole assets comprised only of holdings in Idea Cellular, the Indian company. Explaining the route of the transaction, the Department claims that the gains made from the transaction had an economic and territorial nexus with India as they resulted out of a transfer of a capital asset situated in India. The Double Taxation Avoidance Agreement (DTAA) between India and the United States provides that the right to tax capital gains is in accordance with domestic tax laws of the country where the gain arises. Upon examination of the steps taken by the Department, it is obvious that in such cases the Department is attempting to lift the corporate veil in such transactions, which is an extreme step. However, the Department holds a strong contention that it is empowered to lift the corporate veil or ignore the shell structure in transactions where it becomes necessary to do so in order to determine taxability of such transactions. Tata maintains its position that since there was no transfer of capital assets in India in the transaction executed overseas, it is not liable to pay tax in India.

Situs of the assets

The situs of a capital asset of a company is the place where registers of the members of the company are kept and maintained. AT&T Cellular is based in Mauritius; therefore, the situs of the shares is in Mauritius. Tata's position is that since India has a DTAA with Mauritius, no tax claims can be made in India for the purchase of the stakes of Idea Cellular from the Mauritius-based AT&T Cellular.

Recent developments

In May, the Income-tax Department has also issued notices to AT&T US calling upon it to file returns in India giving details of the transaction of the sale of its stake in Idea Cellular to the Aditya Birla group. The Department has initiated a notice issuance spree as is seen in this case and in the cases discussed previously, and is exploring all possibilities of potential tax demands which can be raised on the recent cross-border acquisitions of Indian entities. By this latest notice on AT&T US, the Department can levy a penalty on AT&T US for failure to file tax returns of income which amount can be assessed at 100% to a maximum of 200% of the total tax sought to be evaded. Also, by having AT&T file its returns in India, the Department seems to be taking steps to bring the deal between the Aditya Birla group and AT&T deal under the tax net. This notice has also stirred up a significant controversy in view of the fact that the Aditya Birla group had already secured a no-objection certificate (NOC) from the Income-tax Department before making payment to AT&T US of approximately 165 million dollars for acquisition of its controlling stake in Idea Cellular. However, the Department has clarified that the NOC given to the Aditya Birla group was provisional in nature. Therefore, it was not a deterring factor to the Department from the viewpoint of initiating process of enquiry or issuing notices in respect of the transaction. The tax authorities maintain that they have a *locus standi* on such deals as long as the business and profit are generated in India. They maintain that any deal struck overseas, even if it is between non-resident or foreign companies based outside of India, if it brings about a change in ownership of Indian companies, is liable to be taxed in India. In the earlier cases of Vodafone-Hutch and Vedanta-Sesa Goa, the Department had only initiated a process of enquiry. However, the AT&T-Tata deal is the first of its kind, i.e., a change of ownership due to a transfer of shares in an offshore company, which has faced a notice of demand under section 156 of the Act to pay the amount of tax assessed. Although Tata has paid the demanded amount, it is pursuing remedial legal action available to it under the law against the said demand.

Afterthoughts

The Vodafone-Essar deal has generated several questions amongst the tax circles in India. One question raised is whether a non-resident seller is liable to tax in India on sale of shares of a foreign investment company. The other crucial question is whether a non-resident purchaser is liable for the deduction of tax on a purchase of shares of the foreign investment company at the time of payment to the non-resident seller. Also, a question which deals with an important part of the Vodafone-Essar case is whether the Indian company can be treated as an agent of the non-resident purchaser and held liable for deduction of tax. Although it is a commonly followed practice among multinational corporations to establish investment companies in tax haven jurisdictions like Mauritius or the Cayman Islands for the purpose of holding their stakes in Indian companies, it is a recent phenomenon that the Income-tax Department sit up and take notice of such arrangements and to play a proactive role in bringing acquisitions of such companies within its tax net.

Generally, it has been well accepted that any transfer of shares of such an investment company established outside India by the MNC is not taxable in India, as the transfer pertains to shares of a foreign company by a non-resident. Section 9(1)(i) of the Act speaks of taxability on the basis of location of an asset in India. It says that income is deemed to accrue or arise in India if it is from the transfer of an asset situated in India or through or from a business connection in India and hence liable to tax in India. In the current case, the transfer that took place was of shares in an investment company situated outside India. Since the shares, the subject of the transfer, were located outside India, such a transaction cannot be made liable to tax in India. However, the Income-tax Department has taken the position that in effect the transfer in the specific case amounted to a transfer of the beneficial interest in the shares of the underlying Indian company, i.e., Essar, and hence the transaction is taxable in India. Another point where the Department has placed a strong reliance is the fact that Hutch and Vodafone had to secure an approval from certain Indian authorities including the FIPB. According to the Department, the fact that an approval was needed from the FIPB further supported the belief of the existence of the underlying asset in India. This, according to some experts, seems to be a clear case of tax authorities attempting to lift the corporate veil. Although investments from countries such as Mauritius and Cyprus do not attract capital gains tax in India due to the existence of the DTAA with those countries, in the given case, since the non-resident seller of shares is a Hong Kong-based company, the tax authorities have sought to tax the transaction as India does not have any DTAA with Hong Kong and thus no treaty benefit could be availed of in the case.

On the aspect of agent, since the definition of an agent under section 163 of the Act includes a person who has a business connection with the non-resident, the tax authorities have invoked section 163 on Vodafone-Essar considering it as an agent of the seller non-resident company merely because it is a subsidiary of the non-resident. It can be safely concluded at this stage that all the issues penned above which are before the Bombay High Court will take a long-drawn-out legal battle, which will impact several non-resident investors who are awaiting the final outcome of the decision. The India-Mauritius DTAA was signed years ago for the purpose of encouraging investments into India by providing incentives and opportunities for tax planning. The treaties provided an impetus to foreign investments in India. Today, if companies are using the treaties to their advantage in terms of tax planning on transactions pertaining to India, the sudden alert of the Income-tax Department on such deals seems to suggest that the earlier use of treaties, which was considered good tax planning, is now being regarded as tax evasion by the authorities. Until such treaties are in existence, the Government should not cast a probing eye on transactions routed through such countries and if it is required to do so, they can alter the terms of the DTAA accordingly to plug any loopholes. Also, it is an accepted principle that the right to lift the corporate veil must be exercised only under certain exceptional circumstances where it is imperative to do so to detect tax evasion and avoidance, specifically in cases of suspected fraud or gross negligence. However, if the parties to a transaction are well within the ambit of the tax treaties without any violation of provisions containing any anti-avoidance measures, any measures adopted by them, whether by way of acquisitions of controlling stakes in offshore companies or otherwise, should not be treated as tax evasion or avoidance or as colorable devices.

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n1 The full text of the Act can be found at the official website of the Finance Ministry at <http://law.incometaxindia.gov.in/TaxmannDit/DisplayPage/dpage1.aspx>.

n2 A special Board set up by the Government of India with a view to promote foreign direct investments (FDI) into India by facilitating them through negotiations and clearances of proposals. Information on FIPB can be found at http://finmin.nic.in/the_ministry/dept_eco_affairs/fipb/fipb_index.htm.

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New Bailout Legislation Contains Extensive Tax Provisions

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By Jerry Paulukonis

October 15, 2008

SUMMARY: The financial markets bailout bill (H.R. 1424) was enacted as Public Law 110-343 on October 3, 2008. The legislation contains extensive amendments to the Internal Revenue Code, including credits, AMT, executive compensation, and depreciation. The legislation is a combination of different pieces of legislation, such as the Extenders Bill. The legislation is of interest to Wall Street and Main Street in dealing with the current financial crisis.

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ARTICLE: Bailout Legislation (Public Law 110-343) Contains Extensive Tax Provisions

The financial markets bailout bill (H.R. 1424) was enacted as Public Law 110-343 on October 3, 2008. The legislation (henceforth referred to as the Act) contains extensive amendments to the Internal Revenue Code. This article details the tax highlights of the legislation.

AMT Provisions

The Act contains several provisions affecting the alternative minimum tax:

- . It increases the AMT exemption amount for tax years beginning in 2008 only to \$69,950 for joint filers and surviving spouses and \$46,200, *IRC* § 55(d). For 2007, these amounts were \$66,250 and \$44,350, respectively.

- . It increases the AMT refundable credit amount for individuals with long-term unused credits for prior year minimum tax liability. Effective for taxable years beginning after December 31, 2007, the AMT refundable credit amount means with respect to any taxable year, the amount (not in excess of the long-term unused minimum tax credit for the taxable year) equal to the greater of (1) 50 percent of the long-term unused minimum tax credit for the taxable year, or (2) the amount (if any) of the AMT refundable credit amount determined for the taxpayer's preceding taxable year. The AMT refundable credit amount for this purpose does not include any increase related to interest and penalties already paid with respect to incentive stock options that would have been abated had they not been paid, *IRC* § 53(e)(2); see, *IRC* § 53(f)(2). Relief is given to taxpayers who incurred significant AMT liability resulting from AMT treatment of incentive stock options under *IRC* Section 56(b)(3). Many taxpayers were subject to AMT on phantom income when their ISO stock plunged in price after they exercised an option to purchase. The Act abates any underpayment of tax

outstanding on October 3, 2008 that is attributable to the AMT treatment of ISOs, *IRC § 56(b)(3)*, for any taxable year ending before January 1, 2008. Any interest or penalty with respect to any underpayment that is outstanding on October 3, 2008 is also abated. The amount of a taxpayers minimum tax credit see, *IRC § 53(b)(2)*, does not include any tax abated under this provision, *IRC § 53(f)(1)*. For taxpayers who have already paid interest and penalties related to ISO AMT liabilities, the AMT refundable credit amount, and the minimum tax credit, *IRC § 53(b)(2)*, for the taxpayer's first 2 taxable years beginning after December 31, 2007, are each increased by 50 percent of the aggregate amount of the interest and penalties which were paid by the taxpayer before October 4, 2008, and which would (but for that payment) have been abated under *IRC Section 53(f)(1)*, *IRC § 53(f)(2)*. The new increase in the standard deduction allowed by virtue of a disaster loss deduction see, *IRC § 63(c)(1)(D)*, discussed below, is allowed in computing alternative minimum taxable income, *IRC § 56(b)(1)(E)*. The new federal provision allowing a 5-year NOL carryback for losses attributable to federally declared disasters, *IRC § 172(b)(1)(J)*, (j), *discussed below*, also applies for AMT purposes, *IRC § 56(d)(3)*.

Child Tax Credit

The Act provides a reduced income threshold (\$8,500, rather than the \$10,000) for calculating the refundable portion of the child tax credit. The reduced dollar threshold applies only for tax years beginning in, 2008. *IRC § 24(d)(4)*.

Extensions and Modifications of Expired or Expiring Credits

The credit for nonbusiness energy property previously expired, for property placed in service after 2007. The credit has been revived for one year, for property placed in service in calendar year 2009. The credit is not available for property placed in service during 2008. *IRC § 25C (g)*. The following changes are also made to the credit:

- . Biomass fuel property is added to the list of qualified energy efficient building property that is eligible for a \$300 credit, *IRC § 25C (b)(3)(C)*. Biomass fuel property is a stove that burns biomass fuel to heat a dwelling unit located in the United States and used as a principal residence by the taxpayer, or to heat water for such dwelling unit, and that has a thermal efficiency rating of at least 75 percent, *IRC § 25C (d)(3)(F)*. Biomass fuel is any plant-derived fuel available on a renewable or recurring basis, including agricultural crops and trees, wood and wood waste and residues (including wood pellets), plants (including aquatic plants), grasses, residues, and fibers, *IRC § 25C (d)(6)*.

- . The credit for geothermal heat pumps is eliminated to conform with the establishment of a residential geothermal heat pump credit under, *IRC Section 25D*, discussed below, *IRC § 25C (d)(3)(C)* repealed.

- . Water heater requirements are also modified to also qualify if they have a thermal efficiency of at least 90 percent, *IRC § 25C (d)(3)(E)*.

- . Asphalt roofs with appropriate cooling granules are added as a qualified energy efficiency improvement and as a building envelope component, *IRC § 25C (c)(1)*, (2), effective for property placed in service after October 3, 2008.

The credit for residential energy efficient property is extended for 8 years, through December 31, 2016, *IRC § 25D (g)*. The following amendments are also made to the credit, effective for taxable years beginning after December 31, 2007 (unless otherwise noted):

- . The credit may be claimed against the alternative minimum tax, *IRC § 25D (c)*.

- . The credit cap (currently \$2,000) for solar electric property is eliminated, effective for taxable years beginning after December 31, 2008, *IRC § 25D (b)(1)*, (e)(4)(A).

- . A new 30-percent credit is added for qualified small wind energy property expenses made by the taxpayer during the taxable year, effective for property placed in service after December 31, 2007, *IRC § 25D (a)(4)*. The credit is

limited to \$500 with respect to each half kilowatt of capacity, not to exceed \$4,000, *IRC § 25D (b)(1)(D)*. Qualified expenditures are those for property that uses a wind turbine to generate electricity for use in a dwelling unit located in the U.S. and used as a residence by the taxpayer, *IRC § 25D (d)(4)*.

. A new 30-percent credit is added for qualified geothermal heat pump property expenditures, not to exceed \$2,000, effective for property placed in service after December 31, 2007 *IRC § 25D (a)(5)*, (b)(1)(E). These include expenditures for qualified geothermal heat pump property installed on or in connection with a dwelling unit located in the U.S. and used as a residence by the taxpayer, *IRC § 25D (d)(5)*. The credit for geothermal heat pumps that was formerly part of the nonbusiness energy property credit has been eliminated see, *IRC § 25C (c)(3)*, before amendment by Pub Law No 110-343.

The Act extends for one year, through taxable years beginning in 2008, the alternative minimum tax relief for nonrefundable personal credits. Nonrefundable personal credits are allowed up to the sum of the taxpayers regular tax liability (reduced by the foreign tax credit) and the amount of the taxpayers alternative minimum tax liability for the year, *IRC § 26 (a)(2)*.

The credit for alternative fuel vehicle refueling property for property other than hydrogen is extended for one year, through December 31, 2010. Electricity is also added as a clean-burning fuel for purposes of the credit, *IRC § 30C (g)*, (c)(2).

The railroad track maintenance credit is extended for two years, for expenditures made before January 1, 2010, *IRC § 45G (f)*. The credit is also allowed against the alternative minimum tax, effective for in taxable years beginning after December 31, 2007, and to carrybacks of those credits. *IRC § 38 (c)(4)(v)*.

The solar energy credit is extended for 8 years, through January 1, 2017 *IRC § 48* Shepardize (a). Similar extensions are provided for qualifying fuel cell property and microturbine property that are eligible for the credit, *IRC § 48 (c)(1)(E)*, (2)(E). The following additional changes are made to the credit:

. The credit is allowed against the alternative minimum tax, effective for credits in taxable years beginning after October 3, 2008, and to carrybacks of those credits, *IRC § 38 (c)(4)(vi)*.

. Qualifying energy property eligible for the credit is expanded to include combined heat and power system property, *IRC § 48 (a)(3)(A)(v)*, (c)(3), qualified small wind energy property, *IRC § 48 (a)(2)(A)(i)(IV)*, (3)(A)(vi), (c)(4), and geothermal heat pump systems *IRC § 48 (a)(3)(A)(vii)*, effective generally after October 3, 2008, in tax years ending after that date.

. The credit limitation for fuel cell property is increased from \$500 to \$1,500 per each 0.5 kilowatt of capacity, *IRC § 48 (c)(1)(B)*, effective October 3, 2008.

. Public utility property is no longer ineligible for the credit, *IRC § 48 (a)(3)*, effective generally after February 13, 2008 in tax years ending after that date.

The credits for biodiesel and renewable diesel are extended for one year, through December 31, 2009, *IRC §§ 40A (g)*, 6426(c)(6), 6427(e)(5)(B). The following additional changes are made to the credits, effective after December 31, 2008 unless otherwise noted:

. The credit rate is increased from 50 cents to \$1 for each gallon of qualifying fuel, *IRC §§ 40A (b)(1)(A)*, (2)(A), 6426(c)(2).

. With respect to renewable diesel fuel, the credit applies more broadly to all diesel produced from biomass, without regard to the particular process as long as statutory registration and testing requirements are met, *IRC § 40A (f)(3)*.

. The term agri-biodiesel is expanded to include fuel derived from camelina, *IRC § 40A (d)(2)*.

. Renewable diesel fuel that is derived from co-processing biomass with a feedstock which is not biomass is not eligible for the credit, *IRC § 40A (f)(3)*, effective for fuel produced, and sold or used, after October 3, 2008.

. Certain aviation fuel can qualify as renewable diesel and thereby be eligible for the credit, *IRC § 40A (f)(4)*.

The credit for research activities has been extended for two years, to December 31, 2009, *IRC § 41 (h)*. The same extension applies to the clinical testing expense credit for certain drugs for rare diseases, *IRC § 45C (b)(1)(D)*. The ability to elect the alternative incremental credit see, *IRC § 41 (c)(4)* terminates, effective for tax years beginning after December 31, 2008, *IRC § 41 (h)(2)*. The amount of the elective alternative simplified credit is increased from 12 percent to 14 percent, effective for taxable years ending after December 31, 2008, *IRC § 41 (c)(5)(A)*.

For wind and refined coal facilities, the renewable energy credit is extended one year, for property placed in service before January 1, 2010, *IRC § 45 (d)(1)*, (8). The credit is extended 2 years, for property placed in service before January 1, 2011 for close-loop biomass facilities, *IRC § 45 (d)(2)(A)(i)*, (ii), open-loop biomass facilities, *IRC § 45 (d)(3)(A)(i)(I)*, (ii), geothermal or solar energy facilities, *IRC § 45 (d)(4)*, landfill gas facilities, *IRC § 45 (d)(6)*, trash combustion facilities, *IRC § 45 (d)(7)*, and certain qualified hydroelectric power facilities, *IRC § 45 (d)(9)(A)*, (B). The credit for Indian coal production facilities has not been extended beyond 2008, *IRC § 45 (d)(10)*. Small irrigation power facilities are eligible for the credit only if placed in service before October 3, 2008, *IRC § 45 (d)(5)*. Several other modifications are made to the credit:

. Qualified energy resources for purposes of the credit are extended to include marine and hydrokinetic renewable energy, *IRC § 45 (c)(1)(I)*, (10), (d)(11).

. The increased value test for defining refined coal, *IRC § 45 (c)(7)(A)(i)(IV)* is repealed, and the required emission reduction for refined coal is increased from 20 percent to 40 percent for sulfur dioxide or mercury, *IRC § 45 (c)(7)(B)*.

. Steel industry fuel can also qualify as refined coal for purposes of the renewable energy credit, *IRC § 45 (c)(7)(A)(ii)*, (C), (e)(8)(D). Any such fuel for which a renewable energy credit is allowed is not eligible for the nonconventional source production credit, *IRC § 45K (g)(2)(E)*.

. The renewable energy credit is extended to expansions of existing closed-loop and open-loop biomass facilities, *IRC § 45 (d)(2)(B)*, (3)(B), effective for property placed in service after the October 3, 2008.

. The rules for hydropower production are also modified, *IRC § 45 (c)(8)(C)*.

The Indian employment credit is extended two years, for tax years beginning before January 1, 2010, *IRC § 45A (f)*.

The Act extends the new markets tax credit limitation of \$3.5 billion to calendar year 2009, *IRC § 45D (f)(1)(D)*.

The new energy efficient homes credit is extended for one year, for homes acquired through December 31, 2009, *IRC § 45L (g)*.

The Act extends the credit for energy efficient appliances for three years, through 2010. The amount of the credit is modified for dishwashers, clothes dryers, and refrigerators manufactured after 2007, *IRC § 45M (b)*. The credits for the different appliances vary according to their year of manufacture and their energy and water usage, *IRC § 45M (b)*. The special rule for eligible production of refrigerators is eliminated, *IRC § 45M (c)*, and eligible production for all appliances is determined using a 2-year base rather than a 3-year base, *IRC § 45M (c)(2)*. The aggregate credit amount that may be claimed by a taxpayer is also increased, *IRC § 45M (e)*.

The mine rescue team training credit is extended one year, through December 31, 2009, *IRC § 45N (e)*.

The credit for clean renewable energy bonds is extended for one year, through December 31, 2009, *IRC § 54 (m)*.

Advanced Coal and Gasification Credits

The qualifying advanced coal project credit, *IRC § 48A* is expanded and modified. A 30-percent credit is added for certain advanced coal-based generation technology projects, *IRC § 48A (a)(3), (d)(3)(B)(iii)*. The aggregate credits allowable are increased from \$1,300,000,000 to \$2,550,000,000, *IRC § 48A (d)(3)(A)*. A new requirement is imposed under which a qualifying advanced coal project must meet specified standards for capturing and sequestering carbon dioxide emissions, *IRC § 48A (e)(1)(G)*, and highest priority is to be given to these projects, *IRC § 48A (e)(3)(C)*. Priority is also given to certain research partnerships, *IRC § 48A (e)(3)(B)(iii)*. A new provision also calls for recapture of the credit if a project fails to meet sequestering standards, *IRC § 48A (i)*. A new public disclosure requirement is added, under which the Secretary, upon making a certification, must publicly disclose the identity of the applicant and the amount of the certified credit, *IRC § 48A (d)(5)*.

The coal gasification investment credit, *IRC § 48B* is expanded and modified. The credit is increased from 20 to 30 percent for qualifying projects that include equipment which separates and sequesters at least 75 percent of the project's total carbon dioxide emissions, *IRC § 48B (a), (d)(1)(B)*. An additional \$250 million in credits for these projects is authorized, *IRC § 48B (d)(1)*. A new provision requires recapture of the credit if a project fails to meet separating and sequestering standards, *IRC § 48B (f)*. Priority in selection for qualified projects is to be given to the projects with the greatest separation and sequestration percentage and to research partnerships, *IRC § 48B (d)(4)*. Eligible projects are extended to include transportation grade liquid fuels, *IRC § 48B (c)(7)(H)*.

Alcohol and Biodiesel Credits

The alcohol fuels credit, biodiesel fuels credit, alternate fuels excise tax credit, are no longer available to fuels that are produced outside the US for use as fuel outside the US now limited to those qualifying fuels that are produced inside the US, *IRC §§ 40 (d)(7), 40A(d)(5), 6426(i), 6427(e)(5)*, effective for claims for credit or payment made on or after May 15, 2008.

Qualified Tax Bond Credit

The credit for holders of qualified tax credit bonds is expanded, *IRC § 54A (d)(1), (2)*. In addition to qualified forestry bonds, *IRC § 54B*, the credit is available for three new types of bonds--new clean renewable energy bonds, *IRC § 54C*, qualified energy conservation bonds, *IRC § 54D*, and qualified zone academy bonds, *IRC § 54E*. Details with respect to each of the bonds are provided for in their respective statutory provisions. The new qualified zone academy bonds under, *IRC § 54E*, replace the credit for bonds that was available under, *IRC § 1397E*, and, *IRC § 1397E*, does not apply to any obligation issued after October 3, 2008, *IRC § 1397E (m)*.

Deduction for Expenses of Elementary and Secondary School Teachers Extended

The provision allowing elementary and secondary school teachers to deduct up to \$250 in school supplies is extended two years, through 2009, *IRC § 62 (a)(2)(D)*.

Standard Deduction for Real Property Taxes for Non-Itemizing Taxpayers Extended for One Year

The provision allowing taxpayers who do not itemize deductions to deduct real property taxes is extended for one year, through 2009, *IRC § 63 (c)(1)(C)*.

Deduction for State and Local Sales Taxes Extended for Two Years

The election to deduct state and local sales taxes in lieu of state and local income taxes is extended for two years, for tax years beginning before January 1, 2010, *IRC § 164 (b)(5)(I)*.

3-Year Extension of Exclusion of Income from Discharge of Qualified Principal Residence Indebtedness

The discharge of indebtedness that is qualified principal residence indebtedness is excluded from gross income, for discharges occurring before January 1, 2010. The Act extends the exclusion for three years, to discharges occurring before January 1, 2013, *IRC § 108 (a)(1)(E)*.

New Loss Deduction Rules for Losses Due to Federally Declared Disasters

The Act provides several new rules allowing more extensive deduction of losses related to federally declared disasters. First is a temporary waiver of the 10-percent of AGI rule for deducting losses resulting from a federal disaster. Any net disaster loss is now deductible without regard to whether it exceeds 10 percent of a taxpayers adjusted gross income, *IRC § 165 (h)(3)(A)*; see, *IRC § 165 (h)(2)(A)(ii)*. A net disaster loss is the excess of the personal casualty losses (1) attributable to a federally declared disaster occurring before January 1, 2010, and (2) occurring in a disaster area, over personal casualty gains, *IRC § 165 (h)(3)(B)*. Second, the Act increases a taxpayers standard deduction by the amount of the disaster loss deduction, *IRC § 63 (c)(1)(D)*, and this portion of the standard deduction is also allowed for AMT purposes, *IRC § 56 (b)(1)(E)*. The disaster loss deduction is equal to the net disaster loss, *IRC § 63 (c)(8)*. These provisions are effective for disasters declared in taxable years beginning after December 31, 2007.

Five-Year NOL Carryback for Qualified Disaster Losses

The Act adds a provision to the net operating loss (NOL) rules allowing qualified disaster losses to be carried back for 5 years as an NOL, *IRC § 172 (b)(1)(J)*. Carrybacks and carryovers of qualified disaster losses are also allowed for AMT purposes, *IRC § 56 (d)(3)*. A taxpayer may elect not to take advantage of the provision, *IRC § 172 (j)(3)*. A qualified disaster loss is the lesser of (1) otherwise deductible losses attributable to federally declared disasters occurring in 2008 or 2009, plus the allowable deduction for qualified disaster expenses under, *IRC § 198A* (discussed below), or (2) the net operating loss for the taxable year, *IRC § 172 (j)(1)*. The provision does not apply to golf courses, hot tub and sun tan facilities, gambling or animal racing property, or certain property used primarily for sale of alcoholic beverages, *IRC §§ 172 (j)(4), 1400N(p)(3)*.

New Provision Allows Deduction for Qualified Disaster Expenses

The Act adds a new provision under which taxpayers may elect to deduct qualified disaster expenses, *IRC § 198A*. The provision is effective for amounts paid or incurred after December 31, 2007 in connection with disasters declared after that date and occurring before 2010. To be deductible the expenditure must meet the following requirements, *IRC § 198A (b)*:

- . It must be incurred in connection with a trade or business or with business-related property;
- . It must be for (1) the abatement or control of hazardous substances that were released on account of a federally declared disaster; (2) the removal of debris from, or the demolition of structures on, real property which is business-related property damaged or destroyed as a result of a federally declared disaster; or (3) the repair of business-related property damaged as a result of a federally declared disaster; and
- . It must otherwise chargeable to capital account.

Any deduction taken under, *IRC § 198A*, is treated as a depreciation deduction which is recaptured in the case of a sale or other disposition of the property, *IRC § 198A (d)*; see, *IRC § 1245*. Other statutory provisions dealing with expensing of environmental remediation expenditures see, *IRC § 198*, capitalization of demolition costs, *IRC § 280B* and certain mining and solid waste costs see, *IRC § 468*, do not apply to costs expensed under, *IRC § 198A*, *IRC § 198A (e)*.

Waiver of Certain Mortgage Revenue Bond Requirements for Principal Residences Destroyed in Disasters

A bond can qualify as a mortgage revenue bond only if at least 95 percent of its proceeds are used to finance residences of owners who did not own a home for three years before executing the mortgage, *IRC § 143 (d)(1)*. Effective for disasters occurring after 2007, the Act allows this requirement to be waived at the election of a taxpayer if a taxpayer's principal residence is rendered unsafe as the result of a federally declared disaster occurring before 2010, or if the home is demolished or relocated as the result of an order of a State or local government in response to a federally declared disaster before that date. The waiver applies for the 2-year period beginning on the date of the disaster declaration, *IRC § 143 (k)(12)(A)*.

Another requirement for mortgage revenue bonds is that the acquisition cost of each financed residence generally cannot exceed 90 percent of the average area purchase price applicable to that residence, *IRC § 143 (e)(1)*. For residences destroyed as described in the above paragraph, this provision is applied using 110 percent, rather than 90 percent, *IRC § 143 (k)(12)(A)*. The increased percentage applies for the 2-year period beginning on the date of the disaster declaration, *IRC § 143 (k)(12)(A)*.

In addition, at the election of the taxpayer, if the taxpayer's principal residence was damaged as the result of a federally declared disaster occurring before January 1, 2010, any owner-financing provided in connection with the repair or reconstruction of the residence--up to \$150,000--is treated as a qualified rehabilitation loan, *IRC § 143 (k)(12)(B)(i)*, (ii).

Any election under the above provisions cannot be revoked without IRS consent, *IRC § 143 (k)(12)(D)(i)*. Taxpayers who make an election under the above provisions cannot also claim the benefits for residences in disaster areas provided by, *IRC § 143 (k)(11)*, *IRC § 143 (k)(12)(D)(ii)*. Those benefits include a waiver of the 3-year prior ownership requirement, *IRC § 143 (d)*, and the treatment of the home as a targeted area residence for purposes of applying the purchase price and income requirements, *IRC § 143 (e)*, (f) for two years after the date of the disaster declaration, *IRC § 143 (k)(11)*.

Increase in Casualty/Theft Loss Limitation

One unfavorable amendment for taxpayers is that the limit on individual losses per casualty or theft is temporarily increased from \$100 to \$500, effective for tax years beginning in 2009 only. Thus for that one year taxpayers may deduct a casualty or theft loss only to the extent it exceeds \$500, *IRC § 165 (h)(1)*.

Transportation Fringe Benefits Extended to Bicycle Commuting Reimbursements

The Act adds a new transportation fringe benefit for bicycle commuters--allowing them to exclude from gross income any qualified bicycle commuting reimbursement, *IRC § 132 (f)(1)(D)*. The exclusion is limited to \$20 per month, and is available only for months in which the employee (1) regularly uses a bicycle for a substantial portion of the travel between the employee's residence and place of employment, and (2) does not receive one of the other transportation fringe benefits, *IRC § 132 (f)(2)(C)*, (5)(F). The provision is effective for taxable years beginning after December 31, 2008.

3-Year Extension for Qualified Green Building and Sustainable Design Bonds

Bonds used to provide qualified green building and sustainable design projects can qualify as exempt facility bonds, provided the bonds are issued by September 30, 2009, *IRC § 142 (a)(14)*, (l)(8). The Act extends the eligibility for qualification for three years, for qualifying bonds issued by September 30, 2012, *IRC § 142 (a)(14)*. The treatment of current refunding bonds for these issues is also extended for three years, *IRC § 142 (l)(9)*.

New Credit for Plug-In Electric Motor Vehicles

A new credit is added for plug-in electric motor vehicles, *IRC § 30D*. For each qualifying vehicle placed in service during the year, taxpayers are eligible for a credit of \$2,500 plus \$417 for each kilowatt hour of traction battery capacity in excess of 4 kilowatt hours, *IRC § 30D (a)(2)*. The credit has a cap from \$7,500 to \$15,000, depending on the weight of the vehicle, *IRC § 30D (b)(1)*. The credit is further reduced after 250,000 qualified vehicles have been sold for use in the US, *IRC § 30D (b)(2)*. To the extent the credit is applied to depreciable property (i.e. property used in a trade or business), the credit is part of the general business credit, *IRC § 38 (b)(35)*. The remainder is treated as a personal credit, *IRC § 30D (d)*. Vehicles for which this credit is taken are not eligible for the alternative motor vehicle credit, *IRC § 30B (d)(3)(D)*.

The credit is effective for tax years beginning after December 31, 2008; the credit expires December 31, 2014.

New Credit for Carbon Dioxide Sequestration

A new credit is added for carbon dioxide sequestration, *IRC § 45Q*. The amount of the credit is

\$20 per metric ton of qualified carbon dioxide that is captured by the taxpayer at a qualified facility, and disposed of by the taxpayer in secure geological storage, and \$10 per metric ton of qualified carbon dioxide that is captured by the taxpayer at a qualified facility, and used by the taxpayer as a tertiary injectant in a qualified enhanced oil or natural gas recovery project, *IRC § 45Q (a)*. Only taxpayers that own a facility that captures at least 500,000 metric tons of carbon dioxide during the year are eligible for the credit, *IRC § 45Q (c)*. The credit is part of the general business credit, *IRC § 38 (b)(34)* and is available for apply to carbon dioxide captured after October 3, 2008.

New Executive Compensation and Golden Parachute Payment Rules for Employers Participating in the Troubled Assets Relief Program

The Act adds a rule reducing to \$500,000 the amount of otherwise deductible annual executive compensation, *IRC § 162 (m)(5)*. This limit applies only for employers at least \$300 million of whose assets are acquired under the troubled assets relief program (TARP) established by the legislation, *IRC § 162 (m)(5)(A)(i)*, (B)(i). Employers subject to this limit can include both public and private corporations and even non-corporate taxpayers such as partnerships. A special rule is used to apply the \$500,000 limit to deferred compensation that is not deductible until a later year, *IRC § 162 (m)(5)(A)(ii)*. The \$500,000 limit is also coordinated with disallowed parachute payment and stock compensation of insiders in expatriated corporations under the same coordination rules that apply under existing, *IRC § 162 (m)*, *IRC § 162 (m)(5)(G)*, see, *IRC § 162 (m)(4)(F)*, (G). The Act also makes nondeductible an expanded definition of golden parachute payments that are made to executives subject to the \$500,000 executive compensation limit under, *IRC § 162 (m)(5)*, *IRC § 280G (e)*.

Two-Year Extension for Accelerated Depreciation on Indian Reservation Property

The Act extends for two years, through 2009, the accelerated depreciation provision for property located on Indian reservations, *IRC § 168 (j)(8)*.

Additional Depreciation Provision Substitutes Cellulosic Biofuel for Cellulosic Biomass Ethanol Property

The additional depreciation allowed for cellulosic biomass ethanol plant property is altered and extended to apply to cellulosic biofuel, *IRC § 168 (l)*. The term cellulosic biofuel means any liquid fuel which is produced from any

lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, *IRC § 168 (l)(3)*.

Smart Meters and Smart Grid Systems Are Added as 10-Year Property for MACRS Purposes

The Act adds as 10-year property for MACRS depreciation purposes qualified smart electric meters and qualified smart electric grid systems, *IRC § 168 (e)(3)(D)(iii)*, (iv); *IRC § 168 (i)(18)* (qualified smart electric meter defined); *IRC § 168 (i)(19)* (qualified smart electric grid system defined). The 150-percent declining balance method will apply for that property, *IRC § 168 (b)(2)(C)*. The provisions apply to property placed in service after October 4, 2008. The changes will benefit providers of electric energy.

Certain Farming Machinery Added as 5-Year Property for MACRS Purposes

Any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business is treated as 5-year property for MACRS depreciation purposes. This rule applies only if the original use of the property commences with the taxpayer after December 31, 2008, and the property is placed in service during calendar year 2009, *IRC § 168 (b)(3)(B)(vii)*.

2-Year Extension of Accelerated Recovery for Qualified Leasehold Improvements, Qualified Restaurant Property, and for Motorsports Complexes

The 15-year straight line cost recovery for qualified leasehold improvements and qualified restaurant property is extended for two years, for property placed in service before January 1, 2010, *IRC § 168 (e)(3)(E)(iv)*, (v). The definition of qualified restaurant property is expanded to include new construction of a building, in addition to improvements, *IRC § 168 (e)(7)(A)*. Any restaurant property eligible for 15-year cost recovery is not eligible for bonus depreciation under, *IRC § 168 (k)*, *IRC § 168 (e)(7)(B)*.

The 7-year cost recovery period for motorsports racing track facilities is also extended for two years, for property placed in service through December 31, 2009, *IRC § 168 (i)(15)(D)*.

Certain Improvements to Retail Space Eligible for 15-year Straight-Line Recovery

The Act adds as 15-year property any qualified retail improvement property placed in service after December 31, 2008, and before January 1, 2010, *IRC § 168 (e)(3)(E)(ix)*. The property must be depreciated over 15 years using straight-line depreciation, *IRC § 168 (b)(3)(I)*. Qualified retail improvement property means any improvement to an interior portion of a nonresidential building if the portion is open to the general public and is used in the retail trade or business of selling tangible personal property, and the improvement is placed in service more than three years after the building was first placed in service, *IRC § 168 (e)(8)(A)*. In the case of owner-owned improvements, the improvement is eligible for 15-year recovery only so long as the improvement is held by the owner that made the improvement, *IRC § 168 (e)(8)(B)*. The accelerated recovery is not available for enlargements of a building, an elevator or escalator, improvements to any structural component benefiting a common area, or improvements to the internal structural framework of a building, *IRC § 168 (e)(8)(C)*. Qualifying property is not eligible for bonus depreciation under, *IRC § 168 (k)*, *IRC § 168 (e)(8)(D)*.

50-Percent First-Year Bonus Depreciation Allowed for Qualified Reuse and Recycling Property

The Act adds new, *IRC Section 168 (m)*, which provides an additional 50-percent depreciation for qualified reuse and recycling property in the tax year the property is placed in service, *IRC § 168 (m)(1)(A)*. The deduction is allowed both for regular and AMT purposes, *IRC § 168 (m)(2)(D)*. The adjusted basis of the property is reduced by the amount of the deduction taken, *IRC § 168 (m)(1)(B)*. The deduction generally applies to property acquired and placed in service by the taxpayer August 31, 2008, and for property whose construction by the taxpayer begins after that date, *IRC § 168 (m)(2)(A), (C)*. A taxpayer may elect not to take the deduction with respect to any class of property placed in service during a taxable year, *IRC § 168 (m)(2)(B)(iii)*.

Qualifying property includes property used exclusively to collect, distribute, or recycle qualified reuse and recyclable materials. This can include machinery and equipment (not including buildings or real estate), along with all appurtenances thereto, including software necessary to operate that equipment *IRC § 168 (m)(3)(A)(i)*. It also includes scrap plastic, scrap glass, scrap textiles, scrap rubber, scrap packaging, recovered fiber, scrap ferrous and nonferrous metals, or electronic scrap generated by an individual or business, *IRC § 168 (m)(3)(B)(i)*. Rolling stock or other equipment used to transport reuse and recyclable materials is not eligible, *IRC § 168 (m)(3)(A)(ii)*.

50-Percent First-Year Bonus Depreciation Allowed for Qualified Disaster Assistance Property

The Act adds a new provision, *IRC Section 168 (n)*, which provides an additional 50-percent depreciation for qualified disaster assistance property in the year the property is placed in service, *IRC § 168 (n)(1)(A)*. The provision generally applies to property that replaces or rehabilitates property that is destroyed or condemned in a disaster occurring in 2008 or 2009. The deduction is allowed both for regular and AMT purposes, *IRC § 168 (n)(2)(D)*. The adjusted basis of the property is reduced by the amount of the deduction taken, *IRC § 168 (n)(1)(B)*. A taxpayer may elect not to take the deduction with respect to any class of property placed in service during a taxable year, *IRC § 168 (n)(2)(B)(v)*.

Qualified disaster assistance property includes (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) computer software other than computer software covered by, *IRC Section 197*; (3) water utility property; (4) qualified leasehold improvement property, See, *IRC § 168 (k)(3)* for a definition; (5) nonresidential real property; or (6) residential rental property, *IRC § 168 (n)(2)(A)(i)*. Substantially all of the property must be used in a trade or business in an area with respect to a federally declared disaster occurring before January 1, 2010, *IRC § 168 (n)(2)(A)(ii)*, and it must generally rehabilitate or replace property destroyed or condemned in the disaster. It must also be similar in nature to, and located in the same county as, the property being rehabilitated or replaced. Property is treated as replacing property destroyed or condemned if, as part of an integrated plan, it replaces property that is included in a continuous area which includes real property destroyed or condemned, *IRC § 168 (n)(2)(A)(iii)*.

To qualify for the bonus depreciation, the original use of the property in the disaster area must begin with an eligible taxpayer on or after the date of the disaster, the property generally must be purchased by the taxpayer after the date of the disaster, and the property must be placed in service by the end of the third calendar year following the date of the disaster (fourth calendar year, in the case of nonresidential real property and residential rental property), *IRC § 168(n)(2)(A)(iv), (v), (vi)*. The bonus depreciation is available for self-constructed property whose construction or manufacture by the taxpayer begins before 2009, and also for sale-leasebacks and syndicated property, *IRC § 168(n)(2)(C)*; see, *IRC § 168(k)(2)(E)*.

The following property is not eligible for the bonus depreciation, *IRC § 168(n)(2)(B)*: property for which bonus depreciation is taken under other provisions; property for which the alternative depreciation system, *IRC § 168(g)*, must be used; tax-exempt bond financed property; and qualified revitalization building with respect to which the taxpayer has elected the commercial revitalization deduction see, *IRC § 1400I(a)*.

Increased *IRC Section 179* Expensing Allowed for Qualified Disaster Assistance Property

The Act increases by \$100,000 the amount that can be expensed under, *IRC Section 179* for qualified Section 179 disaster assistance property placed in service during a taxable year, *IRC § 179(e)(1)(A)*. The phase-out threshold for reducing the amount that can be expensed with respect to qualified, *IRC Section 179*, disaster assistance property is increased by \$600,000, *IRC § 179(e)(1)(B)*. Qualified, *IRC Section 179*, disaster assistance property is, *IRC Section 179*, property see, *IRC § 179(d)*, that is also qualified disaster assistance property as defined in, *IRC Section 168(n)(2)*, discussed above, *IRC § 179(e)(2)*. Property for which this expensing is claimed cannot be treated as qualified zone property or qualified renewal property under, *IRC Sections 1397A*, and *1400J*, *IRC § 179(e)(3)*.

Amendments to Charitable Deduction Provisions

The Act makes the following changes to, *IRC Section 170*, affecting charitable deductions:

- . The enhanced deductions for qualified computer contributions, *IRC § 170(e)(6)(G)*, food inventory, *IRC § 170(e)(3)(C)(iv)*, and book inventory, *IRC § 170(e)(3)(D)(iv)*, are each extended for two years, through December 31, 2009.

- . For contributions of food by a qualified farmer or rancher from October 3, 2008 through December 31, 2008, the deduction limit on charitable contributions is suspended, *IRC § 170(b)(3)*.

Extension and Modification of Election to Expense Certain Refineries

The election to expense certain refinery property is extended for two years, for property placed in service before January 1, 2014, *IRC § 179C(c)*. The eligibility for newly constructed property for expensing under 179C is extended for two years, to construction contracts entered into before January 1, 2010, for property placed in service before January 1, 2010. The provisions is also extended for two years for self-constructed property, to property the construction of which begins before 2010, *IRC § 179C(c)(1)*. The provision is also extended to refineries that process liquid fuel directly from shale or tar sands, *IRC § 179C(d)*. All of the amendments apply to property placed in service after October 3, 2008.

Five-Year Extension of Deduction for Energy Efficient Commercial Buildings

The deduction for energy efficient commercial buildings is extended for five years, through 2013, *IRC § 179D(h)*.

One-Year Extension of Election to Expense Advanced Mine Safety Equipment

The election to expense advanced mine safety equipment is extended for one year, through December 31, 2009, *IRC § 179E(g)*.

Provisions Affecting Film and Television Productions

The Act makes the following changes to provisions affecting film and television productions:

- . The election to expense qualified costs is extended for one year, through December 31, 2009, *IRC § 181(f)*.
- . The general dollar limitation for the expensing under *IRC Section 181* is \$15 million, *IRC § 181(a)(2)(A)*.
- . For purposes of the deduction under, *IRC Section 199*, for domestic production activities, the definition of W-2

wages is modified in the case of a qualified film to include compensation for services performed in the United States by actors, production personnel, directors, and producers, *IRC § 199(b)(2)(D)*, (c)(6). S corporation shareholders and partners with a 20-percent capital or stock interest are treated as engaging directly in any film produced by the S corporation or partnership, and vice versa, *IRC § 199(d)(1)(A)(iv)*.

Two-Year Extension of Expensing of Environmental Remediation Costs

The provision allowing the expensing of certain environmental remediation costs. *IRC § 198*, is extended for two years, for expenses paid or incurred through December 31, 2009, *IRC § 198(h)*.

Reduction in Domestic Production Activities Deduction for Certain Oil and Gas Producers

The Act adds a clause that limits the deduction under, *IRC Section 199*, for taxpayers with oil related qualified production activities income. The provision applies for tax years beginning after 2009. Under the limitation, if a taxpayer has oil-related qualified production activities income in a tax year, the amount otherwise deductible under, *IRC Section 199*, is reduced by 3 percent of the least of the following: (1) the oil related qualified production activities income of the taxpayer for the taxable year; (2) the qualified production activities income of the taxpayer for the taxable year, or (3) taxable income (or adjusted gross income, in the case of individuals), without regard to the deduction under, *IRC Section 199*, *IRC § 199(d)(9)(A)*. Oil related qualified production activities income is qualified production activities income that is attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof during a taxable year, *IRC § 199(d)(9)(B)*.

IRC Section 199 Deduction for Activities in Puerto Rico Extended for Two Years

The deduction under *IRC Section 199* for domestic production activities in Puerto Rico is extended for two years, through taxable years of taxpayers beginning before January 1, 2010, *IRC § 199(d)(8)(C)*.

Two-Year Extension for Deduction for Qualified Tuition

The deduction for qualified tuition and related expenses is extended for two years, through tax years beginning before January 1, 2010, *IRC § 222(e)*.

Two-Year Extension for Tax-Free Charitable Distributions from IRAs

The ability to make tax-free charitable distributions from IRAs is extended for two years, through tax years beginning before January 1, 2010, *IRC § 408(d)(8)(F)*.

Amendments to Implement FERC and State Electric Restructuring Policy

The Act contains several amendments under, *IRC Section 451(i)*, relating to inclusion timing rules for electric transmission transactions:

- . The statutory year of inclusion rule for certain electric transmission transactions is extended to sales or dispositions occurring before January 1, 2010, for qualified electric utilities, *IRC § 451(i)(3)*, (6).

- . The date for which the transfer of operational control authorized by FERC must take place is extended from December 31, 2007 to the date that is 4 years after the close of the taxable year in which the transaction occurs, *IRC § 451(i)(4)(B)(ii)*.

. A new provision prevents property located outside the US from being treated as exempt utility property, *IRC § 451(i)(5)(C)*.

New Provision for Inclusion of Deferred Compensation from Tax-Indifferent Parties

The Act adopts a detailed new provision--*IRC Section 457A*--which provides that any compensation of a service provider that is deferred under a nonqualified deferred compensation plan of a nonqualified entity is includible in gross income by the service provider when there is no substantial risk of forfeiture of the service providers rights to the compensation, *IRC § 457A(a)*. The provision contains detailed rules as to the deferred compensation plans that are covered, *IRC § 457A(d)(3)*, when compensation is subject to a substantial risk of forfeiture, *IRC § 457A(c)*, (d), and which entities are subject to the provision, *IRC § 457A(b)*.

The provision is generally intended to apply to offshore funds; its focus is preventing the deferral of recognition of various fees earned by fund managers in nonqualified deferred compensation plans.

Treatment of Excess Payments to Controlling Exempt Corporations Extended for Two Years

The provision treating certain excess payments to controlling exempt organizations as taxable unrelated business income is extended for two years, for payments received or accrued through December 31, 2009, *IRC § 512(b)(9)(E)*.

One-Year Reinstatement of Suspension of Taxable Income Limit on Certain Percentage Depletion

IRC Section 613(a), imposes a taxable income limit for percentage depletion. The income limit on percentage depletion for oil and natural gas produced from marginal properties was suspended for taxable years beginning before January 1, 2008. The Act reinstates the suspension of the taxable income limit for percentage depletion deductions from those properties, effective for taxable years beginning after December 31, 2008, and before January 1, 2010, *IRC § 613A(c)(6)(H)*. The income limit does apply, however, for taxable years beginning in calendar year 2008.

Regulated Investment Company Provisions

The Act extends for two years the exemption from withholding tax of interest-related dividends received from a regulated investment company (RIC), to taxable years of a RIC beginning before January 1, 2010, *IRC § 871(k)(1)(C)*. The definition of short-term capital gain dividends under the RIC provision is also amended to include dividends with respect to any taxable year of a company beginning before January 1, 2010, *IRC § 871(k)(2)(C)*.

The Act also extends for two years the inclusion of a RIC within the definition of a qualified investment entity, through December 31, 2009, for those situations in which that inclusion otherwise expired at the end of 2007, *IRC § 897(h)(4)(A)(ii)*.

Foreign Oil and Gas Income Provisions

The Act makes the following changes to foreign oil and gas income provisions, effective for taxable years beginning after December 31, 2008:

. The scope of the present-law foreign oil and gas extraction income (FOGEI) rules is extended to all foreign income from production and other activity related to the sale of oil and gas product--i.e., the sum of foreign oil related income (FORI) and FOGEI. Thus, amounts claimed as taxes paid on that amount of (combined) foreign oil and gas income are creditable in a given taxable year (if they otherwise so qualify) only to the extent they do not exceed the product of the highest marginal US tax rate on corporations (in the case of corporations) multiplied by that combined foreign oil and gas income for the taxable year, *IRC § 907(a)*. As under current FOGEI rules, excess foreign taxes may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited (not

deducted) to the extent that the taxpayer otherwise has excess limitation with regard to combined foreign oil and gas income in a carryover year, *IRC § 907(f)(1), (2)*.

. Under a transition rule, pre-2009 credits carried forward to post-2008 years will continue to be governed by present law for purposes of determining the amount of carryforward credits eligible to be claimed in a post-2008 year, *IRC § 907(f)(4)(A)*. Similarly, solely for purposes of determining whether excess credits generated in 2009 and carried back can be claimed to offset 2008 tax liability, the new rules will be deemed to apply in determining overall (combined FOGEI-FORI) limitation for the carryback year, *IRC § 907(f)(4)(B)*.

. The present-law, *IRC Section 907(b)*, FORI limitation is repealed.

One-Year Extension of Subpart F Exception for Active Financing Income

The Act extends for one year (for taxable years beginning before 2010) the present law temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business, *IRC §§ 953(e)(10), 954(h)(9)*.

One-Year Extension of Look-through Rule for Certain Controlled Foreign Corporations

Under a statutory look-through rule, dividends, interest (including certain factoring income), rents, and royalties received by one controlled foreign corporation (CFC) from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F nor treated as income from sources within the United States which is effectively connected with the conduct by that CFC of a trade or business within the United States, *IRC § 954(c)(6)(A)*. The Act extends for one year the application of this look-through rule, to taxable years of foreign corporations beginning before January 1, 2010, and for taxable years of U.S. shareholders with or within which those taxable years of those foreign corporations end, *IRC § 954(c)(6)(C)*.

Two-Year Extension of Stock Basis Adjustment Rule for S Corporations Making Charitable Contributions

In the case of charitable contributions made by an S corporation in taxable years beginning after December 31, 2005, and before January 1, 2008, the amount of a shareholders basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation is equal to the shareholders pro rata share of the adjusted basis of the contributed property. The Act extends this rule for two years, to contributions made in taxable years beginning before January 1, 2010, *IRC § 1367(a)(2)*.

DC Zone Tax Benefits Extended for Two Years

The Act makes the following changes regarding special DC Zone tax benefits:

. Extends the designation of the DC Enterprise Zone for two years (through December 31, 2009), *IRC § 1400(f)(1), (2)*, thus extending the wage credit, *IRC §§ 1396(d)(1)(B), 1400(d)* and increased, *IRC Section 179*, expensing, *IRC § 1400J*, for two years.

. Extends the tax-exempt financing authority for two years, applying to bonds issued during the period beginning on January 1, 1998, and ending on December 31, 2009, *IRC § 1400A(b)*;

. Extends the zero-percent capital gains rate applicable to capital gains from the sale of certain qualified DC Zone assets for two years. DC Zone assets may be acquired by the taxpayer before 2010, *IRC § 1400B(b)*, and gain attributable to periods through 2014 are eligible for the zero-percent rate, *IRC § 1400B(e)(2), (g)(2)*.

. Extends the first-time homebuyer credit for two years, through December 31, 2009, *IRC § 1400C(i)*.

One-Year Extension of Increased Rehabilitation Credit in GO Zone

The provision providing for an increase in rehabilitation credit for qualified expenditures in the GO Zone is extended for one year, to expenditures paid or incurred through December 31, 2009, *IRC § 1400N(h)*.

Two-Year Extension of Look-Through Rule for RIC Stock in Estates of Nonresident Non-citizens

The gross estate of a nonresident non-citizen decedent generally includes only property that at the time of the decedent's death is situated within the United States, *IRC § 2103*. Although stock issued by a domestic corporation generally is treated as property within the US, stock of a regulated investment company (RIC) that was owned by a nonresident non-citizen is not deemed property within the US in the proportion that, at the end of the quarter of the RIC's taxable year immediately before a decedent's date of death, the assets held by the RIC are debt obligations, deposits, or other property that would be treated as situated outside the United States if held directly by the estate (look-through rule), *IRC § 2105(d)(1)*. The Act extends this look-through rule for two years, for estates of decedents dying through December 31, 2009, *IRC § 2105(d)(3)*.

One-Year Extension for 6.2 Percent FUTA Tax Rate

The 6.2 tax rate for federal unemployment tax is extended for one year, through 2009, *IRC § 3301*.

New Exemptions from Heavy Vehicle Excise Tax

The Act adds two new exemptions from the heavy vehicle excise tax under *IRC Section 4051*, effective for retail sales or installations made after October 3, 2008--one for the cost of qualifying idling reduction devices, and one for the installation of advanced insulation, *IRC § 4053(9), (10)*.

Extension of Increased Coal Excise Tax Rate

The Act retains the excise tax on coal at the current rates (\$1.10 per ton for coal from underground mines and \$.55 per ton for coal from surface mines) until the earlier of the following dates: (1) January 1, 2019, and (2) the day after the first December 31 after 2007 on which the Black Lung Disability Trust Fund has repaid, with interest, all amounts borrowed from the General Fund. On and after that date, the reduced rates of \$.50 per ton for coal from

underground mines and \$.25 per ton for coal from surface mines will apply and the tax per ton of coal will be capped at two percent of the amount for which it is sold by the producer, *IRC § 4121(e)(2)*.

New Exemption from Excise Tax on Wood Arrows

The Act adds an exemption from the excise tax on arrow shafts for certain shafts (whether sold separately or incorporated as part of a finished or unfinished product) that consist of all natural wood with no laminations or artificial means of enhancing the spine of the shaft, effective for shafts first sold after October 3, 2008, *IRC § 4161(b)(2)*.

Extension and Increase of Oil Spill Liability Trust Fund Tax

The Act extends the oil spill tax through December 31, 2017, *IRC § 4611(f)(2)*. It also

increases the tax rate from five cents to eight cents per barrel beginning January 1, 2009 through December 31, 2016, and then increases the rate to nine cents per barrel for calendar year 2017, *IRC § 4511(c)(2)(B)*. The Act also repeals the requirement that the tax be suspended when the unobligated balance exceeds \$2.7 billion see former, *IRC § 4611(f)(2)*.

New Broker Reporting Requirements on Customers Basis in Securities Transactions

The Act changes to February 15 the present-law January 31 deadline for furnishing certain information statements to customers, effective for statements required to be furnished after December 31, 2008, *IRC § 6045(b)*. The statements to which the new February 15 deadline applies are (1) statements showing gross proceeds (under *IRC Section 6045(b)*) or substitute payments (under, *IRC Section 6045(d)*) and (2) statements with respect to reportable items (including, but not limited to, interest, dividends, and royalties) that are furnished with consolidated reporting statements (as defined in regulations), *IRC § 6045(b)*.

The Act adopts a number of new information reporting requirements for brokers which will begin to take effect in 2011:

- . Every broker that is required to file a return under, *IRC Section 6045(a)*, reporting the gross proceeds from the sale of a covered security must include in the return (1) the customers adjusted basis in the security and (2) whether any gain or loss with respect to the security is long-term or short-term, *IRC § 6045(g)(2)(A)*. Securities subject to the requirement include those acquired on or after an applicable date if the security was (1) acquired through a transaction in the account in which the security is held or (2) was transferred to that account from an account in which the security was a covered security, but only if the transferee broker received a statement under, *IRC Section 6045A*, (described below) with respect to the transfer, *IRC § 6045(g)(3)(A)*, (B). For most corporate stock, the applicable date is January 1, 2011. For any stock for which an average basis method is permissible (such as stock acquired through a periodic stock investment plan), or stock in a regulated investment company the applicable date is January 1, 2012. For other securities subject to the provision, the applicable date is January 1, 2013, or a later date determined by the Secretary, *IRC § 6045(g)(3)(C)*.

- . The Act adds detailed rules under which a customers adjusted basis in securities is determined see, *IRC §§ 1012(c)*, (d), *6045(g)(2)(B)*. Subject to certain exceptions, a first-in first-out method is used, but stock for which an average basis method is permissible is determined using the brokers default method. Various elections are available to use different methods, *IRC § 6045(g)(2)(B)(i)*. Unless the Secretary provides otherwise, a customers adjusted basis in a covered security generally is determined without taking into account the effect on basis of the wash sale rules of, *IRC Section 1091*. These rules are taken into account, however, if the acquisition and sale transactions resulting in a wash sale occur in the same account and are in identical securities, *IRC § 6045(g)(2)(B)(ii)*.

- . Gross proceeds and basis reporting for short sales is required in the year in which the short sale is closed, *IRC § 6045(g)(5)*.

- . The Act adds gross proceeds and basis information reporting requirements with respect to certain options, which will apply only to options granted or acquired after 2012, *IRC § 6045(h)*.

- . For purposes of reporting requirements, S corporations (other than financial institutions) are treated in the same manner as partnerships, effective for sales of securities acquired by an S corporation after 2011. When this rule takes effect, brokers generally will be required to report gross proceeds and basis information to customers that are S corporations, *IRC § 6045(g)(4)*.

- . A new provision, *IRC § 6045A*, requires persons who transfer securities to broker to furnish within 15 days of the transfer a statement containing information that allows the transferee broker to satisfy the statutory basis and holding

period reporting requirements, *IRC § 6045A(a)*, (c). Penalties may be assessed if the statement is not provided, *IRC § 6724(d)(2)(I)*. The Secretary is to provide regulations regarding the specified information required and the manner of furnishing it, *IRC § 6045A(a)*.

. A new provision, *IRC Section 6045B*, requires, according to forms or regulations prescribed by the Secretary, any issuer of a specified security to file a return setting forth a description of any organizational action (such as a stock split or a merger or acquisition) that affects the basis of the specified security, the quantitative effect on the basis of that specified security, and any other information required by the Secretary, *IRC § 6045B(a)*. This return must be filed within 45 days after the date of the organizational action or, if earlier, by January 15 of the year following the calendar year during which the action occurred, *IRC § 6045B(b)*. Every person required to file this return for a specified security also must furnish, according to forms or regulations prescribed by the Secretary, to the nominee with respect to that security (or to a certificate holder if there is no nominee) a written statement containing specified information. This statement must be furnished to the nominee or certificate holder on or before January 15 of the year following the calendar year in which the organizational action took place, *IRC § 6045B(c)*. Public reporting in lieu of a return is allowed in some cases, *IRC § 6045B(e)*. Penalties may be assessed if the statement is not provided, *IRC § 6724(d)(1)(B)(iv)*, *6724(d)(2)(J)*.

Extension and Modification of Alternate Fuels Credit

The Act makes the following amendments to the alternate fuel credit, effective for fuel sold or used after October 3, 2008:

. The alternative fuel credit and alternative fuel mixture credit are both extended for three months, through December 31, 2009, *IRC § 6426(d)(5)*, *6426(e)(3)*, *6427(e)(5)(C)*.

. Alternative fuel subject to the credit is extended to compressed or liquefied gas derived from biomass, *IRC § 6426(d)(2)(F)*; see, *IRC § 45K(c)(3)*.

. The credit is extended to fuel sold for use in aviation, *IRC § 6426(d)(1)*.

. A carbon capture requirement is imposed for fuel that is certified as having been derived from coal produced at a gasification facilities meeting specified separation and sequestration requirements for their carbon dioxide emissions, *IRC § 6426(d)(2)(E)*, (d)(4).

Tax Return Preparer Understatement of Tax Liability Penalty Modified

The Act revises the definition of an unreasonable position and changes the standards for imposition of the tax return preparer penalty, *IRC § 6694(a)*. The preparer standard for undisclosed positions is reduced to substantial authority, *IRC § 6694(a)(2)(A)*, and the preparer standard for disclosed positions is set at reasonable basis, *IRC § 6694(a)(2)(B)*. The preparer standard for reportable transactions, to which, *IRC Section 6662A*, applies (i.e., listed transactions and reportable transactions with significant avoidance or evasion purposes), remains unchanged. For reportable transactions the preparer must have a reasonable belief that the position would more likely than not be sustained on its merits, *IRC § 6694(a)(2)(C)*. No penalty is imposed if it is shown that there is reasonable cause for the understatement and the tax return preparer acted in good faith, *IRC § 6694(a)(3)*. The amendments generally are effective with respect to returns

prepared after May 25, 2007. In the case of reportable transactions, the amendments are effective for returns prepared for taxable years beginning after October 3, 2008.

Rules for IRS Undercover Authority are Made Permanent

The authorization for IRS officers to engage in undercover operations is made permanent, *IRC § 7608(c)(6)* repealed.

Increase On Limit on Cover Over of Rum Excise Tax

The temporary increase in the limit on cover over of the rum excise tax to Puerto Rico and the Virgin Islands is extended for two years, through December 31, 2009, *IRC § 7652(f)(1)*.

Qualifying Income of Publicly Traded Partnerships Expanded

The Act expands the qualifying income of a publicly traded partnership to include income and gains derived in connection with industrial source carbon dioxide, or from the transportation or storage of certain fuels, *IRC § 7704(d)(1)(E)*. The fuels are: (1) alcohol fuel mixtures, biodiesel mixtures, alternative fuels (which include liquefied petroleum gas, P Series Fuels, compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process, and liquid fuel derived from biomass), and alternative fuel mixtures, *IRC § 6426(b)*, (c), (d), (e); (2) alcohol other than alcohol derived from petroleum, natural gas, or coal, or having a proof of less than 190 see, *IRC § 6426(b)(4)(A)*, and (3) biodiesel see, *IRC § 40A(d)(1)*. The provisions are effective October 3, 2008, in taxable years ending after that date.

Group Health Plan Parity Requirements Modified and Extended to Substance Use Disorder Benefits

The Act makes the following amendments to *IRC Section 9812*, dealing with parity requirements for group health plans in the application of certain limits to mental health and substance use disorder benefits:

- . Parity requirements are extended to a new category of substance use disorder benefits, as defined. The term is separate from mental health benefits, *IRC § 9812(e)(4)*, (5).

- . Detailed financial requirements parity and treatment limitation parity requirements are imposed with respect to mental health or substance use disorder benefits on group health plans that provide both medical and surgical benefits and mental health or substance use disorder benefits, *IRC § 9812(a)(3)*. Parity requirements extend to use of out-of-network providers, *IRC § 9812(a)(5)*. Plan information must be made available, *IRC § 9812(a)(4)*.

- . The small employer exemption is changed, *IRC § 9812(b)* to apply to employers who employ not more than 50 employees on business days during the preceding calendar year. Certain aggregation, part-year, and predecessor employer rules apply in determining if a taxpayer is a small employer, *IRC § 9812(c)(1)*.

- . The cost exemption is modified to use a 2-percent increase percent in the case of the first plan year in which the parity provisions apply and 1 percent for later years, *IRC § 9812(c)(2)(A)*, (B). Various notice, determination, and audit requirements apply with respect to the exemption, *IRC § 9812(c)(2)(C)*, (D), (E).

- . The parity requirements are made permanent, *IRC § 9812(f)* repealed.

Ordinary Gain and Loss Treatment for Certain Sales or Dispositions of Preferred Stock

By Financial Institutions

The Act contains an uncodified provision, Pub Law 110-343, Div A Title III, § 301, which provides that gain or loss recognized by an applicable financial institution from the sale or exchange of applicable preferred stock is treated

as ordinary income or loss, Pub Law 110-343, Div A Title III, § 301(a). An applicable financial institution is a financial institution referred to in Section 582(c)(2) or a depository institution holding company (as defined in Section 3(w)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813(w)(1)), Pub Law 110-343, Div A Title III, § 301(c)(1). Applicable preferred stock is preferred stock of Fannie Mae or Freddie Mac that was (i) held by the applicable financial institution on September 6, 2008, or (ii) was sold or exchanged by the applicable financial institution on or after January 1, 2008, and before September 7, 2008, Pub Law 110-343, Div A Title III, § 301(b)(2).

In the case of a sale or exchange of applicable preferred stock on or after January 1, 2008, and before September 7, 2008, the provision applies only to taxpayers that were applicable financial institutions at the time of the sale or exchange, Pub Law 110-343, Div A Title III, § 301(c)(2)(A). In the case of a sale or exchange of applicable preferred stock after September 6, 2008, by a taxpayer that held that preferred stock on September 6, 2008, the provision applies only where the taxpayer was an applicable financial institution at all times during the period beginning on September 6, 2008, and ending on the date of the sale or exchange of the applicable preferred stock, Pub Law 110-343, Div A Title III, § 301(c)(2)(B). Thus, the provision is generally inapplicable to any Fannie Mae or Freddie Mac preferred stock held by a taxpayer that was not an applicable financial institution on September 6, 2008 (even if the taxpayer subsequently became an applicable financial institution).

The Secretary is given authority to extend the provision to cases in which (1) gain or loss is recognized on the sale or exchange of applicable preferred stock acquired in a carryover basis transaction by an applicable financial institution after September 6, 2008, Pub Law 110-343, Div A Title III, § 301(d)(1), or (2) the applicable financial institution is a partner in a partnership which (a) held the stock on September 6, 2008, and later sold or exchanged it, or such stock, or (b) sold or exchanged the stock on or after January 1, 2008, and before September 7, 2008, Pub Law 110-343, Div A Title III, § 301(d)(2). The Secretary may also provide guidance, rules, or regulations as are necessary to carry out the purposes of this provision, Pub Law 110-343, Div A Title.

Temporary Tax Relief for Midwestern Disaster Area and Hurricane Ike Disaster Area

Uncodified legislation provides extensive temporary tax relief to taxpayers in areas in the Midwest damaged by severe storms, tornados and flooding, Pub Law 110-343, § 702. Covered areas include parts of Arkansas, Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, and Wisconsin, Pub Law 110-343, § 702(b)(1). The relief provisions incorporate by reference many of the Gulf Opportunity Zone tax relief provisions, *IRC §§ 1400N* through *1400T*, and uncodified provisions of the Katrina Emergency Tax Relief Act of 2005, but with different effective dates and geographic coverage.

Uncodified legislation also provides temporary tax-exempt bond financing and low-income housing tax relief for areas damaged by Hurricane Ike, Pub Law 110-343, § 704.

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Passive Activity Losses

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Neil E. Harl on Passive Activity Losses: The Misunderstood Provision

By Neil E. Harl

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SUMMARY: The centerpiece of the landmark Tax Reform Act of 1986, the passive activity loss provision, was designed to reduce shelter activity in the agricultural sector but in several respects the provision has proved to be disappointing.

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ARTICLE: Harl on Passive Activity Losses: The Misunderstood Provision

by Neil E. Harl

The centerpiece of the landmark Tax Reform Act of 1986, n1 the passive activity loss provision, was designed to reduce shelter activity in the agricultural sector but in several respects the provision has proved to be disappointing. n2 Part of the disappointment has been that the Internal Revenue Service and the Department of the Treasury n3 do not understand how the agricultural sector functions and the opinions in the few agricultural cases to reach the courts have not demonstrated insightful analyses of the statute. n4

Notwithstanding those obstacles, the passive activity rules, along with other statutory enactments since 1969, have likely reduced significantly the tax motivated transactions that once plagued the sector and are still making news. n5

Meaning of material participation for purposes of passive activity losses

The heart of the passive activity rules is the definition of material participation. n6 An activity is considered a passive activity if it involves the conduct of a trade or business and the taxpayer does not *materially participate* in the activity or a rental activity. n7 But material participation is not the same term used for self-employment tax and social security purposes; n8 a taxpayer is treated as materially participating for passive activity loss purposes only if the person is involved in the operations of the activity *on a basis which is regular, continuous, and substantial*. n9

The bottom line is that, for passive trade or business activities, to the extent deductions exceed income from all passive activities (exclusive of portfolio income), the losses cannot be deducted against other income. n10 Rather, the loss or credit which is disallowed can be carried forward until the amounts can be utilized. n11

But it all comes down to the meaning of material participation for passive activity loss purposes which was intended to be more demanding than the traditional meaning of the term and it is a more demanding bar. n12 Temporary regulations issued by IRS laid out seven tests for material participation. n13 The tests are heavily weighted on what the taxpayer can demonstrate in terms of time devoted to the activity.

Test number one. Under the first test, an individual is considered to be materially participating if the individual participates in the activity for more than 500 hours during the year. n14

Test number two. The second test is for situations requiring less than 500 hours of involvement or less than 500 hours by any one individual during the year. n15 If an individual's participation in the activity constitutes substantially all of the participation in the activity by all individuals during the year, it is considered material participation.

Test number three. Under the third test, an individual is considered to be materially participating if the individual puts more than 100 hours into the activity and the individual's participation is not less than that of any other individual. n16

Test number four. The fourth test introduces a new term significant participation. An individual is treated as materially participating in significant participation activities if the individual's aggregate participation in significant participation activities for the year exceeds 500 hours. n17 A significant participation activity is a trade or business activity in which the individual participates for more than 100 hours during the taxable year. n18 This rule is intended to reach those individuals who devote more than 500 hours per year spread over several activities. The idea is to treat that individual as favorably as someone who devotes an equivalent amount of time to a single activity.

Test number five. Under the fifth test, an individual is treated as materially participating if the individual materially participated in the activity for any five of the ten taxable years immediately preceding the taxable year. n19 The idea behind this rule is that substantial involvement over a lengthy period indicates that it was probably the individual's principal livelihood.

Test number six. Under the sixth test, for those involved in personal service activities, an individual is treated as materially participating in a personal service activity for a taxable year if the taxpayer materially participated in the activity for any three taxable years preceding the taxable year. n20 Personal service activities are those involving the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting or any other trade or business in which capital is not a material income-producing factor. n21

Test number seven. The seventh and final test specifies that an individual may be treated as materially participating in an activity based on all the facts and circumstances. n22 The regulations point out three factors to keep in mind in applying that test. (1) Material participation for purposes of social security or special use valuation of land for federal estate tax purposes is not taken into account. n23 This seems inconsistent with a passage in the committee reports. As the Senate Finance Committee report stated, in the case of farming, the committee anticipates that an individual who does not perform physical work relating to a farm, but who is treated as having self-employment income with respect to the farm under section 1402, generally will be treated as materially participating. n24 (2) An individual who does not participate in an activity for more than 100 hours cannot meet the facts and circumstances test. n25 (3) An individual's participation in management of an activity is not taken into account in applying the facts and circumstances test *if a paid manager participates in the activity and no individual performs services in connection with the management of the activity that exceeds (by hours) the amount of service performed by the individual.* n26 This is the toughest of the three rules on imputation n27 and means that anyone represented by a paid manager or agent is *unlikely to be able to meet the facts and circumstances test.*

Material participation by trusts

In *The Mattie K. Carter Trust v. United States*,ⁿ²⁸ a testamentary trust had been set up to hold and manage a 15,000 acre ranch and oil and gas interests in Texas. The trustee of the trust, as the court noted, dedicated a substantial amount of time to ranch activities.ⁿ²⁹ The trust also employed a full-time ranch manager along with other full and part-time employees.ⁿ³⁰ In 1994 and 1995, the trust incurred sizeable operating losses which IRS disallowed on the grounds that the trust was a passive activity and the trustee did not meet the material participation requirements.ⁿ³¹

The trust paid the tax and filed a claim for refund which was denied. The United States District Court for the Northern District of Texas dismissed the argument by IRS that only the trustee's involvement counted, which was based on the passage in the committee reports indicating that the material participation test was met if the fiduciary met the test.ⁿ³² The court held that, in determining material participation for trusts and estates, the activities of employees of the trust should be included in determining whether the participation was regular, continuous, and substantial.ⁿ³³ The case was not appealed.

A technical advice memorandum (TAM) dated August 17, 2007,ⁿ³⁴ states that an estate or trust is treated as materially participating in an activity if an executor or fiduciary, in his capacity as such, is so participating.ⁿ³⁵ The TAM continues with the statement that as a general matter, the owner of a business may not look to the activities of the owner's employees to satisfy the material participation requirement.ⁿ³⁶ Thus, by the IRS view, the activities of agents or employees are not imputed or attributed to the taxpayer and the *focus is solely on the activities of the trustee or trustees* which must be at a level which is regular, continuous, and substantial.ⁿ³⁷ That, states the TAM, is the proper standard to apply to trusts for purposes of § 469.ⁿ³⁸ Thus, imputation is generally barred under the passive loss rules as has been argued for several years.ⁿ³⁹ The court in *The Mattie K. Carter Trust v. United States*ⁿ⁴⁰ obviously disagreed with that position.

This sharply worded difference assures that there will be further litigation. As a matter of planning, taxpayers and tax practitioners would be well advised to follow the TAM.ⁿ⁴¹ The reasoning of the TAM seems to be firmly grounded in relevant tax law.

The active participation test

Basic requirements. The passive activity loss statuteⁿ⁴² allows a taxpayer to deduct annually up to \$25,000 of passive activity losses and the deduction equivalent of passive activity credits attributable to rental real estate activities in which the taxpayer *actively participates*.ⁿ⁴³ The active participation requirement applies both in the year of loss and in the year of allowance of the loss.ⁿ⁴⁴

The \$25,000 allowance phases out ratably as the taxpayer's adjusted gross income (determined without regard to the passive activity losses) increases from \$100,000 to \$150,000.ⁿ⁴⁵ Moreover, the \$25,000 allowance is not available to corporate taxpayersⁿ⁴⁶ but is available to estates for up to two years after the death of the decedent.ⁿ⁴⁷

What is rental real estate? Under the regulations,ⁿ⁴⁸ a 50-50 crop share lease is termed a joint venture *and not as a rental activity* without regard to whether the taxpayer performs any services in the farming activity.ⁿ⁴⁹ By contrast, the instructions to Form 4835 (which is the form non-material participation share rent landlords are encouraged to file) suggested that the deduction under the active participation test would be available for a non-material participation share lease landlord. However, the Department of the Treasury indicated in a letter to Sen. Charles Grassley of Iowa in 1990 (which was published in *Tax Notes*)ⁿ⁵⁰ that the passage in the regulations is the correct interpretation. The position of

the Department of the Treasury has been criticized. n51 In early 1991, the Department of the Treasury announced that the inconsistency would be addressed. Nothing has been issued since 1991 on this point.

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n1 Pub. L. No. 99-514, §§ 501, 502, *100 Stat. 2233 (1986)*.

n2 I.R.C. § 469. See generally 2 Harl, *Farm Income Tax Manual* § 4.08 (2007 ed.); 4 Harl, *Agricultural Law* § 30.08 (2008); Harl, *Agricultural Law Manual* § 4.05[3] (2008). See also Harl, IRS Asserts Its Position on Material Participation by Trusts, 18 *Agric. L. Dig.* 137 (2007).

n3 See Letter from Kenneth Gideon, Assistant Secretary (Tax Policy) to Senator Charles E. Grassley, October 24, 1990, published in Tax Notes, *Highlights and Documents*, November 12, 1990, p. 749.

n4 See *The Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

n5 See, e.g., *River City Ranches #1, Ltd. v. Commr, T.C. Memo. 2007-171, on remand from, 401 F.3d 1136 (9th Cir. 2005)*, appealed to 9th Cir. 10/9/07 (sheep partnership transactions were tax motivated, were shams and lacked economic substance); *Nault v. United States*, 08-1 U.S.T.C. 50,195 (1st Cir. 2008) (agriculture-based limited partnerships involving AMCOR partnerships lacked economic substance; IRS and TMP settlement specified 72 percent of claimed deductions disallowed).

n6 I.R.C. § 469(h)(1).

n7 I.R.C. § 469(c)(1). See *Carlstedt v. Commr, T.C. Memo. 1997-331* (taxpayer deemed to be materially participating in company activities so income could not be used to offset passive losses of related partnership).

n8 I.R.C. § 1402(a)(1).

n9 *I.R.C. § 469(h)(1)* (emphasis added). See *Chapin v. Commr, T.C. Memo. 1996-56* (taxpayers involvement in renting beach-front condominium did not constitute material participation; rental agent handled all rental arrangements).

n10 *I.R.C. § 469(a)*.

n11 *I.R.C. § 469(b)*.

n12 S. Rep. 99-313, 99th Cong., 2d Sess. P. 732 (1986). See 2 Harl, *Farm Income Tax Manual* § 4.08[2][a] (2007 ed.).

n13 *Temp. Treas. Reg. § 1.469-5T(a)*.

n14 *Temp. Treas. Reg. § 1.469-5T(a)(1)*. See *Bohannon v. Commr, T.C. Memo. 1997-153* (taxpayers testimony of working 400 to 500 hours per year in automobile dealership not credible); *Lapid v. Commr, T.C. Memo. 2004-222* (time spent on investment activities did not count for 500-hour test).

n15 *Temp. Treas. Reg. § 1.469-5T(a)(2)*.

n16 *Temp. Treas. Reg. § 1.469-5T(a)(3)*. See *Barnaskis v. Commr, T.C. Memo. 1999-258* (over 100 hours but not more than management company for condominium unit).

n17 *Temp. Treas. Reg. § 1.469-5T(a)(4)*.

n18 *Temp. Treas. Reg. § 1.469-5T(c)(1)*.

n19 *Temp. Treas. Reg. § 1.469-5T(a)(5)*.

n20 *Temp. Treas. Reg. § 1.469-5T(a)(6)*.

n21 *Temp. Treas. Reg. § 1.469-5T(d)*.

n22 *Temp. Treas. Reg. § 1.469-5T(a)(7)*.

n23 *Temp. Treas. Reg. § 1.469-5T(b)(2)(i)*.

n24 S. Rep. 99-313, 99th Cong., 2d Sess. 733-34 (1986).

n25 *Temp. Treas. Reg. § 1.469-5T(b)(2)(iii)*.

n26 *Temp. Treas. Reg. § 1.469-5T(b)(2)(ii)*.

n27 5 Harl, *Agricultural Law* § 41.06 (2008). See 2 Harl, *Farm Income Tax Manual* § 4.08[2][c] (2007 ed.).

n28 256 F. Supp. 2d 536 (N.D. Tex. 2003).

n29 *Id.*

n30 *Id.*

n31 *Id.*

n32 S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986).

n33 *I.R.C. § 469(h)(1).*

n34 *TAM 200733023*, August 17, 2007.

n35 S. Rep. No. 99-313, 99th Cong., 2d Sess. 735 (1986).

n36 *TAM 200733023*, August 17, 2007.

n37 *I.R.C. § 469(h)(1).*

n38 *TAM 200733023*, August 17, 2007.

n39 See 5 Harl, *Agricultural Law* § 41.06 (2008); Harl, Imputing Activities from Agent to Property Owner as Principal, 10 *Agric. L. Dig.* 89 (1999).

n40 256 *F. Supp. 2d* 536 (*N.D. Tex.* 2003).

n41 *TAM 200733023*, August 17, 2007.

n42 *I.R.C. § 469(i)*.

n43 *Id.*

n44 *I.R.C. § 469(i)(a)*.

n45 *I.R.C. § 469(i)(3)*.

n46 *I.R.C. § 469(i)(1)*.

n47 *I.R.C. § 469(i)(4)(A)*.

n48 *Temp. Treas. Reg. § 1.469-1T(e)(3)(viii)*, Example 8.

n49 *Id.*

n50 Letter from Kenneth W. Gideon, Assistant Secretary (Tax Policy) to Sen. Charles E. Grassley, October 24, 1990.

n51 See Harl, Crop Share Leases and Material Participation Dichotomy, 49 *Tax Notes* 1255 (1990).

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Chapter 12 Bankruptcy Treatment

2008 Emerging Issues 2964

Neil E. Harl on Chapter 12 Bankruptcy Treatment

By Neil E. Harl

October 1, 2008

SUMMARY: The income tax treatment of bankruptcy estates has been a problem for decades. The separate entity in bankruptcy is an integral part of U.S. bankruptcy law. But the concept of a new tax entity was not extended to Chapter 12 filers after the 1986 enactment of that chapter. That omission has posed serious problems for dealing with income tax liability incurred in the course of reorganization of farm and ranch businesses.

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ARTICLE: The income tax treatment of bankruptcy estates has been a problem for decades. n1 The Bankruptcy Tax Act of 1980 n2 expanded and clarified the income tax treatment of taxpayers in bankruptcy and authorized the creation of a new tax entity for individuals (but not partnerships and corporations) filing under Chapters 7 and 11 of the Bankruptcy Code. n3 With separate entity status, the debtors assets as well as tax attributes n4 pass into the bankruptcy estate which becomes liable for payment of income taxes triggered in bankruptcy. n5 Thus, the separate entity in bankruptcy is an integral part of the fresh start which is a prominent feature of U.S. bankruptcy law. The separate entity insulates debtors from tax liability arising from ordinary income and capital gains as well as most other tax consequences during the period the separate entity is functioning. n6

But the concept of a new tax entity was not extended to Chapter 13 filers n7 or to Chapter 12 filers after the 1986 enactment of that chapter. n8 That omission, especially for Chapter 12 filers, has posed serious problems for dealing with income tax liability incurred in the course of reorganization of farm and ranch businesses. As part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, n9 the Congress attempted to remedy the omission for Chapter 12 filers. n10

The 2005 enactment

In the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, n11 the Congress attempted to remedy the omission as to Chapter 12. n12 The approach taken was not to add Chapter 12 filers to the list of those eligible for a new tax entity at death, n13 but to provide that a Chapter 12 bankruptcy filer could treat liabilities arising out of claims owed to a governmental unit, such as income tax on the gain or recapture income, as a result of sale, transfer, exchange, or other disposition of any farm asset used in the debtors farming operation as an unsecured claim.

n14 As an unsecured claim, the amount is not entitled to priority under *Section 507(a) of the Bankruptcy Code*. n15 All of this is possible, *if the debtor receives a discharge*. n16 By declaring such claims owed to a governmental unit to be unsecured claims, rather than priority claims, the amounts would be eligible for discharge.

Under prior law, taxes were a priority claim that had to be paid in full although taxes could be paid on a deferred payment basis. n17 However, in many instances, farm debtors did not have sufficient funds to pay the taxes in full, even in deferred payments. n18

The language used by the Congress left some questions to be resolved. (1) First, does the passage sale, transfer, exchange, or other disposition of any farm asset used in the debtors farming operation include breeding and dairy stock, machinery and equipment, land, slaughter livestock, grain and other crops produced for sale? Or does the term include only land, machinery and equipment and breeding and dairy animals? (2) Second, does the provision extend to assets disposed of in pre-petition transfers, post-petition transfers and transfers occurring post-confirmation but before the entry of Chapter 12 discharge? (3) Third, is it appropriate to use a Chapter 12 liquidation analysis, which adds the portion of taxes treated as an unsecured claim to the traditional unsecured claims in determining whether the best-interest-of-creditors test is met, or is it necessary to use the Chapter 7 analysis which requires that the tax claims be treated as a priority claim to be paid in full?

Bankruptcy Court interpretations

In re Knudsen. In the first judicial interpretation of the 2005 enactment addressing the tax treatment of Chapter 12 bankruptcy filers, *In re Knudsen*, n19 the Bankruptcy Court first held that the language, farm asset used in the debtors farming operation limited the scope of the provision to assets used in the trade or business which are eligible for capital gain treatment n20 (and, presumably, capital assets as well). n21 The court believed that the language in the statute was not sufficiently broad to include assets held for sale such as slaughter animals, grain, milk or other farm-produced products. n22

The debtor had argued that, as a relief provision, the favorable treatment outlined in the statute should be extended to taxes arising from the sale or other disposition of any farm asset, when the disposition was made in furtherance of restructuring the debtors farming operation. n23 The debtor further argued that the key words, farm asset used in the debtors farming operation should be given the broader interpretation of being *involved in or associated with* the debtors farming operation rather than the interpretation arising out of the technical tax meaning of the term (noting that the legislation was not the product of the tax committees in Congress).

If sustained on appeal, n24 which it was not, the courts approach on this issue could have led to creative restructuring of the debtors operation with the conversion of assets ordinarily producing ordinary income into assets held for use in the business. n25 Examples include the sale of land with an unharvested crop to one person in one transaction so that the sale of the growing crop is considered a sale of an asset eligible for long-term capital gain treatment along with the gain on the land. n26 Another example would be failure to identify a hedge as a hedge which could result in capital gain or loss treatment as a speculative transaction rather than ordinary gain or loss treatment as a hedge. n27

The Bankruptcy Court in *Knudsen* n28 also held that, in allocating tax claims between those attributable to the sale of farm assets eligible for the special treatment allowing possible discharge of the tax as an unsecured claim, and those subject to priority status (which are not eligible for possible discharge and must be paid in full in order to get the Chapter 12 plan confirmed, the method used should be to pro rate the taxes. n29 The debtor had argued for a marginal approach which, because of graduated income tax rates, would be more favorable to the debtor.

The Bankruptcy Court in the case of *In re Knudsen* n30 agreed with the debtor that the statutory language changes the character of the taxes from a priority classification to unsecured status. That cleared the way, upon entry of a discharge in bankruptcy, for the unpaid portion of the tax to be discharged along with any interest and penalties. n31

The Bankruptcy Court also agreed that the relief provision in the 2005 enactment on making taxes eligible for a discharge applies to post-petition taxes and, while a separate estate is not created, the taxes on the income of the debtors can be treated as administrative expenses. n32 The post-petition taxes on the sale of farm assets eligible for the special treatment are also treated as an unsecured claim rather than a priority claim. Thus, the post-petition taxes are dischargeable without payment in full provided the amounts are provided for in the plan *and the debtor receives a Chapter 12 discharge*.

The court indicated that it is appropriate to use a Chapter 12 liquidation analysis (which adds the portion of tax treated as an unsecured claim to the traditional unsecured claims in determining whether the best-interests-of-creditors test is met) rather than the Chapter 7 liquidation analysis (which requires that the tax claims be treated as priority claims to be paid in full. n33 Using the Chapter 12 liquidation analysis allows more plans to be confirmed than would be the case with the Chapter 7 approach.

In re Hall. A 2007 Arizona Bankruptcy Court case, *In re Hall*, n34 held that the post-petition sales of assets used in the debtors farming operation do not qualify for the special treatment with tax claims treated as unsecured claims rather than as priority claims. The Arizona Bankruptcy Court read the definition of administrative claim in conjunction with the tax law and concluded that, because there was no separate taxable entity created in Chapter 12, n35 the capital gains tax arising from post-petition dispositions of assets could not be incurred by the estate. n36 Therefore, the income tax liability for post-petition sales and other dispositions do not qualify for discharge as unsecured claims.

In re Schilke. The Nebraska Bankruptcy Court, in the case of *In re Schilke*, n37 followed *In re Knudsen*, the Iowa case, in holding that the bankruptcy estate had sufficient existence to support treatment of capital gains from the sale or other disposition of estate property as a claim against the estate and not solely against the debtor outside of bankruptcy.

In re Dawes. In a 2008 case by the Bankruptcy Court in Kansas, *In re Dawes*, n38 the court also followed *In re Knudsen*. n39 As for the issue that led the *Hall* court to hold that capital gains taxes arising from post-petition sales and other dispositions could not be incurred by the estate, and, therefore, could not be eligible for discharge as unsecured claims, the court in *Dawes* found that the phrase incurred by the estate n40 is ambiguous and noted that for all bankruptcy chapters, including Chapter 12, the filing of a petition creates an estate comprised of all of the property of the debtor. n41 The court went on to note that the term incurred by the estate could have reference to the time at which liability for the tax accrues did the liability arise before or after the creation of the estate as used in that sense?

The Bankruptcy Court then proceeded to look at the legislative history and concluded that the evidence indicates that Congress intended the phrase incurred by the estate to have reference to *when* the tax liability was incurred, not the entity having liability for the tax. n42 In support of that conclusion, the Bankruptcy Court in *Dawes* n43 points out, if administrative claim status were dependent upon the creation of a new taxpaying entity upon the filing of a petition, federal taxes incurred by Chapter 7 and Chapter 11 corporate debtors n44 would be denied administrative claim status, as a corporations filing of a petition under either Chapter 7 or Chapter 11 does not create a new taxpayer. n45

With *Knudsen*, *Schilke* and *Dawes* aligned in support of the debtor and in opposition to the position of the Internal Revenue Service, with only *Hall* in support of the Service position, the focus was on the United States District Court for the Northern District of Iowa to which *Knudsen* was appealed.

The appellate decision in *In re Knudsen*

In a well-reasoned and persuasive opinion, the United States District Court for the Northern District of Iowa, on June 12, 2008, ordered the Bankruptcy Court to confirm the plan in the case of *In re Knudsen*. n46 The judge held that the sale of slaughter hogs qualified as assets used in the debtors farming operation, finding that the debtors farming operation is the debtors farming operation under the reorganization plan and specifically rejected the narrow interpretation that used in the debtors farming operation limited the scope of the provision to those assets covered by *I.R.C. § 1231* (assets used in the trade or business with gains eligible for capital gains treatment) and *I.R.C. § 1221*

(capital assets).ⁿ⁴⁷ The court upheld the Bankruptcy Courts conclusion that the 2005 enactmentⁿ⁴⁸ applied to post-petition transfers utilizing the rationale of *In re Dawes*ⁿ⁴⁹ and, even though a separate estate is not created, the taxes could be treated as administrative expensesⁿ⁵⁰ which means the taxes could be handled as an unsecured claim.ⁿ⁵¹ The appellate court also adopted the marginal methodology as opposed to a model of pro rating the taxes.

What is next?

The big question is whether the *Knudsen* case will be appealed to the Eighth Circuit Court of Appeals and whether other bankruptcy court cases may be appealed as well.

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ⁿ¹ See generally 2 Harl, *Farm Income Tax Manual* § 9.05 (2007 ed.); 5 Harl, *Agricultural Law* § 39.04 (2008). See also Harl, Bankruptcy Court Interpretation of Chapter 12 Tax Rules, 17 *Agric.L. Dig.* 185 (2006).

ⁿ² Pub. L. No. 96-589, § 3(a)(1), 94 *Stat.* 3389 (1980), adding *I.R.C.* §§ 1398, 1399.

ⁿ³ *I.R.C.* §§ 1398(a), 1399.

ⁿ⁴ *I.R.C.* § 1398(f), (g).

ⁿ⁵ See 5 Harl, *supra* note 1 for a detailed discussion of the functioning of the bankruptcy estate as a new tax entity.

ⁿ⁶ See *I.R.C.* § 1398(f)(1), (f)(2).

ⁿ⁷ *Id.*

n8 See 2 Harl, *Farm Income Tax Manual* § 9.05[3] (2007 ed.); 13 Harl, *Agricultural Law* § 120.08 (2008).

n9 Pub. L. No. 109-8, § 1003, *119 Stat. 23* (2005).

n10 See U.S.C. § 1222(a)(2).

n11 Pub. L. No. 109-8, § 1003, *119 Stat. 23* (2005).

n12 See *11 U.S.C. § 1222(a)(2)*.

n13 *I.R.C. § 1398(a)*.

n14 *11 U.S.C. § 1222(a)(2)*.

n15 *Id.*

n16 BAPCPA of 2005, § 1003, *119 Stat. 23* (2005), adding *11 U.S.C. § 1222(a)(2)*.

n17 *11 U.S.C. §§ 507(a), 1222(a)(2)*.

n18 See, e.g., *In re Specht*, No. 96-21022 (*Bankr. N.D. Iowa* 1997).

n19 *356 B.R. 480* (*Bankr. N.D. Iowa* 2006).

n20 *I.R.C. § 1231(b)*.

n21 *I.R.C. § 1221*.

n22 *In Re Knudsen*, 356 B.R. 480 (Bankr. N.D. Iowa 2006).

n23 *Id.*

n24 *In re Knudsen*, 356 B.R. 480 (Bankr. N.D. Iowa 2006), was appealed to the United States District Court for the Northern District of Iowa.

n25 *I.R.C. § 1231(b)*.

n26 See *I.R.C. § 1231(b)(4)*.

n27 *Treas. Reg. § 1.1221-2(f)(1)*.

n28 *In re Knudsen*, 356 B.R. 480 (Bankr. N.D. Iowa 2006).

n29 *Id.*

n30 356 B.R. 480 (Bankr. N.D. Iowa 2006).

n31 11 U.S.C. § 1222(a)(2).

n32 See 11 U.S.C. § 501(b)(1)(B).

n33 *In re Knudsen*, 356 B.R. 480 (Bankr. N.D. Iowa 2006).

n34 376 B.R. 741 (Bankr. D. Ariz. 2007).

n35 I.R.C. § 1398(a).

n36 *In re Hall*, 376 B.R. 741, 746 (Bankr. D. Ariz. 2007).

n37 379 B.R. 899 (Bankr. D. Neb. 2007).

n38 382 B.R. 509 (Bankr. D. Kan. 2008).

n39 356 B.R. 480 (Bankr. N.D. Iowa 2006).

n40 11 U.S.C. § 503(b)(1)(B)(i).

n41 See 11 U.S.C. § 541.

n42 See S. Rep. No. 95-1106, 95th Cong., 2d Sess.13 (1978).

n43 *In re Dawes*, 382 B.R. 509 (Bankr. D. Kan. 2008).

n44 See *I.R.C. § 1398(a)* (a new tax entity is available for Chapter 7 and Chapter 11 cases which the debtor is an individual).

n45 *In re Dawes*, 382 B.R. 509 (Bankr. D. Kan. 2008).

n46 No. C07-3011-MWB (N.D. Iowa 2008).

n47 *Id.*

n48 *11 U.S.C. § 1222(a)(2)(A)*.

n49 *382 B.R. 509 (Bankr. D. Kan. 2008)*.

n50 See *11 U.S.C. § 501(b)(1)(B)*.

n51 *Id.*

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and the Commission on Federal Payment Limitations in Agriculture, 2002-2003.

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Food, Conservation, and Energy Act of 2008

2008 Emerging Issues 2965

Neil E. Harl on the Food, Conservation, and Energy Act of 2008

By Neil E. Harl

October 1, 2008

SUMMARY: The 2008 Farm Bill should be viewed more as evolutionary rather than revolutionary in nature although some parts of the bill represent a sharp departure from past policy, including the limitations imposed on subsidy payments under the bill. The 2008 bill was also marked by inclusion of several income tax and self-employment tax provisions that were of importance to the agricultural sector.

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ARTICLE: Enactment of the five-year farm bill is always a major event in the agricultural sector; the 2008 legislation is no exception. The Food, Conservation and Energy Act of 2008 n1 was passed after a series of unprecedented delays, a Presidential veto, the discovery that one of the titles (Trade) had been inadvertently omitted from the enrolled bill that had been forwarded to the White House and votes in the U.S. House of Representatives and U.S. Senate to override the veto.

The 2008 legislation should be viewed more as evolutionary rather than revolutionary in nature although some parts of the bill represent a sharp departure from past policy, including the limitations imposed on subsidy payments under the bill. n2 The 2008 farm bill was also marked by inclusion of several income tax and self-employment tax provisions that were of importance to the agricultural sector. n3

I. Payment limitations

Through many farm bills, and in an occasional separate enactment, the Congress wove an intricate web of rules on who (or what) was a person and the regulations added to the complexity. n4 Thus, corporations were generally considered a separate person, entitled to receive federal subsidy payments as a person n5 as were limited partnerships, limited liability companies and, under some circumstances, irrevocable trusts. n6 Yet, general partnerships or joint ventures were not separate persons although the individual partners were viewed as separate persons. n7 This state of affairs had led to a proliferation of persons because of the limits on the amount each person could receive in payments. Prior to 2008, the payment limits were \$40,000 *per person* for direct payments, \$65,000 *per person* for counter-cyclical payments and \$75,000 *per person* for marketing loan benefits. n8 The rules governing persons provided the opportunity for the creation of additional persons and benefits paid under two of the four ways to receive marketing assistance benefits did not count against the \$75,000 payment limitation for that type of benefit. n9

Definition of person. The 2008 legislation changes the definition of person to mean a natural person *and that does not include an entity*. n10 All subsidy payments are deemed to be attributed to a social security number, taking into account direct and indirect ownership interests. n11 Payments to an entity are attributed to those individuals who have a direct or indirect ownership interest in the legal entity. The attribution of ownership is traced through four levels or layers of ownership interest. n12 This amendment should effectively end the proliferation of entities.

Interestingly, payments to a joint venture or general partnership cannot exceed the amount determined by multiplying the maximum payment amount by the number of persons and legal entities comprising the partnership or joint venture entity. n13 Payments to children under the age of 18 are attributed to the parents of the child. n14 For trusts, revocable trusts are considered to be the same person as the grantor of the trust. n15 For irrevocable trusts and estates, the Secretary is to administer the rules in a manner that will ensure the fair and equitable treatment of the beneficiaries of the trusts and estates. n16

In a surprise move, there is no longer a limit on marketing assistance benefits.

The 2008 Act repealed the so-called three entity rule which limited the number of entities through which an individual could receive program payments. n17 Under the three-entity rule, an individual who received payments as an individual could receive payments from no more than two entities. An individual who did not receive payments as an individual could receive payments from up to three entities.

Actively engaged in farming. The legislation also made minor changes in the actively engaged rule for payment eligibility. The person must be actively engaged in farming. Under the new language, to receive payments a person is considered to be actively engaged in a farming operation if (1) the person makes a significant contribution (based on the total value of the farming operation) to the farming operation of (a) capital, equipment or land and (b) personal labor or active personal management; (2) the person's share of the profits or losses from the farming operation must be commensurate with the contributions of the person to the operation and (3) the contributions of the person must be at risk. n18

A legal entity is considered to be actively engaged in a farming operation if (1) the legal entity separately makes a significant contribution (based on the total value of the farming operation) of capital, equipment or land; (2) the stockholders or members collectively make a significant contribution of personal labor or active personal management to the operation; (3) the entity's share of the profits or losses from the farming operation is commensurate with the contributions of the entity to the farming operation; and (4) the contributions of the entity are at risk. n19

Special classes of producers. The 2008 legislation recognizes six classes of producers for the actively-engaged test

- For *landowners*, a contribution of owned land is considered to meet the actively-engaged-in-farming test if the returns from the land are based on a share of production from the land, the share of profits or losses is commensurate with the contributions to the farming operation and the contributions are at risk;
- For an *adult family member*, if a majority of the participants in a farming operation are family members, an adult family member is considered to be actively engaged in the farming operation if the adult family member makes a significant contribution, based on the total value of the farming operation, of active personal management or personal labor, the shares of profits or losses are commensurate with the contributions to the farming operation and the contributions are at risk;
- For a *sharecropper*, a significant contribution of personal labor is considered to be actively engaged in farming with respect to the farming operation if the share of profits and losses is commensurate with the contributions to the farming operation and the contributions are at risk;
- For *growers of hybrid seed*, the existence of a hybrid seed contract is not taken into consideration;
- For *persons or entities receiving custom farming services*, the test is met if the general requirements for actively engaged are met or the landowner, adult family member, sharecropper or grower of hybrid seed requirements are met and no other rules with respect to custom farming shall apply; and
- If one *spouse or estate of a deceased spouse* is determined to be actively engaged, the other spouse is considered to

have met the requirements. n20

Adjusted gross income limit. A person or legal entity is not eligible to receive farm program payments if the average non-farm income of the person or entity exceeds \$500,000. n21 The calculation involves the last three preceding taxable years. n22 Moreover, the person or legal entity is not eligible to receive a *direct* payment during a crop year if the average adjusted gross *farm* income of the person or legal entity exceeds \$750,000. n23

Conservation program limits. For an array of conservation benefits, a person or legal entity is not eligible to receive benefits if average adjusted non-farm income of the person or entity exceeds \$1,000,000 unless not less than 66.66 percent of the average adjusted gross income of the person or entity is average adjusted gross *farm* income. n24 Those limitations can be waived if it is determined that environmentally sensitive land of special significance would be protected. n25

II. Tax Provisions

It is unusual for a farm bill to include tax provisions but the 2008 legislation included several.

Conservation reserve program fix

The 2008 legislation includes a partial fix on the long-running dispute between taxpayers and the Internal Revenue Service over whether all Conservation Reserve Program Payments should be subjected to the 15.3 percent self-employment tax. n26 IRS had insisted, in a 2003 Chief Counsels ruling, n27 and a late 2006 Notice n28 that *all* CRP payments were subject to self-employment tax, contrary to a prior ruling n29 and cases n30 on the issue.

The provision in the 2008 farm bill provides that individuals receiving benefits under sections 202 or 203 of the Social Security Act (retirement benefits and disability benefits) are not subject to SE tax. n31 Thus, the basic issue involved, where the line is drawn between a trade or business on the one hand and an investment activity on the other, continues to be a problem and likely must await litigation to establish where that line is drawn.

Conservation contributions

The 2008 legislation extends for two years (through 2009) for individuals and corporations the provision permitting deductions for conservation contributions. n32

Ethanol credit and tariff

The 2008 farm bill reduced the ethanol fuels credit from 51 cents per gallon to 45 cents per gallon, effective after 2008. n33 The bill extended for two years (to January 1, 2011), the ethanol tariff (of 54 cents per gallon) which is levied on imported ethanol. n34

Like-kind exchanges of ditch, reservoir or irrigation company stock for land

The legislation allows like-kind exchange treatment for exchanges involving mutual ditch, reservoir or irrigation company stock n35 *provided* the stock has been recognized by the states highest court as representing real property or interests in real property. n36 The amendment is effective for exchanges *completed* after the date of enactment of the legislation. n37

Race horses

The legislation specifies that any race horse placed in service before January 1, 2014, is classified as three year property for depreciation purposes and race horses placed in service after December 31, 2013, are like-wise to be three year property if more than two years old at the time the horse is placed in service by the purchaser. n38 The provision is effective for property placed in service after December 31, 2008. n39

III. Other Provisions

A discussion of more of the provisions in the Food, Conservation and Energy Act of 2008 n40 appears in *Agricultural Law Digest*. n41

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n1 Pub. L. No. 110-234, 110th Cong., 2d Sess. (2008), hereinafter referred to as the Act.

n2 *Report of the Commission on the Application of Payment Limitations in Agriculture*, August 2003, published by the Office of the Chief Economist, U.S. Department of Agriculture, Washington, D.C., available in electronic form at <http://www.usda.gov/oce>. See generally 11 Harl, *Agricultural Law* Ch. 91, Ch. 91A (2008); 1 Harl, *Farm Income Tax Manual* § 2.09 (2007 ed.); Harl, *Agricultural Law Manual* § 10.03 (2008).

n3 See, e.g., Act § 15301(a), amending *I.R.C. § 1402(a)(1)* and *16 U.S.C. § 3833(a)* (a partial fix for the controversy touched off in 2003 by the Internal Revenue Service which asserted in CCA Ltr. Rul. 200325002, May 29, 2003, that all Conservation Reserve Program payments were subject to the 15.3 percent self-employment tax).

n4 See 11 Harl, *Agricultural Law* § 91A.01[12][b] (2008).

n5 7 *C.F.R. § 1400.101(a)*.

n6 7 *C.F.R. 1400.3*.

n7 See 7 *C.F.R.* § 1400.3.

n8 7 *U.S.C.* § 1308.

n9 See Harl and McEowen, Inconsistency in Handling Farm Income? 99 *Tax Notes* 923 (2003).

n10 Act § 1603(b), amending 7 *U.S.C.* § 1308(a)(4).

n11 *Id.*

n12 *Id.*

n13 *Id.*

n14 *Id.*

n15 *Id.*

n16 *Id.*

n17 Act § 1603(c), amending 7 *U.S.C.* § 1308-1.

n18 7 *U.S.C.* § 1308-1(b)(2)(A)(i), amended by Act § 1603(d); 7 *C.F.R.* § 1400.202.

n19 *Id.*

n20 *Id.*

n21 Act § 1604(a), amending 7 *U.S.C.* § 1308-3a(e).

n22 *Id.*

n23 *Id.* The benefits affected by the two rules include direct payments, counter-cyclical payments, marketing loan gains, loan deficiency payments, a payment or benefit under Section 196 of the 1996 farm bill, a payment or benefit under Section 1506 of the 2008 farm bill (the milk income loss contract program), and a payment under Title IX of the Trade Act of 1974 or Subtitle B of the Federal Crop Insurance Act.

n24 Act § 1604(a), amending 7 *U.S.C.* § 1308-3a(e).

n25 *Id.*

n26 Act § 15301, amending *I.R.C.* § 1402(a)(1) and 16 *U.S.C.* § 3833(a). The amendment is effective for payments made after December 31, 2007.

n27 CCA Ltr. Rul. 200325002, May 29, 2003.

n28 Notice 2006-108, 2006-2 *C.B.* 1118 (obsoleting *Rev. Rul.* 60-32, 1960-1 *C.B.* 23).

n29 *Ltr. Rul. 8822064*, March 7, 1988 (retired landowner who was not materially participating not subject to SE tax on CRP payments).

n30 E.g., *Ray v. Commr, T.C. Memo. 1996-436* (CRP payments subject to SE tax if CRP land had a direct nexus with business of farming).

n31 The legislation does not address the plight of mere investors in land bid into the CRP (whose CRP land does not bear a direct nexus to a farm or ranch business).

n32 Act § 15302(a), amending *I.R.C. § 170(b)(1)(E)(vi)*.

n33 Act § 15331(b).

n34 Act § 15333.

n35 The provision requires that the entity be recognized under *I.R.C. § 501(c)(12)(A)*.

n36 Act § 15342(a), adding *I.R.C. § 1031(i)*.

n37 Act § 15342(b).

n38 Act § 15344(a), amending *I.R.C. § 168(e)(3)(A)(i)*.

n39 Act § 15344(b).

n40 Pub. L. No. 110-234, 110th Cong., 2d Sess. (2008).

n41 *Agric. L. Dig.*, vol. 19, number 12 dated June 13, 2008.

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Dr. Harl has published widely including 28 books; more than 400 professional articles and bulletins; and more than 850 articles in farm and financial publications.

He is author of the 15-volume treatise, *Agricultural Law* and the single volume *Agricultural Law Manual* and *Farm Income Tax Manual*; senior author of two Tax Management Portfolios--*The Family-Owned Business Deduction and Reporting Farm Income* and co-author of *Taxation of Cooperatives* and co-author of *Principles of Agricultural Law*.

He has received more than 30 major awards including the USDA Superior Service Award in 1987; the Presidents Award from the Iowa State Bar Association in 1991; Charles A. Black Award from the Council for Agricultural Science and Technology in 1997, for effectiveness in communicating with the public; the Distinguished Service to Agriculture award from the Chicago Farmers Club in 1999, the *Wallaces Farmer* Iowa Master Farmer Award for Exceptional Service to Agriculture in 2000; the Speaker of the Year Award by the National Society of Accountants in 2000; the Presidential Service Award from Iowa State University in. *All rights reserved.*

2002; and the Service to American and World Agriculture Award from the National Association of County Agricultural Agents in 2006.

Dr. Harl has served on six federal advisory bodies -- a Farm Tax Reform Task Force for the U.S. Department of the Treasury in 1967; the Commissioner's Advisory Group (Commissioner of Internal Revenue) in 1979-80; the USDA Farm Structure Task Force in 1980; the Office of Technology Assessment, Technical Advisory Committee, by Congressional Appointment, 1987-1995 (chair in 1993-94); the USDA Advisory Committee on Agricultural Biotechnology, 2000-2002; and the Commission on Federal Payment Limitations in Agriculture, 2002-2003.

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Taxation of U.S. Citizens Working in a Foreign Country

2008 Emerging Issues 2687

Philip Fink on the Taxation of U.S. Citizens or Residents Living Abroad

By Philip R. Fink

August 13, 2008

SUMMARY: Taxpayers must report all income from wherever it is earned. However, taxpayers who are working abroad are subject to double taxation. The income they earn in a foreign country is subject to taxation in that country, as well as on their U. S. tax returns. To mitigate this double tax burden, individuals with foreign earned income may exclude a certain amount of this income from their U. S. gross income.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Citizens or residents of the U.S. who work in a foreign country can elect to either exclude their foreign earned income or take a foreign tax credit against the amount of income taxes that they owe to the U.S. *IRC Sections 911(a), (b) and (d)* lay out the rules for determining how much of an individuals foreign earned income can be excluded from his or her gross income. In general, taxpayers must report all income from wherever earned. However, taxpayers who are working abroad are subject to a double taxation. That is, the income they earn in a foreign country is subject to taxation in that country as well as on their U. S. tax returns. In an attempt to mitigate this double tax burden, these subsections allow individuals with foreign earned income to exclude a certain amount of this income from their U. S. gross income.

Foreign earned income: Foreign earned income includes salaries, wages, commissions, professional fees, and bonuses earned while working in a foreign country. It may also include business profits, royalties, and rents, provided that this income is tied to the performance of services. It does not include pension or annuity income, dividends, interest, or capital gains in a foreign country.

Caveat: Taxpayers that receive income from a foreign country that does not qualify for the exclusion may be entitled to claim the foreign tax credit in regard to those items.

Qualifications to exclude foreign earned income: To qualify for the exclusion, a taxpayer must: (1) have earned income in a foreign country, and (2) be a bona fide resident of the foreign country, or (3) be a U.S. citizen or U.S. resident and be present in a foreign country (or countries) for at least 330 days during any 12 consecutive months.

Caveat: The presence in a foreign country for 330 days does not have to be in the same calendar year. However, the

exclusion can be applied to two different years where the presence in a foreign country straddles two different years.

Example: Ashley, a U.S. citizen, is in the marketing department of a corporation based in the U.S. She is temporarily assigned to work in France from May 1, 2007 to July 31, 2008. In 2007 and 2008, she earns \$60,000 in salary. Since she is in France for more than 330 days during any 12 month time period, she will be able to exclude income for both 2007 and 2008.

Application of the exclusion for those taxpayers going back and forth to a foreign country: Individuals who work in a foreign country may come back to the U.S. for holidays and other occasions to be with their friends and family. It should be noted that the 330 days do *not* have to be consecutive days, but the 330 days do have to occur in a 12 month consecutive period. Individuals who go back and forth to a foreign country, may use the time from a prior trip in a foreign country to qualify for the exclusion in a subsequent trip.

Example: Bruce works in India from June 3, 2007 until April 20, 2008. He then goes back to India from May 26, 2008 until August 28, 2008. Even though neither trip is for 330 days, the earned income generated while in India for both trips qualifies for the exclusion. That is, for the 12 month period from June 3, 2007 until June 2, 2008, Bruce was in India for a total of 331 days (323 days during his first trip plus 8 days on his second trip from May 26, 2008 until June 2, 2008). In addition, his salary earned on the second trip qualifies for the exclusion since he was in India for 331 days (236 days from August 29, 2007 until April 20, 2008 plus 95 days from May 26, 2008 until August 28, 2008) during the 12 month period ending August 28, 2008.

Amount of the exclusion: The exclusion is limited to \$87,600 per person in 2008 (\$85,700 in 2007). If married individuals file a joint return, and each spouse has foreign earned income, both are entitled to the exclusion up to the applicable amount for the year in question. Since this amount is indexed, it will vary from year-to-year. If all the days in a tax year are not spent in a foreign country, then the taxpayer must compute the maximum exclusion on a daily basis. This is done in three steps. First, divide \$87,600 by the number of days in the entire year. Second, this amount is then multiplied by the number of days that an individual spent in a foreign country. Then, subtract the amount calculated in the second step from the individuals foreign earned income.

Example: Ron works for a U.S. based corporation, but was assigned to England for 340 days in 2008. His salary for the year was \$120,000. Accordingly, if he elects to exclude his foreign earned income, he has to include only \$38,400 of his salary in gross income as the following calculation shows: $\$87,600 / 365 = \$240$; $\$240 \times 340 = \$81,600$; $\$120,000 - \$81,600 = \$38,400$

Making the election: The election is made by attaching Form 2555 to a taxpayers Form 1040.

State income taxes: Many states base their income tax on the amount of the federal adjusted gross income, give or take some minor adjustments. Accordingly, taxpayers who exclude foreign earned income from their federal income tax returns will not have to report it on their state income tax returns unless there is a specific adjustment that requires them to add it back to the amount of their federal adjusted gross income.

Withholding income taxes: Tax professionals should make sure that their clients have an appropriate amount of tax withheld from their paychecks for their federal and state income taxes, as well as the tax withheld in the foreign country.

RELATED LINKS:

- IRC Section 911

ABOUT THE AUTHOR(S):

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Gerald M. Levinson on the Massive Housing and Economic Recovery Act of 2008

2008 Emerging Issues 2102

Gerald M. Levinson on the Massive Housing and Economic Recovery Act of 2008

By Gerald M. Levinson

August 6, 2008

SUMMARY: The Housing and Economic Recovery Act of 2008 was enacted to help resolve the nations economic and housing crisis. It provides tax and real estate incentives to help stimulate the economy and assist homeowners.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Facing what Senator Christopher Dodd (D-CT), Chairman of the Senate Committee on Banking, Housing and Urban Affairs, has called the most serious economic crisis to face our nation in many years, on July 26 the Senate approved a legislative package (H.R. 3221) thats designed to infuse new life into a declining real estate market and the near-recessionary economy that the housing downturn has spawned. The measure has the potential of costing upwards of \$400 billion.

President Bush, who at first had threatened to veto the measure, had a change of heart and signed it into law on July 30, 2008.

Named the *Housing and Economic Recovery Act of 2008* (the Act)), Dodd--who authored the legislation along with Senator Richard Shelby (R-AL)--says its the most sweeping housing legislation since the Great Depression, representing a turning point in our country's commitment to economic growth and affordable housing, and providing relief to homeowners and communities across the country.

Its anticipated that the measure will help at least 400,000 homeowners avoid foreclosure, and will pump about \$4 billion into communities in order to resuscitate homes that have already been foreclosed upon and become blighted. The bill also provides what amounts to a refundable interest-free loan to first time homebuyers, and gives the Treasury Department the authority to provide virtually unlimited financial backing, if need be, to Fannie Mae and Freddie Mac--the mortgage finance goliaths that own or back almost half of this countrys \$12 trillion mortgage debt.

While H.R. 3221s sponsors, co-sponsors, and backers are singing the bills praises, not everyone is ready to give it a standing ovation. The bill has its critics; well get to their beefs later. First, here are some specifics about this mammoth legislations provisions.

First-Time Homebuyer Credit

To help reduce the existing supply of unoccupied housing, the Act in effect gives certain home purchasers an interest-free loan by amending the Internal Revenue Code (IRC) to allow first-time homebuyers a refundable tax credit. The amount of the credit equals the lesser of \$7,500 (\$3,750 for a married individual filing separately) or 10% of the purchase price of a principal residence, and is allowed for the tax year in which the taxpayer buys the home. The credit phases out for individual taxpayers with modified adjusted gross income between \$75,000 and \$95,000 (\$150,000-\$170,000 for joint filers) for the year of purchase.

A taxpayer is considered a first-time homebuyer if he or she had no ownership interest in a principal residence in the U.S. during the 3-year period prior to the purchase of the home to which the credit applies.

Taxpayers receiving this tax credit would be required to repay any amount received under this provision to the government over 15 years in equal installments. The credit begins to phase out for taxpayers with adjusted gross income in excess of \$75,000 (\$150,000 in the case of a joint return). The credit must be paid back as an extra tax amount beginning with the tax return for the second year after the year in which the new home is purchased. First-time homebuyers who buy principal residences in 2008, and claim the \$7,500 credit, will pay it back starting with the 2010 tax return they file in 2011, and ending with the 2024 tax return they file in 2025, at \$500 per year. Generally, the payback is accelerated if the home is sold (or no longer used as a principal residence) before the end of the payback period.

The credit is effective for qualifying home purchases on or after April 9, 2008 and before July 1, 2009 (without regard to whether there was a binding contract to purchase prior to April 9, 2008). An election is provided to treat a home purchased in the eligible period in 2009 as if purchased on December 31, 2008 for purposes of claiming the credit on the 2008 tax return and for establishing the beginning of the recapture period. Taxpayers may amend their returns for this purpose [*Act Section 3011; IRC Section 36*].

Additional Standard Deduction for Real Property Taxes

To somewhat level the playing field between taxpayers who take the standard deduction and those who itemize, the Act provides a standard deduction up to \$500 for single filers and \$1,000 for joint filers for the 28.3 million non-itemizers who pay property taxes. Prior to this change, only those who itemized deductions on their federal tax returns were entitled to deduct state and local property taxes from their income. This provision applies only for 2008.

Under this provision, an individual taxpayers standard deduction is increased by the lesser of (1) the amount allowable to the taxpayer as a deduction for state and local taxes described in *IRC Section 164(a)(1)* (relating to real property taxes), or (2) \$500 (\$1,000 in the case of a married individual filing jointly). The increased standard deduction is determined by taking into account real estate taxes for which a deduction is allowable to the taxpayer under *IRC Section 164*. No taxes deductible in computing adjusted gross income are taken into account in computing the increased standard deduction.

NOTE: In the case of an individual taxpayer who does not elect to itemize deductions, although no itemized deductions are allowed to the taxpayer, itemized deductions are nevertheless treated as allowable for purposes of this provision. [*Act Section 3012; IRC Section 63*].

The HOPE for Homeowners Act

Because the government estimates that as many as 2.8 million homeowners could lose their homes to foreclosure by the end of 2009, the Act creates within the Federal Housing Administration (FHA) a HOPE for Homeowners Program to prevent foreclosures for hundreds of thousands of families. Participation in this program is voluntary on the part of homeowners and existing loan holders. It is designed to: (1) insure refinanced loans for distressed borrowers in order to support long-term, sustainable homeownership; (2) allow homeowners to avoid foreclosure by reducing the principal balance outstanding, and interest rate charged, on their mortgages; (3) help stabilize and provide confidence in mortgage markets by bringing transparency to the value of assets based

on mortgage assets; (4) target mortgage assistance under this section to

homeowners for their principal residence; (5) enhance the administrative capacity of the FHA to carry out its expanded role under the program; (6) ensure that the program remains in effect only for as long as is necessary to provide stability

to the housing market; and (7) provide servicers of delinquent mortgages with additional methods and approaches to avoid foreclosure.

The Act authorizes the Secretary of Housing and Urban Development, upon the application of a mortgage lender, to make commitments to insure, or to insure outright, any eligible mortgage that has been refinanced. To be eligible for this insurance, borrowers must certify, under penalties for perjury, that they have not intentionally defaulted on the mortgage or any other debt, and have not knowingly, or willfully furnished materially false information for the purpose of obtaining any eligible mortgage. Additionally, to qualify, borrowers must, as

of March 1, 2008, have been paying more than 31% of their income toward their mortgage (the percentage can be increased by the HOPE Program Board of Directors)

The principal amount of the refinanced eligible mortgage to be insured under the program will depend on the borrowers ability to make his or her mortgage payments, and cannot exceed 90% of the appraised value of the mortgaged property.

The Act allocates \$300 billion to refinance and insure distressed loans under the HOPE Program which, begins Oct. 1, 2008 and ends Sept. 30, 2011 [*Act Section 1402; National Housing Act Section 257*].

Assistance for Communities Devastated by Foreclosures

To ensure that communities can mitigate the harmful effects of foreclosures, the Act provides that \$3.92 billion in supplemental Community Development Block Grant Funds will be made available to communities hardest hit by foreclosures and delinquencies for the redevelopment of abandoned and foreclosed upon homes and residential properties. The amounts will be allocated to state and local governments according to a funding formula that's designed to assure funds are distributed to governments with the greatest need. The formula must be established within 60 days of enactment, and must be based on (1) the number and percentage of home foreclosures in each state or unit of general local government; (2) the number and percentage of homes financed by a subprime mortgage-related loan in each state or local unit, and (3) the number and percentage of homes in default or delinquency in each state or local governmental unit.

Comment:

President Bush initially threatened to veto H.R. 3221, finally focusing his threat on this provision. He argued the grant to state and local governments would prompt lenders to foreclose on properties rather than assist distressed homeowners retain their homes. But Treasury Secretary Paulson reportedly convinced the President that passage of the legislation was necessary to calm financial and credit markets, both in the U.S. and abroad [*Act Section 2301*].

Treasury Emergency Authority Over Fannie and Freddie

The Act contains several temporary provisions requested by Secretary Paulson that are intended to shore up the confidence of the financial markets in mortgage finance Government Sponsored Enterprises (GSEs)-- the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan and Mortgage Corp. (Freddie Mac), and the Federal Home Loan Banks.

Principally aimed at shoring up Fannie and Freddie (F+F), the Act would give Treasury virtually unlimited

authority for 18 months to recapitalize both institutions through capital infusions, via purchases of the duos stock, or through direct loans to the mortgage giants. To this end, the Act establishes the Federal Housing Finance Agency (the Agency), an independent agency with supervisory and regulatory authority over F+H and the Federal Home Loan Banks.

The Agency is charged with ensuring that each regulated entity operates in a safe and sound manner, including maintenance of adequate capital and internal controls, and that the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets (including activities relating to mortgages on housing for low- and moderate-

income families involving a reasonable economic return that may be less than the return earned on other activities).

To accomplish its mandate, the Agency will issue regulations to establish

criteria governing the portfolio holdings of the enterprises, to ensure that the holdings are backed by sufficient capital and consistent with the mission and the safe and sound operations of the enterprises. In establishing such criteria, the Director shall consider the ability of the enterprises to provide a liquid secondary market through securitization activities, the portfolio holdings in relation to the overall mortgage market, and adherence to the standards of prudent operation and management specified in the Act [*Act Section 1101 et seq; Federal Housing Enterprises Financial Safety and Soundness Act Section 1311*].

Enhancing Mortgage Disclosure

To ensure that consumers know the exact amounts of their mortgage payments, including the maximum possible payment under the terms of the loan and changes in payments associated with adjustable rate mortgages (ARMs), the Act requires lenders to provide borrowers with more timely and meaningful mortgage disclosures on all home purchase loans, loans that refinance a home, and loans that provide a home equity line of credit. With respect to ARMs, commonly regarded as causing homeowners--caught between falling home prices and rising mortgage payments--to default on home loans and impel foreclosures, the Act requires banks and other mortgage lenders to conspicuously provide ARM details in loan disclosure statements. This includes, in prominent type size and format, examples of adjustments to the regular required payment based on interest rate changes.

Another required example is an example reflecting the maximum payment amount of the regular required payments on the mortgage loan or other extension of credit, based on the maximum interest rate allowed under the mortgage note or bond, or other contract. Disclosures should also emphasize the fact that the initial regular payments are for a specific time period that will end on a certain date, that payments will adjust afterwards, potentially to a higher amount, and that there is no guarantee that the borrower will be able to refinance to a lower amount.

Consumers must receive the required disclosures before paying any fee to the lender, creditor or other person in connection with the consumers application

for a mortgage loan or other extension of credit thats secured by the consumers dwelling [*Act Section 2501; Truth in Lending Act Section 128*].

Mortgage Foreclosure Protections for Service Members

The Act contains several provisions to help returning soldiers avoid foreclosure, including lengthening the time a lender must wait before starting foreclosure from three months to nine months after a soldier returns from service. Other protections include a temporary increase in the maximum loan guaranty amount--up to 125% of the area median price for a single family

residence--for certain housing loans guaranteed by the Secretary of Veterans Affairs, counseling on mortgage foreclosures for members of the Armed Forces

returning from service abroad, and enhancement of protections for service members relating to mortgages and mortgage foreclosures.

The Act also provides for (1) home improvements and structural alterations for totally disabled members of the Armed Forces before discharge or release from the Service, (2) eligibility for specially adapted housing benefits and assistance for soldiers with service-connected disabilities and for service members

residing outside the U.S., (3) specially adapted housing assistance for individuals with severe burn injuries, (4) extension of assistance for service members residing temporarily in housing owned by a family member, (5) an increase in specially adapted housing benefits for disabled veterans, and (6) payment of transportation of baggage and household effects for service members who relocate due to foreclosure of leased housing [*Act Sections 2201 2203, 2601 -2609*].

Modification of Exclusion of Gain on Sale of a Principal Residence

Effective for transactions after December 31, 2008, the Act amends the

IRC Section 121 exclusion of up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence, if the residence was used as a principal residence for at least two of the previous five years. Generally, the break may be used only once every two years.

The Act provides that gain from the sale or exchange of a principal residence allocated to periods of nonqualified use-- meaning any period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence--is not excluded from gross income. The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction, the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property.

For purposes of determining periods of nonqualified use, the following periods are not taken into account : (1) any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period); and (2) any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances. The present-law election for the uniformed services is unchanged.

If any gain is attributable to post-May 6, 1997, depreciation, the exclusion does not apply to that amount of gain, as under prior law, and that gain is not taken into account in determining the amount of gain allocated to nonqualified use.

Example 1. Assume that an individual buys a property on January 1, 2009, for \$400,000, and uses it as rental property for two years claiming \$20,000 of depreciation deductions. On January 1, 2011, the taxpayer converts the property to his principal residence. On January 1, 2013, the taxpayer moves out, and the taxpayer sells the property for \$700,000 on January 1, 2014. As under prior law, the \$20,000 gain attributable to the depreciation deductions is included in income. Of the remaining \$300,000 gain, 40% of the gain (2 years divided by 5 years), or

\$120,000, is allocated to nonqualified use and is not eligible for the exclusion. Since the remaining gain of \$180,000 is less than the maximum gain of \$250,000 that may be excluded, that gain of \$180,000 is excluded from gross income.

Example 2. Assume that an individual buys a principal residence on January 1, 2009, for \$400,000, moves out on January 1, 2019, and on December 1, 2021 sells the property for \$600,000. The entire \$200,000 gain is excluded from gross income, as under prior law, because periods after the last qualified use do not constitute nonqualified use [*Act*

Section 3092; IRC Section 121].

Additional Tax Changes

The Act also includes tax breaks for tax-exempt bonds, REITs, and AMT transactions; as well as changes for businesses, such as credit card transaction reporting, and an election to claim additional research tax credits or minimum tax credits instead of bonus depreciation.

Some Call Legislation A Monster

Some of the criticism leveled at H.R. 3221 focused on the fact that, while the measure would temporarily help some homeowners avoid foreclosure, it does little or nothing to help those who are in jeopardy of losing their homes, but whose equity in their homesteads--once relied upon for retirement or that rainy day--has evaporated. Other critics disparaged specific bill provisions, for instance the HOPE for Homeowners Program, which is supposed to help homeowners sidestep foreclosure. Because the system is voluntary, the bills detractors speculate that banks may be in no hurry to deal with desperate homeowners, and may wait until they're on the very brink of losing everything before they act, if at all.

However, far and away the biggest gripe with the legislation is its size and the unprecedented risks it presents to the financial system and to taxpayers. By using tax dollars to prop up Government Sponsored Enterprises such as Fannie Mae and Freddie Mac, and doing so without safeguards to assure any return on the investment, Uncle Sam has become, in effect, subprime borrower supreme, and does so in light of the fact that F+G have not themselves been models of economic decorum.

Paul Krugman, Princeton University professor of economics and international affairs and op-ed columnist for *The New York Times*, writes that the legislation is the latest in a series of temporary fixes to the financial system -- attempts to hold the thing together with bungee cords and masking tape -- that have, at least so far, succeeded in staving off complete collapse. He notes, however, that such fixes have done nothing to resolve the systems underlying flaws. In fact, they set the stage for even bigger future disasters -- unless they're followed up with fundamental reforms. As reported in *The Times*, on the floor of the House during the debate surrounding the bill, Rep. Jeff Flake (R AZ) echoed this sentiment, saying H.R. 3221 has moral hazard written all over it, and opined that We are pretending to chain a monster here, and we are, instead, letting that monster loose.

ABOUT THE AUTHOR(S):

Gerald M. Levinson, Esq. is a tax attorney and founder of Benefits Research & Communications in Escondido, California. He has practiced tax law for many years, and is a frequent tax commentator. He specializes in pension and trust law.

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Taxation of Complimentary Meals -- A Nevada Tax Practice Insight

2008 Emerging Issues 2615

Taxation of Complimentary Meals and the Sparks Nugget Case -- a Nevada Tax Practice Insight

By Steve Johnson

July 29, 2008

SUMMARY: Professor Steve Johnson comments on the Nevada use tax exemption on complimentary meals provided to casino patrons. The Nevada Supreme Court has held the states use tax inapplicable to food provided in such complimentary meals. *Sparks Nugget, Inc. v. State of Nevada ex rel. Nevada Department of Taxation*, 179 P.3d 570, 2008 Nev. LEXIS 17, 124 Nev. Adv. Rep. 15 (Nev. March 27, 2008), rehearing denied, No. 45755 (July 16, 2008).

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ARTICLE: In their search for new sources of revenue, states have legalized and sought to tax many kinds of gaming. Forty-eight of the fifty states (the exceptions being Hawaii and Utah) permit one or more types of legal gambling. An important technique in casino and some other types of gaming is giving comps complimentary goods or services to player-customers. A frequent type of comp is free meals on the casino premises or elsewhere. Gaming establishments also often give free meals to their employees.

Comps have been controversial for federal income tax purposes. *E.g., Churchill Downs, Inc. v. Commr*, 115 T.C. 279 (2000), affd, 307 F.3d 423 (6th Cir. 2002); IRS Tech. Adv. Memo. 9641005 (Oct. 11, 1996) (addressing the deductibility of meal and non-meal comps). *Sparks Nugget* and related cases illustrate that comps also can present important questions as to sales and use taxes in many states. *Sparks Nugget, Inc. v. State of Nevada ex rel. Nevada Department of Taxation*, 179 P.3d 570, 2008 Nev. LEXIS 17, 124 Nev. Adv. Rep. 15 (Nev. March 27, 2008) (per curiam), petition for rehearing denied, No. 45755 (July 16, 2008)

Background. Nevadas sales and use tax structure is similar in relevant respects to many other states structures. The sales tax is imposed on in-state retail sales and is back-stopped by a use tax generally imposed on the in-state use of property that escaped the sales tax. The state constitution and statutes exempt from tax food for personal consumption, but the exemption does not apply to food prepared for immediate consumption.

The Taxability of Food Distributed Free of Charge is Challenged. Sparks Nugget (the Nugget), is a Nevada casino/hotel/resort that buys food for service to patrons. After preparation, some of the food is sold in the Nuggets restaurants, and some is given away to patrons and employees in the form of complimentary meals. It was uncontroversial that the Nugget properly did not pay sales tax when it bought the food and that the Nugget properly collected and remitted to the state sales tax on the food it sold. The controversy arose as to the food used for

complimentary meals. Disagreeing with the Department of Taxation and reversing the trial court, the Nevada Supreme Court, with one justice dissenting, held that the Nugget does not have to pay use tax on the food used for comped meals. The state petitioned the Nevada Supreme Court for rehearing.

While the petition for rehearing was pending, the Nevada Legislature met in special session. Legislation to reverse the *Sparks Nugget* result, Assembly Bill 2, passed the Assembly but died in the Senate. Thereafter, the Nevada Supreme Court denied the states petition for rehearing. The one justice who had dissented in the original decision concurred in the denial of rehearing and stated that, in view of the Legislatures action/inaction, he now accepts the majoritys view as to what constitutes a taxable event.

This Commentary explores three questions:

- 1) What will be the fiscal consequences of *Sparks Nugget*?
- 2) Is the decision correct on the merits?
- 3) Are there grounds beyond those already argued on which the state might be able to tax the food used in complimentary meals?

Fiscal Consequences. As a result of *Sparks Nugget*, state coffers will be depleted by refunds to the Nugget and other, similarly situated establishments for years open under the statute of limitations for refunds of tax overpayments. See Nev. Rev. Stat. Ann. § 372.635 (in general, establishing a three-year limitations period for filing sales and use tax refund claims). The Nugget would be due a refund of about \$1.3 million. Moreover, according to the Department of Taxation, 92 other casinos have claimed refunds on the same theory as advanced by the Nugget, and these claims total about \$92 million. See *Costly Court Decision Rehearing Urged*, *Las Vegas Review-Journal*, April 15, 2008, p. 7B.

In addition to having to pay sizeable refunds, Nevada also would lose substantial use taxes on a going forward basis. The state might attempt to amend its statutes to legislatively reverse *Sparks Nugget*. See Nev. Rev. Stat. Ann. § 372.284 (defining the food for human consumption exception). However, such an attempt would be problematic. Nevadas Legislature sits only every other year and then for only 120 days (unless a special session is called). See Nev. Const. Art. IV, § 2. The Legislatures next regular session will be in spring 2009. Legislation may be introduced in that session similar to the bill that failed to pass in the 2008 special session. Whether any such measure would pass is unpredictable. If it does pass, it presumably would be effective only prospectively. Moreover the food for human consumption exception appears in Nevadas constitution. See Nev. Const. Art. X, § 3[A]. Amending the Nevada constitution can take years, see Nev. Const. Art. XVI, § 1, and amending the statute without amending the constitution could result in a challenge that the amended statute would violate the unamended constitution.

Although casino gaming is most prominent in Nevada, it legally occurs in many other states as well. The budgets of such other states at least those whose sales and use tax regimes resemble Nevadas also could be negatively affected by similar resolution of the issue. Last year, the Indiana Tax Court held to the same effect as the Nevada Supreme Court. See *Horseshoe Hammond, LLC v. Indiana Dept of State Revenue*, 865 N.E.2d 725 (*Ind. Tax* 2007), *review denied*, 878 N.E.2d 207 (*Ind.* 2007). Moreover, the New Jersey courts confronted a somewhat related issue in a different context. See *Boardwalk Regency Corp. v. Director, Div. of Taxn*, 18 N.J. Tax 328 (*Superior Ct. A.D.* 1999) (agreeing with the New Jersey Tax Court that the complimentary providing of non-alcoholic beverages to casino patrons and employees is a sale for no consideration, so is not a resale of beverages for sales and use tax purposes), *revq & remanding on other grounds*, 17 N.J. Tax 331 (*Tax* 1998).

The budgets of many states, including Nevada, are strained in current economic circumstances. In this environment, decisions like *Sparks Nugget* and *Horseshoe Hammond* are bitter fiscal pills for states to swallow.

Considering the Merits. As nearly all tax cases are, *Sparks Nugget* is a matter of textual interpretation, and whether one thinks the case was correctly decided may depend upon which school of interpretation one finds most

persuasive. In *Sparks Nugget*, both constitutional and statutory provisions required interpretation. The clash between the majority and the dissent involved four interpretational dimensions: text, structure, purpose, and canons.

The Textual Interpretation. The Nevada Supreme Court is perhaps overly fond of plain meaning arguments. The *Sparks Nugget* majority emphasized the plain meaning of the constitution's food for human consumption exemption. See *Sparks Nugget, Inc. v. State of Nevada ex rel. Nevada Department of Taxation*, 179 P.3d at 572 and 576 n.31. The dissent, on the other hand, emphasized the plain meaning of the statutes prepared food for immediate consumption exception to the exemption. See *Sparks Nugget, Inc. v. State of Nevada ex rel. Nevada Department of Taxation*, 179 P.3d at 577-78 (Douglas, J., dissenting). When plain meaning can plausibly be enlisted on both sides of a dispute, meaning may not be plain after all.

The majority and the dissent may have failed to heed the teaching of our foremost textualist jurist that ambiguity is a function not just of words but also of context. See, e.g., *United Savings Assn of Texas v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. at 371 (1988) (Scalia, J., writing for the Court). When the provisions enlisted by the majority and the dissent are read together, there is room for more than one construction. Despite its invocation by both sides, plain meaning does not resolve the controversy.

The Structural Dimension. The majority also advanced an argument from the structure of the sales/use tax regime, an argument that is more persuasive than plain meaning. It noted that the role of the use tax is to catch otherwise taxable items that had avoided tax at the time of purchase (for example, by being purchased in a different state). In contrast, the food at issue did not slip through the net, but was deliberately excluded from taxation by a constitutional provision. Thus, imposing use tax would distort the back-stop function of that tax. *Sparks Nugget, Inc. v. State of Nevada ex rel. Nevada Department of Taxation*, 179 P.3d at 575.

Analysis of Legislative Purpose. The dissent argued with some force that, via the exemption, the Legislature intended to cover food purchased for preparation and consumption at home, not meals provided (even at no charge) in a restaurant. *Sparks Nugget, Inc. v. State of Nevada ex rel. Nevada Department of Taxation*, 179 P.3d at 578. Similarly, the state in its petition for rehearing heavily emphasized the Legislature's purpose. To the extent that the majority's decision trenches on the constitution, not on statutes, the Legislature's purpose arguably is not controlling. In any event, finding the text clear, the majority held that it was inappropriate to consider legislative intent. *Sparks Nugget, Inc. v. State of Nevada ex rel. Nevada Department of Taxation*, 179 P.3d at 578.

Canons Lacked Influence in Decision. Canons of construction are recited aplenty in judicial decisions, but they more often are makeweights than real bases of decisions. See, e.g., Steve R. Johnson, *The Canon that Tax Penalties Should Be Strictly Construed*, 3 Nev. L.J. at 496-97 (2003).

So it seems to have been in *Sparks Nugget*. The dissent began by rehearsing the canon, which appears in both state and federal cases, that exemptions from taxation are narrowly construed. *Sparks Nugget, Inc. v. State of Nevada ex rel. Nevada Department of Taxation*, 179 P.3d at 577; see also *Commissioner v. Schleier*, 515 U.S. at 328 (1995). The majority acknowledged that this canon exists, but brushed past it by observing that, although an exemption is read narrowly, it should not be read so narrowly as to defeat[] cases rightly falling within its ambit. *Sparks Nugget, Inc. v. State of Nevada ex rel. Nevada Department of Taxation*, 179 P.3d at 574, quoting *Dawley, Inc. v. Indiana Dept of State Revenue*, 605 N.E.2d at 1225 (Ind. T.C. 1992). A canon so easily pushed aside has little force to compel an outcome in any given case, and it serves as little more than window dressing.

Alternative Theory of Taxation. Now that the petition for rehearing has been denied, the question becomes whether the Department of Taxation can find a new or alternative ground on which it can deny the refund claims of other casinos with a respectable chance that the courts of Nevada will uphold the denials. The *Sparks Nugget* majority suggested one possibility, although it did not commit itself to it. The majority noted that the Department had relied upon the use tax, not the sales tax. In particular, the Department did not demonstrate that the complimentary meals constituted a transfer of personal property for consideration, a requirement for application of the sales tax. But the

majority offered: we do not foreclose the possibility that complimentary meals such as the ones at issue in this case may be subject to sales tax where consideration is properly demonstrated. *Sparks Nugget, Inc. v. State of Nevada ex rel. Nevada Department of Taxation*, 179 P.3d at 575 and n.15.

The state was alert to this signal. In a brief paragraph, the petition for rehearing requested, as alternative relief to rehearing, that the case be remanded to permit fact-finding as to the sales tax theory. The Nevada Supreme Court properly denied the request for remand because the state had its chance to make its record on audit and at trial. However, the state presumably could develop this argument in the other pending refund cases and in future audits.

Nonetheless, there are obstacles to the success of the sales tax theory. First, for the theory to prevail, the courts would have to liberalize the concepts of consideration and bargained-for exchange, at least for tax purposes. The *Sparks Nugget* court noted that consideration is an essential part of a sales taxable transaction. *Id.* The state might attempt to argue that complimentary meals are in consideration for previous play or services or for future play or services, but this could be a hard position to sustain.

Both in Nevada and elsewhere, consideration for sales tax purposes evolved from the law of contracts. *Monarch Beverage Co. v. Indiana Dept of State Revenue*, 589 N.E.2d at 1212 (Ind. Tax 1992). The *Sparks Nugget* majority (179 P.3d at 575 n.15) cited a non-tax case, *Pink v. Busch*, 691 P.2d at 459 (1984) (per curiam). *Pink* seems to erect a high bar: To constitute consideration, a performance or return promise must be bargained for. A performance or return promise is bargained for if it is sought by the promisor in exchange for his promise and is given by the promisee in exchange for that promise. *Pink v. Busch*, 691 P.2d at 459 (1984) (per curiam), quoting Restatement (Second) of Contracts § 71(1), (2) (1982).

It would require a stretch to say that this bargained for element is present in a complimentary meals situation. Casinos may hope for more patronage tomorrow from those they comp today; they may even expect it. But there's no firm promise. Accordingly, courts in other jurisdictions have rejected the sales tax theory. See *Horseshoe Hammond*, *supra*; *Boardwalk Regency*, *supra*.

A second problem for a sales tax theory is valuation. With complimentary meals, there is no price to the consumer of the meal by which to calculate the amount of sales tax due. One could attempt to construct some alternative or proxy measure of value, but all such measures would be artificial and imprecise to greater or lesser degrees. Too imaginative an attempt may be hard to square with the sales tax statutes as written.

The *Sparks Nugget* majority virtually invited the Department of Taxation to consider a sales tax alternative to the asserted use taxation of complimentary meals. One may expect the Department to strive assiduously to develop the facts necessary to such an argument, and there may be situations in which that effort would succeed. It would be surprising, however, if this alternative would be successful across the board. For conflicting views of the strength of this alternative argument, compare Jennifer Carr & Cara Griffith, Possible Outcomes of Nevadas Complimentary Meals Case, State Tax Notes, May 5, 2008, p. 407 to Andrew W. Swain & Jennifer E. Gauger, Casino Comps Are Freebies Really Free?, State Tax Notes, July 14, 2008, p. 95.

See also Nev. Const. Art. 10, § 3[A] and Nev. Rev. Stat. Ann. §§ 372.015 to 372.284 for relevant provisions of the Nevada sales and use taxes.

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Harl on Deducting Amounts for Fertilizer

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Harl on Deducting Amounts for Fertilizer

By Neil E. Harl

July 24, 2008

SUMMARY: The deduction for fertilizer, lime and other soil amendments has a long and tortuous history. The enactment in 1960 of a provision designed to assure a deduction subject to specified conditions brought a modicum of uncertainty to a situation long characterized by issues of amortization for fertilizer carryover. In the last two decades, the disagreement has been over whether premium fertility is deductible on the purchase of farm property.

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ARTICLE: The deduction for fertilizer, lime and other soil amendments has a long and tortuous history. n1 The enactment in 1960 of a provision designed to assure a deduction subject to specified conditions n2 brought a modicum of uncertainty to a situation long characterized by issues of amortization for fertilizer carryover. n3 In the last two decades, the disagreement has been over whether premium fertility is deductible on the purchase of farm real estate. n4

The Era of Amortization

Before enactment of the current statutory provision n5 in 1960 which permits a current deduction for fertilizer, lime and other soil amendments, under specified circumstances, soil conditioning expenditures were considered to be capital in nature if the effect lasted for more than one year. n6 Of course, most soil amendments, fertilizer included, have some carryover to later years. That is especially true for fall-applied fertilizer where virtually no use is made of the applied fertilizer until the next year. Therefore, the emphasis in the pre-1960 era was on amortization of the cost over some reasonable time period.

IRS as late as 1989 took the position that the cost of fertilizer applied to an existing stand of timber could not be deducted immediately but had to be amortized. n7 However, that General Counsels Memorandum (GCM) has been withdrawn pending further consideration of the issue. n8 In 2004, IRS ruled that the fertilization of timber was a deductible business expense and did not have to be capitalized. n9 IRS rationalized that fertilization after establishment of a stand of timber promotes healthy development and maximizes timber volume and is performed for the management, maintenance and protection of the timber stand and is, therefore, an ordinary and necessary business expense. n10 The ruling points out that a change in how post-establishment fertilization is handled is treated as a change in accounting method. n11

The Enactment of *I.R.C. § 180* Allowing A Deduction

Under the statutory provision allowing a deduction, *I.R.C. § 180*, enacted in 1960, expenditures may be deducted that are paid or incurred . . . by a taxpayer engaged in the business of farming. during the taxable year for the purchase or acquisition of fertilizer, lime, ground limestone, marl, or other materials to enrich, neutralize, or condition land used in farming, or for the application of such materials to such land. n12 Thus, the statute emphasizes two tests for deductibility (1) the fertilizer or other material must be applied to land used in farming and (2) the taxpayer must be engaged in the business of farming. n13

Land Used in Farming. The term land used in farming is defined as land used by the taxpayer or tenant for the production of crops, fruits or other agricultural products or for the sustenance of livestock. n14 Expenditures on land brought into farming for the first time apparently are not eligible for the election to deduct the expense currently. n15

For land used by the immediately preceding owner for farming purposes, the taxpayer is considered to be using the land in farming when the expenditures are made if the taxpayers use of the land is substantially a continuation of its use in farming, whether for the same farming use as that of the predecessor or any of the other permissible uses. n16 The regulations also imply that land not used previously by the taxpayer or tenant in farming is not eligible for the election to deduct n17 but reference to the regulations under the soil and water conservation section (*I.R.C. § 175*) sends a different signal. n18

Taxpayer Engaged in the Business of Farming. The authority to deduct fertilizer and other soil conditioner expenses currently limits the deduction to a taxpayer engaged in the business of farming. n19 To be engaged in the business of farming, a taxpayer must be engaged in a farming operation, be leasing under a crop share or livestock share lease or be materially participating in the operation or management of the farm in the case of a cash rent lease. n20 The same definition of business of farming is used as is employed for purposes of the soil and water conservation expense deduction. n21 In a 1958 IRS ruling, a nursery engaged in the raising of ornamental plants was considered in the business of farming. n22

The Election to Deduct. The deduction for fertilizer and the soil amendments is made by *election*. n23 The election to deduct fertilizer, lime and other soil conditioner expenses currently is made by claiming the deductions on the appropriate schedule on the income tax return, typically Schedule F. n24 Revocation of the election requires the consent of the District Director of Internal Revenue and is made by application to that office with a statement of the reasons for the requested action to revoke. n25 An election is not required for expenditures which are not capital in nature. n26

As a practical matter, most farm taxpayers assume that expenditures for fertilizer, lime and like materials are currently deductible and give little thought to the election procedure. However, a taxpayer can fail to make the election by not including the amount on the appropriate schedule. That strategy might be appropriate, for example, when claiming the fertilizer deduction could lead to a net operating loss with consequent loss of personal deductions and exemption amounts.

Deducting the Premium Fertility Amount or the Residual Fertilizer Supply

In some parts of the country, taxpayers have read the statutory authorization to deduct fertilizer and other soil expense to allow a deduction for premium fertility on the purchase of farmland. In some instances, it is referred to as the residual fertilizer supply. n27

In a late 1991 private letter ruling, n28 a West Central Minnesota farmer purchased a farm with what he thought

had premium fertility. The farmer argued that the prior owner of the farm had applied fertilizer to the point where an increased level of fertilizer in the soil had resulted, which he referred to as the residual fertilizer supply. n29 In a move the farmer thought would strengthen the case for deductibility, the farmer had the purchasers corporation (owned 64 percent by the purchaser) buy the residual fertilizer supply in the land acquired. n30 The acquired land was then leased to the purchasers corporation under a one-year lease. The corporation (the taxpayer) claimed an amortization deduction over a seven year period for the residual fertilizer supply. n31

Taxpayer Must be Beneficial Owner of the Fertilizer. IRS agreed that the capitalized fertilization costs could be amortized, but the taxpayer must be the beneficial owner of the fertilizer in order to be permitted to claim an amortization deduction. n32 IRS noted that the farmer acquired the land containing the alleged residual fertilizer supply

which was incorporated into the land and, for all practical purposes, was inseparable from the land. This fertilizer purportedly made the land more productive than it otherwise would have been. Although the taxpayer [the corporation] allegedly purchased any residual fertilizer supply in the land, the taxpayer was able to derive the benefit from it only by entering into a land lease agreement with the landowners

The ruling points out that the landowners were the beneficial owners of any fertilizer on the land and the corporation could not amortize any of the costs related to the fertilizer. n33

The ruling denied a deduction on two other grounds, which are likely to be the focus of attention where the facts of the situation do not provide an obvious reason to reject the deduction as was the case in the 1991 letter ruling. n34

Must Establish the Presence and Extent of Fertilizer. The 1991 ruling states in order for a taxpayer to claim an amortization deduction for exhaustion of fertilizer acquired with the land, the taxpayer must establish the presence and extent of the fertilizer. n35 The ruling notes that the corporation did not measure nor was data provided to indicate, the level of soil fertility attributable to fertilizer applied to the land by the previous owner. n36 The ruling concludes that the corporation as the taxpayer failed to establish the extent of any residual fertilizer.

In general, those claiming a deduction for premium fertility or the residual fertilizer supply have relied on elaborate soil testing, more recently on a grid basis, to avoid the charge that the acquired land was sampled for soil testing more intensively on the highly fertile areas of the land in question (such as where the farmstead was located and livestock feeding had taken place in the past) and less intensively or not at all on the thinner and lighter soils where fertility is often lower.

Must be Exhausting the Fertility in the Soil. Finally, the ruling notes that, in order to amortize the cost of the fertilizer supply over time, the taxpayer must, in fact, be exhausting the fertilizer in the soil. n37 In the facts of the situation in the 1991 ruling, the soil test reports showed that the level of fertility in the majority of the parcels sampled was not declining as is required for deductibility. As the ruling stated, the taxpayer has provided no evidence indicating the period over which the fertility attributable to the residual fertilizer supply will be exhausted, and if in fact what was claimed as the residual fertilizer level was declining. n38

Need for Further Guidance

Although the 1991 private letter ruling n39 is substantial authority against deductibility of the residual fertilizer supply, no further authority has emerged in the nearly two decades since the ruling was published even though the practice of claiming a deduction has expanded in some areas of the country. In other geographic areas, the practice is not followed. Quite clearly, in the interests of fairness and equity, further guidance is needed as to the guidelines for deductibility (with appropriate regulatory oversight on this issue) if deductions are to be allowed.

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n1 . See 1 Harl, *Farm Income Tax Manual* § 3.08 (2007 ed.); 4 Harl, *Agricultural Law* § 28.04[1] (2008); Harl, *Agricultural Law Manual* § 4.03[3] (2008). See also Harl, Is Residual Fertilizer Supply in Farmland Deductible? 15 *Agric. L. Dig.* 65 (2004).

n2

[2]. *I.R.C. § 180*, added by Pub. L. No. 86-779, § 6(a).

n3

[3]. E.g., *Sanford v. Commr*, 2 *B.T.A.* 181 (1925).

n4

[4]. *Ltr. Rul.* 9211007, December 3, 1991.

n5

[5]. *I.R.C. § 180*.

n6

[6]. *Swaney v. Commr*, 5 *B.T.A.* 990 (1927), acq., II-2 C.B. 7. See *Sanford v. Commr*, 2 *B.T.A.* 181 (1925).

n7

[7]. *GCM* 39791, June 9, 1989.

n8

[8]. *GCM 39844*, April 16, 1991.

n9

[9]. *Rev. Rul. 2004-62, 2004-1 C.B. 1072*.

n10

[10]. *Id.*

n11

[11]. *Id.*

n12

[12]. *I.R.C. § 180(a)*.

n13

[13]. *Id.*

n14

[14]. *I.R.C. § 180(b)*.

n15

[15]. *Id.*

n16

[16]. *Treas. Reg.* §§ 1.180-1(b), 1.175-4(a).

n17

[17]. *Treas. Reg.* § 1.180-1(b).

n18

[18]. *Treas. Reg.* § 1.175-3, -4.

n19

[19]. *I.R.C.* § 180(a). See *Treas. Reg.* §§ 1.180-1(b), 1.175-3.

n20

[20]. *Treas. Reg.* § 1.175-3.

n21

[21]. *I.R.C.* § 175.

n22

[22]. *Rev. Rul.* 59-12, 1959-1 C.B. 59.

n23

[23]. *I.R.C.* § 180(c).

n24

[24]. See *Treas. Reg. § 1.180-2*.

n25

[25]. *Treas. Reg. § 1.180-2*.

n26

[26]. *Treas. Reg. § 1.180-1(a)*.

n27

[27]. *Ltr. Rul. 9211007*, December 3, 1991.

n28

[28]. 9211007, December 3, 1991.

n29

[29]. *Id.*

n30

[30]. *Id.*

n31

[31]. *Id.*

n32

[32]. See *Helvering v. F. & R. Lazarus & Co.*, 308 U.S. 252, 254 (1939).

n33

[33]. *Ltr. Rul.* 9211007, December 3, 1991.

n34

[34]. *Ltr. Rul.* 9211007, December 3, 1991.

n35

[35]. *Id.*

n36

[36]. *Id.*

n37

[37]. *Id.*

n38

[38]. *Id.*

n39

[39]. *Ltr. Rul.* 9211007, December 3, 1991.

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Harl on Classifying Personal Property for Purposes of Like-Kind Treatment

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Harl on Classifying Personal Property for Purposes of Like-Kind Treatment

By Neil E. Harl

July 24, 2008

SUMMARY: When like-kind exchanges first appeared in federal tax law, in 1920, it was likely not anticipated that the issue of property eligible for a tax-free, like-kind exchange would assume the proportions it occupies in modern times.

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ARTICLE: When like-kind exchanges first appeared in federal tax law, in 1920, n1 it was likely not anticipated that the issue of property eligible for a tax-free, like-kind exchange would assume the proportions it occupies in modern times. n2 For depreciable personal property, the framework for classification of assets has become increasingly complex with heavy dependence presently on a 13-item general asset class system, n3 a four digit product class n4 and three sectors (Sectors 31, 32 and 33) of the newer six digit product class. n5

For real property, by contrast, a comprehensive system comparable to the rules applicable to depreciable personal property has not emerged; rather, the classification has developed almost exclusively around IRS rulings, n6 regulations n7 and litigated cases. n8

Importance of Classification

The statute is fairly clear in stating the basic principles of a like-kind exchange

No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment. n9

It is, therefore, critically important to be certain that property in proposed exchanges, both that given up and that acquired in exchange, be deemed to be like-kind. If that is not the case, the exchange is treated as a sale and gain or loss is recognized on the transaction.

As a general proposition, like-kind property is property of the same nature, character or class rather than being of the same grade or quality. n10

Classification of Depreciable Personal Property

Depreciable tangible personal property held for productive use in a trade or business or for investment may be exchanged for property of a like-kind or like class. n11 The regulations, however, do not define the term depreciable tangible personal property. n12

Meaning of Tangible Personal Property. The term tangible personal property is defined for purposes of the since-repealed investment tax credit. n13 Under that provision, the regulations specify that local law shall not be controlling for purposes of determining whether property is or is not tangible or personal. Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment tax credit even though under local law the property is considered to be a fixture and therefore real property. n14 The investment tax credit regulations have been applied to situations involving the classification of property for depreciation purposes. n15

The investment tax credit regulations define tangible personal property to include

any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property. n16

The term tangible personal property has been held to include--(1) air conditioning units; n17 (2) propane storage tanks; n18 (3) photo labs (but not the concrete foundations); n19 (4) bulk tanks and storage tanks used in bulk petroleum distribution and retail operations; n20 (5) fire extinguishers; n21 (6) fixed or floating docks (but not the pilings); n22 (7) construction site trailers; n23 (8) billboards, signs, lighting fixtures and detachable poles at retail service stations (but not the concrete foundations); n24 and (9) bank vault doors, record vault doors, night depository facilities and walk-up and drive-up tellers windows (but a drive-up tellers booth is a building). n25

General Asset Classes and Product Classes. Property is of a like class to other depreciable tangible personal property if the properties exchanged are within the same *general asset class* or the same *product class*. n26 Property cannot be classified within more than one general asset class or within more than one product class. Property classified in a general asset class may not be classified within a product class. n27

General Asset Classes. Depreciable tangible personal property is classified into 13 general asset classes. n28 The classes are listed in the IRS publication for determining classification for depreciation purposes as asset classes 00.11 through 00.28 and 00.4. n29 The general asset classes are--(1) office furniture, fixtures and equipment; (2) information systems; (3) data handling equipment; (4) airplanes (other than commercial airliners or freight carriers); (5) automobiles and taxis; (6) buses; (7) light general purpose trucks; (8) heavy general purpose trucks; (9) railroad cars and locomotives, except those owned by railroad transportation companies; (10) tractor units for use over-the-road; (11) trailers and trailer-mounted containers; (12) vessels, barges, tugs and similar water transportation equipment, except those used in

marine construction; and (13) industrial steam and electric generation and/or distribution systems. n30

It is fairly clear that the general asset classes are of only limited usefulness in classifications of farm and ranch property.

Product Classes. Depreciable tangible personal property that is not classified with any general asset class is classified into four or six digit *product* classes. n31

The guidance for four digit product classification has come from the *Standard Industrial Classification Manual* (SIC Manual). n32 The *Manual* has been replaced *in part* by the *North American Industry Classification Manual* (NAICS Manual) but only as to Sectors 31 through 33 to date. IRS released the guidance for using the NAICS Manual for federal income tax purposes on August 12, 2004. n33 The regulations adopted only sectors 31 through 33 *for defining product classes*.

The 2004 regulations apply to transfers on or after August 12, 2004, although taxpayers may apply the provisions to transfers of property on or after January 1, 1997, in taxable years for which the period of limitation had not expired. n34 The four digit product class system could continue to be used for sectors 31 through 33 until the regulations became final. n35 The regulations became final on May 19, 2005. n36

Properties within the same product class generally are considered of a like class. n37

Much of the personal property used in a farm business is included in product class 3523, Farm Machinery and Equipment, under the SIC system. Under the NAICS system, farm machinery and equipment are under product class 333111. n38 Under the NAICS system, product class 333111 specifically lists combines, cotton gin machinery, feed processing equipment, fertilizer equipment, planters, plows, farm tractors, haying machinery, milking machines and poultry feeding and watering equipment. n39 Thus, an exchange of one piece of farm machinery and equipment for any other item of farm machinery and equipment is considered to be a like-kind exchange if the other requirements are met.

For livestock, each species of livestock is considered a separate product class *although livestock of different sexes by statute is not property of a like-kind*. n40 Here is a table showing the classification of livestock under the four and six digit classification systems

Product Class SIC NAICS

Beef cattle 0212 112111

Hogs 0213 112210

Dairy cattle 0241 112120

Sheep and goats 0214 112410

Horses 0272 112920

Rabbits and other fur bearing animals 0271 112930

Chickens (egg production) -- 112310

Broilers -- 112320

Turkeys -- 112330

Other poultry -- 112390

Animal aquaculture -- 112511

Under earlier authority, half-blood heifers (which were artificially inseminated) and three-quarter blood heifers (which were the offspring of the artificially inseminated heifers) have been held to qualify as like-kind. n41 A trade of steer calves (which the court found were not held for sale in the ordinary course of business) for registered Aberdeen-Angus cattle has been held not to be a taxable exchange. n42 An exchange of cows with calves at side was considered like-kind but only 103 of 425 mixed yearlings were considered held for breeding purposes rather than for sale and thus were considered like-kind. n43 It is believed that an exchange of a grade beef cow for a purebred registered beef cow would be considered like-kind. However, an exchange of a dairy cow for a beef cow would not be considered like-kind under either the four digit or six digit classification systems.

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n1 . See Reg. 45, 1920 ed., Act 1563 (regulations issued under the 1918 Act provided that no gain or loss would be recognized from the acquisition and subsequent disposition of property unless there was a change of substance and not merely in form. The statutory framework for exchanges of property held for productive use in a trade or business or for investment has largely remained unchanged since 1924. See Revenue Act of 1924, § 203(b)(1). Harl, Like-Kind Exchanges: A Popular Option for Property Transfers, 11 *Drake J. of Ag. L.* 25, footnote 2 (2006).

n2

[2]. See generally 1 Harl, *Farm Income Tax Manual* § 2.07[2] (2007 ed.); 4 Harl, *Agricultural Law* § 27.04[3][b] (2008); Harl, *Agricultural Law Manual* § 4.02[16][b] (2008). See also Harl, What Is Like-Kind for Real Estate, 17 *Agric. L. Dig.* 177 (2006).

n3

[3]. *Treas. Reg.* § 1.1031(a)-2(b)(2).

n4

[4]. *Treas. Reg.* § 1.1031(a)12(b)(3).

n5

[5]. Temp. Treas. Reg. § 1.1031(a)-2T.

n6

[6]. E.g., *Rev. Rul. 73-476, 1973-2 C.B. 300.*

n7

[7]. *Treas. Reg. § 1.1031(a)-1(c)* (lessee of real property with a total unexpired term of 30 years or more can exchange the leasehold for a fee simple interest in real estate).

n8

[8]. *Treas. Reg. § 1.1031(a)-1*. See, e.g., *Starker v. United States, 602 F.2d 1341 (9th Cir. 1979)* (purchasers rights under installment contract considered equivalent to fee simple interest).

n9

[9]. *I.R.C. § 1031(a)(1)*. See *Treas. Reg. § 1.1002-1(d)*.

n10

[10]. *Treas. Reg. § 1.1031(a)-1(b)*.

n11

[11]. *Treas. Reg. § 1.1031(a)-2(b)(1)*.

n12

[12]. See Treas. Reg. § 1.1031(a)-(2)(l).

n13

[13]. *I.R.C.* § 48.

n14

[14]. *Treas. Reg.* § 1.48-1(c).

n15

[15]. See Ltr. Rul. 9924044, March 24, 1999 (magnetic stripe keycard door locking system for hotels).

n16

[16]. *Treas. Reg.* § 1.48-1(c).

n17

[17]. *Texas Instruments, Inc. v. Commr, T.C. Memo. 1992-306* (to meet temperature and humidity requirements).

n18

[18]. *Rev. Rul. 83-146, 1982-2 C.B. 17.*

n19

[19]. *Fox Photo, Inc. v. Commr, T.C. Memo. 1985-348.*

n20

[20]. *Siler v. Commr, T.C. Memo. 1985-257.*

n21

[21]. *Rev. Rul. 67-417, 1967-2 C.B. 49.*

n22

[22]. *Estate of Morgan v. Commr, 448 F.2d 1397 (9th Cir. 1971).*

n23

[23]. *Rev. Rul. 77-8, 1977-1 C.B. 3.*

n24

[24]. *Rev. Rul. 80-151, 1980-1 C.B. 7. See Standard Oil Co. v. Commr, 77 T.C. 349 (1981).*

n25

[25]. *Rev. Rul. 65-79, 1965-1 C.B. 26.*

n26

[26]. *Treas. Reg. § 1.1031(a)-2(b).*

n27

[27]. *Id.*

n28

[28]. *Treas. Reg. § 1.1031(a)-2(b)(2)*.

n29

[29]. *Rev. Proc. 87-56, 1987-2 C.B. 674*.

n30

[30]. *Treas. Reg. § 1.1031(a)-2(b)*.

n31

[31]. *Treas. Reg. § 1.1031(a)-2(b)(3)*.

n32

[32]. Office of Management and Budget, U.S. Government, Washington, D.C. (1987).

n33

[33]. *T.D. 9151*, Temp. *Treas. Reg. §§ 1.1031(a)-2T; 1.1031(a)-2*.

n34

[34]. *T.D. 9151*, Temp. *Treas. Reg. § 1.1031(a)-2T(d)*.

n35

[35]. See Temp. *Treas. Reg. § 1.1031(a)-2T(b)(8)*.

n36

[36]. *Treas. Reg. § 1.1031(a)-2(b)*, (d), adopted by *T.D. 9202*.

n37

[37]. *Treas. Reg. § 1.1031(a)-2(b)(1)*.

n38

[38]. North American Industry Classification System, United States 396 (2002).

n39

[39]. *Id.*

n40

[40]. *I.R.C. § 1031(e)*. See *Treas. Reg. § 1.1031(e)-1*.

n41

[41]. See *Rutherford v. Commr, T.C. Memo. 1978-505*.

n42

[42]. *Wylie v. United States*, 68-1 U.S.T.C. 9286 (N.D. Tex. 1968).

n43

[43]. *Woodbury v. Commr*, 49 T.C. 180 (1967), acq., 1969-2 C.B. xxv.

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Harl on Special Income Deferral Provisions Because of Bad Weather

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Harl on Special Income Deferral Provisions Because of Bad Weather

By Neil E. Harl

July 24, 2008

SUMMARY: The agricultural sector is uniquely exposed to the vagaries of weather, disease and environmental contamination, not to mention fire and other casualties. Over time, the Congress has responded with various relief provisions to ease the economic and financial pain from physical disasters, complete with special income tax options. Relief from low prices has been dealt with for the past 75 years in federal farm programs.

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ARTICLE: The agricultural sector is uniquely exposed to the vagaries of weather, n1 disease n2 and environmental contamination, n3 not to mention fire and other casualties. n4 Over time, the Congress has responded with various relief provisions to ease the economic and financial pain from physical disasters, complete with special income tax options. Relief from low prices has been dealt with for the past 75 years in federal farm programs. n5

In this article, the discussion is limited to one-year deferral of income from crop insurance and disaster payments n6 and the one-year deferral for livestock sold because of weather-related conditions. n7

Crop Insurance and Disaster Payments

In the absence of relief provisions, the proceeds from crop insurance and disaster payments would be (and are) taxed in the year actually or constructively n8 received for taxpayers on the cash method of accounting. n9 In effect, destruction or damage to crops and receipt of insurance proceeds are treated as a sale of the crop. For taxpayers who typically carry over the crop until the following year before the crop is sold, such treatment can cause a doubling up of income in the year of crop loss.

One-Year Deferral. Under a special provision, enacted in 1969, n10 taxpayers on the cash method accounting may elect to include crop insurance and disaster payments in the taxable year following the year of destruction or damage to the crop if, under the taxpayers practice, income from sale of the crop would have been reported in a later year. n11 Under that provision, crop insurance and disaster payments must be treated the same way *if received in the same taxable year*. n12 That's the requirement for amounts received by a trade or business. For taxpayers carrying on separate trades or businesses, the decision to defer or not can be made on a separate basis for each trade or business.

For taxable years ending before April 1, 1990, an election to defer crop insurance proceeds was permissible without also deferring disaster payments. n13

The election to defer taxability of crop insurance proceeds applies also to disaster payments as noted above. Through 1989, that provision required specific statutory authorization by reference to the source of the federal funding for the disaster payments. However, the amendment was inadvertently omitted for payments under the Disaster Assistance Act of 1989 so the U.S. Treasury in a nearly unprecedented move, issued regulations permitting deferral despite the statute. n14

What is Meant by the Practice of Deferral? The statute specifies that a one-year deferral is available if the taxpayer establishes that, *under his practice*, income from such crops would have been reported *in a following taxable year*. n15 Does that mean the taxpayer must have a history of one year of deferral? Or three years? Or five? The answer is not clear. But in a 1974 IRS ruling, n16 the taxpayer established that a substantial part of five crops (more than 50 percent) would have been reported in a following taxable year and so the taxpayer was eligible to elect to defer. n17 In a 2008 Tax Court case, *Nelson v. Commissioner*, n18 two related farm partnerships were involved in the production of sugar beets and, in one of the partnerships, other crops as well. The taxpayers had been following what the Tax Court referred to as a method of allocation whereby 65 percent of the sugar beet crop was arbitrarily reported in the year the crop was harvested and 35 percent the following year. n19 The court noted that similar formulas were utilized for the other crops produced. The Tax Court agreed with IRS that the 35 percent of the crop carried over was not sufficient to support the deferral of the entire amount of insurance proceeds.

It is not completely clear how one reports insurance and disaster proceeds on a crop normally sold at harvest if other crops are normally carried over, but it would seem that the proceeds of a crop normally sold at harvest could not be deferred on the strength of a history of carryover of other crops.

Prevented Planting Payments. Under the statute, n20 the inability to plant crops because of a natural disaster is treated as insurance proceeds received as a result of destruction or damage to crops. n21 This language clearly makes prevented planting payments eligible for the one-year deferral (after the year of destruction or damage to crops). n22 One question that arises is whether it makes crop insurance proceeds eligible for involuntary eligible for involuntary conversion treatment. In a 1959 IRS ruling, a farmer collected insurance on hail damage to the wheat crop. IRS said it was an involuntary conversion and gain could be avoided by investing the insurance proceeds in another crop of standing wheat or a harvested crop. n23

IRS has allowed a farmer on the crop method of accounting to deduct costs sufficient to bring the new crop to the level of maturity that the converted crop had reached. n24 But the use of the insurance proceeds to cover the costs of planting a new crop is not the acquisition of eligible replacement property. n25

To avoid a possible double deduction for crop costs, n26 the Chief Counsel has stated that the expenses of replanting could not be deducted. n27 That view is subject to critical comment in that it would appear that if crop loss occur, and replanting takes place, there are really two crops involved with two revenue streams and with two sets of deductions. That is to be expected.

Meaning of Destruction or Damage to Crops. The clear language in the statute, that deferral is limited to where there has been destruction or damage to crops, raises questions as to whether revenue insurance or so-called rain insurance indemnities are eligible for deferral. Agreements with insurance companies that provide for payments without regard to actual losses of the insured do not constitute insurance payments for the destruction or damage to crops; therefore, such payments do not qualify for deferral under the one-year deferral provision. n28

Some of the newer types of crop insurance such as Crop Revenue Coverage (CRC), Revenue Assurance (RA), Income Protection (IP), Group Risk Plan (GRP), Market Value Protection (MVP and Replacement Coverage (RC) include coverage for destruction or damage to crops and revenue insurance. It appears to be necessary for recoveries

under such dual policies to be separated into amounts representing destruction or damage to crops (which are deferrable) and revenue insurance recoveries which are not deferrable.

Deferring Only a Portion of the Recovery. In 1974, IRS ruled ⁿ²⁹ that a taxpayer may not elect to defer only a portion of the insurance proceeds (and disaster benefits) to the following year. Thus, the deferral provision cannot be used to fine tune a tax management strategy. If eligible, the entire recovery can be deferred to the year following the year of destruction or damage to crops. ⁿ³⁰ On the other hand, the taxpayer can report the proceeds as received. What is not permitted is to report a portion and to defer the remainder.

The Election. The election is made by attaching a separate, signed statement to the income tax return for the tax year of destruction or damage or on an amended return. ⁿ³¹ An election counts only for the tax year in which made; application to revoke the election must be made to the District Director. ⁿ³² One election covers the insurance proceeds attributable to all crops representing a trade or business. ⁿ³³

The election is to include the name and address of the taxpayer (or duly authorized representative) along with--(1) a declaration that the taxpayer is making an election under *I.R.C. § 451(d)* and *Treas. Reg. § 1.451-6*; (2) identification of the specific crop or crops destroyed or damaged; (3) a declaration that, under the taxpayers normal business practice, the income derived from the crops that were damaged or destroyed would have been included in the taxpayers gross income for a taxable year following the taxable year of such destruction or damage; (4) the cause of the destruction or damage of crops and the date or dates on which the destruction or damage occurred; (5) the total amount of payments received from payors (e.g., insurance carriers and government agencies), itemized with respect to each specific crop and with respect to the date each payment was received; and (6) the name or names of the payor or payors from whom payments were received.

Weather-Related Sales of Livestock

In a companion provision to the one-year deferral for crop insurance and disaster payments, ⁿ³⁴ farm and ranch taxpayers on the cash method accounting who are forced because of drought or other weather-related conditions to dispose of livestock may be able to defer reporting the gain until the following year. ⁿ³⁵

Conditions for Deferral. To be eligible for deferral, the taxpayers principal business must be farming. ⁿ³⁶ However, IRS has taken a relaxed view of what that means. In a 1989 private letter ruling, a rancher *grossing* an average of \$121,000 per year (no mention of the net) and earning \$65,000 per year in a full-time, off-farm job, was considered eligible to defer gains from livestock sold because of drought. ⁿ³⁷ In the facts of that ruling, the taxpayer devoted 750-1,000 hours per year to the ranching operations and the spouse contributed another 300 hours. The taxpayers principal trade or business was deemed to be farming. ⁿ³⁸

The deferral of income is limited to sales in excess of sales under usual business practices and includes livestock held for draft, dairy, breeding or sporting purposes as well as livestock held for sale. ⁿ³⁹ To arrive at the amount of income deferred, the total amount of income from the sale or exchange of livestock in a classification during the taxable year is to be divided by the total number of all livestock sold in that classification. ⁿ⁴⁰

The drought (or other weather-related condition) must have resulted in the farmers area being designated for assistance by the federal government. ⁿ⁴¹ The livestock need not be raised or sold in a drought or weather-related area; however, the sale must occur solely on account of conditions in the designated area which affected the water, grazing or other requirements of the livestock so as to necessitate the sale. ⁿ⁴² The livestock may be sold prior to the disaster designation if sold because of the disaster. Any designation by a federal agency is acceptable for this purpose, including the Farm Service Agency of USDA or the Small Business Administration. ⁿ⁴³ The taxpayer must establish that, under the taxpayers usual business practice, the sale or exchange would not have occurred but for the weather conditions.

The Election. The election must contain--(1) a declaration that an election is being made; (2) evidence of the existence of weather-related conditions which forced the early sale or exchange of the livestock and the date, if known, on which the area was designated as eligible for federal assistance as a result of the conditions--the sale can occur before the designation; n44 (3) a statement explaining the relationship of the area to the taxpayers early sale or exchange of the livestock; (4) the total number of animals sold in each of the three preceding years; (5) the number of animals which would have been sold in the taxable year had the taxpayer followed its normal business practice; (6) the total number of animals sold and the number sold on account of weather-related conditions during the taxable year; and (7) a computation of the amount of income to be deferred.

A taxpayer who has made an election to defer the taxation of gain from the sale of livestock because of weather-related conditions may later revoke the election and make an election with the consent of the Commissioner to defer income by reinvestment. n45 Whether a sale of livestock is an involuntary conversion is left to the IRS District Office. n46 To revoke, it may be necessary to file a letter ruling request or request a determination letter from the District Director.

The National Office does not issue letter rulings on the replacement of involuntarily converted property, whether or not the property has been replaced, if the taxpayer has already filed a return for the tax year in which the property was converted. n47 The District Director may issue a determination letter in such a situation. n48

A 2004 amendment specifies that an election n49 to defer gain is valid if made during the replacement period for livestock sold and the proceeds reinvested n50 if *I.R.C. § 1033(e)(2)* applies to a sale or exchange of livestock. That means the election can be made during the four year period authorized under that section n51--and an even longer period if the Secretary of the Treasury determines that the weather-related conditions continue for more than three years. n52

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n1 . 2 Harl, *Farm Income Tax Manual* §§ 2.13, 2.14[2] (2007 ed.).

n2

[2]. 2 Harl, *Farm Income Tax Manual* § 2.14[3] (2007 ed.).

n3

[3]. 2 Harl, *Farm Income Tax Manual* § 2.14[4] (2007 ed.).

n4

[4]. 2 Harl, *Farm Income Tax Manual* § 4.02 (2007 ed.). See also 4 Harl, *Agricultural Law* § 30.03 (2008); Harl, *Agricultural Law Manual* § 4.05[2] (2008).

n5

[5]. E.g., Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, 107th Cong., 2d Sess. (2002).

n6

[6]. *I.R.C.* § 451(d). See generally Harl, *Agricultural Law* § 27.03[7] (2008); Harl, *Agricultural Law Manual* § 4.02[4] (2008).

n7

[7]. *I.R.C.* § 451(e).

n8

[8]. E.g., *Rev. Rul. 68-44, 1968-1 C.B. 191* (federal farm program payments constructively received).

n9

[9]. *Treas. Reg.* § 1.61-4(c).

n10

[10]. Tax Reform Act of 1969, Pub. L. No. 91-172, § 215(a).

n11

[11]. *I.R.C.* § 451 (d). See *Rev. Rul. 91-55, 1991-2 C.B. 784*, revoking *Rev. Rul. 75-36, 1975-1 C.B. 143*.

n12

[12]. *Notice 89-55, 1989-1 C.B. 696.*

n13

[13]. *Notice 90-28, 1990-1 C.B. 339* (amended return not necessary for those deferring crop insurance but not disaster payments).

n14

[14]. *Treas. Reg. § 1.451-6.*

n15

[15]. *I.R.C. § 451(d)* (emphasis added).

n16

[16]. *Rev. Rul. 74-145, 1974-1 C.B. 113.*

n17

[17]. *Id.* See *Notice 89-55, 1989-1 C.B. 696.*

n18

[18]. *130 T.C. No. 5 (2008)*. See Harl, *Deferring Crop Insurance and Disaster Payments: How Not to Do It*, 19 *Agric. L. Dig.* 33 (2008).

n19

[19]. *Id.* Such a method of allocation is a questionable method of accounting.

n20

[20]. *I.R.C. §451 (d)*.

n21

[21]. *Id.*

n22

[22]. *Id.*

n23

[23]. *Id.*

n24

[24]. *Rev. Rul. 81-279, 1981-2 C.B. 163.*

n25

[25]. *Id.*

n26

[26]. *Rev. Rul. 62-161, 1962-2 C.B. 175.*

n27

[27]. *GCM 38558*, November 4, 1980.

n28

[28]. *I.R.C. § 451(d)*. See Notice 89-55, 1989-1 C.B. 696.

n29

[29]. *Rev. Rul. 74-145*, 1974-1 C.B. 113.

n30

[30]. *I.R.C. § 451(d)*.

n31

[31]. *Treas. Reg. § 1.451-6(b)*.

n32

[32]. *Treas. Reg. § 1.451-6(b)(2)*.

n33

[33]. *Treas. Reg. § 1.451-6(a)(2)*.

n34

[34]. *I.R.C. § 451(d)*.

n35

[35]. *I.R.C. § 451(e)*.

n36

[36]. *I.R.C. § 451(2)(2)*.

n37

[37]. *Ltr. Rul. 8928050*, April 18, 1989.

n38

[38]. *Id.*

n39

[39]. *I.R.C. § 451(e)*. See *Treas. Reg. § 1.451-7(a)*.

n40

[40]. *Treas. Reg. § 1.451-7(e)(1)*.

n41

[41]. *Treas. Reg. § 1.451-7(a)*.

n42

[42]. *Notice 89-55, 1989-1 C.B. 696*.

n43

[43]. *Id.*

n44

[44]. *Notice 89-55, 1989-1 C.B. 696.*

n45

[45]. *I.R.C. § 1033(e)*. See Ltr. Rul. 9127012, March 25, 1991; *Ltr. Rul. 9214021*, January 6, 1992.

n46

[46]. See Ltr. Rul. 9332032, May 17, 1993.

n47

[47]. *Rev. Proc. 2006-1, 2006-1 C.B. 1, § 6.13.*

n48

[48]. *Rev. Proc. 2006-1, 2006-1 C.B. 1, §§ 6.13, 12.01.*

n49

[49]. *I.R.C. § 451(e)*.

n50

[50]. *I.R.C. § 1033(e)*.

n51

[51]. *I.R.C. § 1033(e)(2)(A)*.

n52

[52]. *I.R.C. § 1033(e)(2)(B)*.**ABOUT THE AUTHOR(S):**

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Dr. Harl has served on six federal advisory bodies a Farm Tax Reform Task Force for the U.S. Department of the Treasury in 1967; the Commissioner's Advisory Group (Commissioner of Internal Revenue) in 1979-80; the USDA Farm Structure Task Force in 1980; the Office of Technology Assessment, Technical Advisory Committee, by Congressional Appointment, 1987-1995 (chair in 1993-94); the USDA Advisory Committee on Agricultural Biotechnology, 2000-2002; and the Commission on Federal Payment Limitations in Agriculture, 2002-2003.

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Harl on Hedging Farm Commodities and Production Inputs

2008 Emerging Issues 2601

Harl on Hedging Farm Commodities and Production Inputs

By Neil E. Harl

July 24, 2008

SUMMARY: The increasing importance of risk management in farm and ranch operations has focused attention on a range of risk management techniques including hedging actual property items in the futures markets.

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ARTICLE: The increasing importance of risk management in farm and ranch operations has focused attention on a range of risk management techniques including hedging actual property items in the futures markets. n1 Wide fluctuations in commodity values over the past several years coupled with changes in the way the Internal Revenue Service has viewed hedging n2 and the changing structure of farm businesses have combined to create uncertainty in handling gains and losses from commodity futures.

Hedging Versus Speculation

The principal matter of concern from an income tax perspective is the line between hedging and speculation. Hedging gains and losses generate ordinary income and ordinary loss and are reported as gains and losses from the actual commodities are reported. n3 Hedge gains or losses are not subject to the loss deferral rules and the mark-to-market provisions that are applicable to speculative transactions. n4 The regulations define a hedge transaction as

a transaction. . . that a taxpayer enters into in the normal course of the taxpayers trade or business primarily--

(1) To manage risk of price changes or currency fluctuations with respect to ordinary property that is held by the taxpayer;

(2) To manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or

(3) To manage such other risks as the Secretary may prescribe in regulations. n5

Stripped to the basics, hedging involves the use of futures contracts to reduce risk with the futures contracts set up to move in the opposite direction to the price movement of the actuals. Thus, a hedge of a bin of shelled corn would be set up so that if the corn increases in price, the futures contract produces an offsetting loss. Likewise, if the bin of shelled corn falls in price, the futures contract is structured to produce an offsetting gain.

Gains from speculative transactions are treated as capital gains; losses are reported as capital losses. n6 Capital gains are usually not objectionable, with the relatively low rate for long-term capital gains in recent years. n7 However, capital losses can only offset capital gains and, for individuals, up to \$3,000 of ordinary income each year. n8 Corporate taxpayers do not even have the \$3,000 offset annually against ordinary income n9 and, moreover, do not enjoy a tax rate break for capital gains--all income, including capital gains is taxed as ordinary income. n10 Excess capital losses can be carried forward indefinitely for individuals n11 and for up to five years for corporate taxpayers. n12 Losses from regulated futures contracts can be carried back by individuals to the three prior years. n13

IRS Litigating Position That All Hedges Were Capital

The U.S. Supreme Court in 1988 decided the case of *Arkansas Best Corp. v. Commissioner*, n14 which held that all items of property are capital assets except what is specifically identified by statute as not being capital assets. n15 IRS quickly concluded that hedges were not mentioned in the statute as not being capital assets (hedges are now specifically listed as a non-capital asset n16 and adopted the litigating position that all hedges were to be treated as capital assets. n17

However, that issue (and others) were litigated with the IRS position rejected by the Tax Court with all 16 Tax Court judge aligned against the IRS position. n18 IRS then abandoned its litigating position and thoroughly overhauled its guidance on hedging in regulations initially issued in late 1993 and made final in 1994. n19

Tests in Evaluating Commodity Futures Transactions as Hedges or as Speculative Transactions

Even with the regulations that became final in late 1994, the authority that developed over the decades prior to 1994 has continued to have considerable influence, particularly in drawing the line between a hedge and a speculative transaction. Courts have, over the years, emphasized two tests in evaluating whether commodity futures contracts are hedges (or as speculative in nature).

Insurance Test. If the taxpayer uses futures trading to offset price changes in actual commodities (the actuals), the futures transactions are hedges. n20

But even if the taxpayer was not using futures trading to offset price movements in actuals, the U.S. Supreme Court has held that futures trading was hedging and not speculation if the commodity transactions were an integral part of the taxpayers business as where futures trading was used as price insurance against subsequent price changes with respect to needed raw materials. n21 In *Corn Products Refining Co. v. Commissioner*, n22 the company, which used corn in its processing operations, would take a position in the corn market around harvest time when the basis was most favorable to the company as a pre-hedge effort to protect itself against price increases and would later acquire the actual corn supplies as needed. The Supreme Court stated the transactions were entitled to hedge treatment as an integral part of the business operations and the actual corn supplies were ultimately acquired. In 1988, the U.S. Supreme Court re-examined *Corn Products* and stated *Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business inventory-purchase system fall within the inventory exclusion of § 1221.

In the mid-1990s, the hedge-to-arrive controversy focused attention on how far into the future a producer can sell commodities before what would otherwise be a hedge becomes speculative. In that era, some farmers had sold five, six, even seven years of production ahead. The *Corn Products* case established that a pre-hedge (hedging in the futures market before the actual commodities are acquired) can be a legitimate hedge. But if the sale of commodities to be produced is beyond the time when the risk can be offloaded into the futures market (or some other risk absorbing mechanism), that makes a transaction speculative. Generally, that limits hedging on forward sales to 18 to 24 months.

More recently, the courts have been asked to apply *Corn Products Refining Co. v. Commissioner* n23 to post-harvest sales of crops and purchases of like amounts of commodities in the futures market under the theory that the post-harvest position in the futures market was an integral part of the farming operation. n24 In that case, a farmer sold soybeans at harvest because of inadequate storage and bought soybean futures. The courts rejected the argument that *Corn Products* should apply because marketing was an integral part of production, parallel to the situation in *Corn Product*. The transactions were held to be speculative on grounds the taxpayer was not protecting against risk of price change as to the actual commodities. n25 IRS restated that position in the preamble to the regulations on hedging issued in final form in 1994. n26

Direct Relation Test. Under the direct relation test, there must be a direct relation between the taxpayers business in the actuals and the commodity market transaction to be considered a hedge. n27 Thus, if a cattle feeder has contracts for 15,000 head of cattle and only 150 head in the feedlot, the direct relation test is not met.

For the direct relation test to be met, the amount of futures trading in the particular commodity involved and the timing of purchases and sales must be related to the position of the taxpayer in the actuals. n28 Thus, where the amount of futures trading exceeds substantially that needed to provide price protection for actual commodities or the pattern of purchases and sales in futures is not consistent with securing price protection for the actuals, the transactions are likely to be treated as speculative rather than hedges with the result that gains and losses are capital gains and losses. n29

Consequences If Owner of Commodities Is Not Owner of Futures Contract

In the event the owner of the commodity to be hedged is not the owner of the futures contract, the transaction becomes speculative. n30 Thus, in a 2001 Tax Court case n31 a farmer had set up a regularly tax or C corporation to engage in the production of corn, soybeans, cattle and hogs. The hog enterprise grew rapidly and that enterprise was spun off into two new C corporations but the futures trading continued to be handled by the original C corporation. The trading losses incurred by the two new C corporations on hogs were speculative and, thus, were capital losses. n32 In a 2003 Tax Court case, n33 the shareholder of two family farm corporations (who had previously operated as a sole proprietorship) engaged in commodity trades in the shareholders own name, not in the name of the corporation owning the commodity to be hedged. The result was capital gains and capital losses. n34 In a technical advice memorandum, n35 a dairy farm was carried on by an S corporation but the taxpayer, as an individual, attempted to hedge feed ingredients. Again, the result was that the transaction was speculative and gains and losses were capital gains and capital losses. n36

This problem often accompanies major changes in the way the farm or ranch business is structured and is inadvertent. Certainly, a review of commodity futures contract procedures is advisable whenever a change in the business plan is contemplated.

Identifying Hedges

In the regulations initially issued in proposed form in 1993 and made final in 1994, n37 harsh rules were included on identifying hedges as hedges. If the hedges were not identified, or were identified improperly, the consequences were severe--a hedge, for example, was deemed to produce capital gains and capital losses. Those rules were abandoned after enduring a chorus of criticism. Currently, to receive ordinary loss treatment, taxpayers must identify hedges when

entered into along with the item or items hedged before the close of the day on which the taxpayer acquired, originated or entered into the transaction. n38 If a transaction is a hedge, the transaction must be accounted for using a permissible method of accounting n39 even though the taxpayer fails to identify the transaction. n40

Accounting for Hedging Transactions

The method of accounting used by a taxpayer for reporting hedging transactions must clearly reflect income. n41 To clearly reflect income, the method used must reasonably match the timing of income, deductions, gains or losses from the hedging transaction with the timing of income, deductions, gains or losses from the items being hedged. n42

Example. A farmer hedges the 2008 corn crop in February of 2008 with a December 2009 futures contract. From February to May of 2008, the contract was a pre-hedge for the corn crop (until the crop was planted). From May until October of 2008 the futures contract was a hedge for the actual corn crop. When the 2008 crop was sold in October of 2008, the futures contract was left in place as a pre-hedge for the 2009 crop and, later, as a hedge for the actual corn crop in 2009.

The regulations seem to require that the gains and losses on the futures be associated with the gains and losses on the actual commodity amounts. However, a taxpayer on the cash method accounting with less than \$5,000,000 of gross receipts *for all taxable years ending on or after September 30, 1993*, is not required to use these accounting rules. n43 However, such a taxpayer may nonetheless use a method of accounting consistent with these rules.

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n1 . I.R.C. § 1221(b)(2). See generally 1 Harl, *Farm Income Tax Manual* § 2.17 (2007 ed.); 4 Harl, *Agricultural Law* § 27.03[10] (2008); Harl, *Agricultural Law Manual* § 4.02[6] (2008). See also Harl, Hedging or Speculation: Watch Who Does the Hedging, 15 *Agric. L. Dig.* 9 (2004).

n2

[2]. See *Federal Natl Mortgage Assn v. Commr*, 100 T.C. 541 (1993); *Treas. Reg.* § 1.1221-2.

n3

[3]. See *Weiler v. United States*, 187 F. Supp. 742 (M.D. Pa. 1961) (egg wholesaler hedged inventory); *Grote v. Commr*, 41 B.T.A. 247 (1940) (wheat farmer engaged in hedging); *Ltr. Rul.* 9930001, March 31, 1999.

n4

[4]. See *I.R.C. §§ 1092(e), 1256(e)(1)*.

n5

[5]. *T.D. 8985, Treas. Reg. § 1.1221-2(b)*.

n6

[6]. See *Marrin v. Commr*, 147 F.3d 147 (2d Cir. 1998) (transactions in securities and futures were capital in nature; ordinary loss deduction denied).

n7

[7]. *I.R.C. § 1(h)*.

n8

[8]. *I.R.C. § 1211*.

n9

[9]. *I.R.C. § 1211(a)*.

n10

[10]. *I.R.C. § 11(b)*.

n11

[11]. *I.R.C. § 1212(h)*.

n12

[12]. *I.R.C. § 1212(a)*.

n13

[13]. *I.R.C. § 1212(c)(1)*.

n14

[14]. *485 U.S. 212 (1988)*.

n15

[15]. *I.R.C. § 1221*.

n16

[16]. *I.R.C. § 1221(a)(7)* (any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into.).

n17

[17]. See Letter, Stuart L. Brown, Associate Chief Counsel, Domestic, Internal Revenue Service, to Henry Bahn, U.S. Dept of Agriculture, January 27, 1993.

n18

[18]. *Federal National Mortgage Assn v. Commr*, 100 T.C. 541 (1993).

n19

[19]. *Treas. Reg. §§ 1.1221-2, 1.446-4*.

n20

[20]. E.g., *Stewart Silk Corp. v. Commr*, 9 T.C. 174 (1947).

n21

[21]. *Corn Products Refining Co. v. United States*, 350 U.S. 46 (1955). See *Crisp, Jr. v. Commr*, T.C. Memo. 1989-668 (futures transactions required as part of loan agreement were integral part of cattle raising business; gains were ordinary income).

n22

[22]. 350 U.S. 46 (1955).

n23

[23]. 350 U.S. 46 (1955).

n24

[24]. *Patterson v. Commr*, T.C. Memo. 1981-43, affd in unpub. op., 676 F.2d 705 (8th Cir. 1982).

n25

[25]. *Id.*

n26

[26]. 59 Fed. Reg. 36,361-36,362 (1994).

n27

[27]. E.g., *Lewis v. Commr*, T.C. Memo. 1981-334 (volume of futures trading by cattle feeder was three to five times the cattle on hand). See *Commissioner v. Banfield*, 122 F.2d 1017 (9th Cir. 1941).

n28

[28]. See *Estate of Laughlin v. Commr*, 1971-52 (going long in soybeans did not provide price protection for soybeans to be produced).

n29

[29]. See *Oringderff v. Commr*, 81-2 U.S.T.C. 9642 (10th Cir. 1981) futures transactions on cattle held to be speculative for cattle feeder; many of the transactions were opened and closed the same day even though the cattle were on 120 to 150 day feed).

n30

[30]. *Pine Creek Farms, Ltd. v. Commr*, T.C. Memo. 2001-176; *Welter v. Commr*, T.C. Memo. 2003-299.

n31

[31]. *Pine Creek Farms, Ltd v. Commr*, T.C. Memo. 2001-176.

n32

[32]. *Id.*

n33

[33]. *Welter v. Commr*, T.C. Memo. 2003-299.

n34

[34]. *Id.*

n35

[35]. *TAM 9720003*, January 15, 1997.

n36

[36]. *Id.*

n37

[37]. *Treas. Reg. §§ 1.1221-2; 1.446-4.*

n38

[38]. *I.R.C. § 1221(a)(7)*. See *Treas. Reg. § 1.1221-2(f)(1)*.

n39

[39]. *I.R.C. § 1.446-4.*

n40

[40]. *Rev. Rul. 2003-127, 2003-2 C.B. 1245.*

n41

[41]. *Treas. Reg. § 1.446-4(b)*. See Ltr. Rul. 9832020, May 7, 1998 (proposed accounting method for metals merchant satisfied clear reflection of income requirement).

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[42]. *Id.*

n43

[43]. *Treas. Reg. § 1.446-4(a)(1)*.

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Harl on Income in Respect of Decedent

2008 Emerging Issues 2602

Harl on Income in Respect of Decedent

By Neil E. Harl

July 24, 2008

SUMMARY: Obtaining a new income tax basis at death on most assets equal to fair market value or the value used for federal estate tax purposes has been a feature of federal income tax law and appears to be assured at least through 2009.

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ARTICLE: Obtaining a new income tax basis at death on most assets equal to fair market value or the value used for federal estate tax purposes n1 has been a feature of federal income tax law and appears to be assured at least through 2009. n2 Under current law, a carryover basis regime will be in effect after 2009, at least for one year, with a basis adjustment applied to the income tax basis in the decedents hands. n3

However, property classified as producing income in respect of decedent has never received a new basis at death, and is unlikely to receive a new basis at death in the future. n4 The concept of income in respect of decedent or IRD is of immense importance to many farm and ranch estates.

Nature of Income in Respect of Decedent Items

Items of property producing income in respect of decedent include property such as income items uncollected at death (such as the last paycheck) where the income is subjected to income taxation to someone other than the decedent, such as an estate heir or beneficiary; passive or investment items producing interest or cash rents; and property that has been sold on contract with contract completion to occur after death. The major feature is that the assets involved do not receive an adjustment in income tax basis at death and the basis of the property, often zero, carries over to whomever triggers the gain on the IRD item.

Share Rents. For farm property held until death, a major item of concern as income in respect of decedent has been crop share or livestock share rents. Share rents held by a non-materially participating landlord at death or share rents which the decedent had a right to receive at the time of the decedents death for economic activities occurring before death are income in respect of decedent. n5 The share rents in question are taxable for income tax purposes on subsequent sale or exchange by the estate or other successor with the gain calculated using the decedents income tax

basis n6 with a possible adjustment for a portion of the federal estate tax attributable to the item. n7 Note that the estate of a share rent landlord, either crop share or livestock share, who is *materially participating under the lease*, n8 receives an adjusted income tax basis at death equal to fair market value at death or the federal estate tax value at death n9 (or the alternate valuation date). n10 The term material participation has the meaning given to the term as it is used for determining liability for self-employment tax. n11

Of course, to a farmer on the cash method of accounting, unsold livestock and grain inventories are not income in respect of decedent. n12 .

Death During A Rental Period. If a non-materially participating landlord dies during a rent period, with crops and livestock sold after death, the portion of the proceeds allocable to the period before death is income in respect of decedent. n13 That portion is also includible in the gross estate for federal estate tax purposes as accrued rent. n14 The remaining amount represents ordinary income earned by the estate after the landlords death. The proceeds of sale are apportioned according to the number of days in the rental period before and after death.

Death After The Rental Period. For rents received in kind and held by the landlord at death which are later sold, the proceeds of sale are similarly allocated between income in respect of decedent and ordinary income. n15 For a critical discussion of the allocation concept see 1 Harl, *Farm Income Tax Manual* § 2.10[4] (2007 ed.).

Share Rents Fed To Livestock. What if crop share rents are fed to livestock before death? Presumably, the animals (if owned on shares by the decedent and a livestock share lease tenant) would be treated as income in respect of decedent. n16 If share rents are fed by the estate to livestock, the crops would have a zero basis and the income would be recognized on sale of the livestock (with no deduction for the zero basis crops as feed).

Planning Strategies. As noted, a landlords share of rental income is not treated as income in respect of decedent if the decedent was a materially participating landlord. n17 If this issue is raised, as a matter of pre-death or post-death estate planning, it should be noted that material participation by a landlord creates possible liability for self-employment taxes even after the landlord is retired and receiving benefits. Therefore, raising the issue might subject the estate to claims for self-employment tax for prior years.

But the stakes are high enough in terms of obtaining a new income tax basis at death to justify some self-employment tax. How can that be attained? One good possibility is for the decedent, during life, to recruit someone in a position to provide material participation under the lease of which the decedent-to-be is the landlord. The individual could be a son or daughter, for example. It is generally advisable to enter into an agency agreement with the recruited individual, reciting what authorities have been given to the individual to act as agent for the decedent -to-be. Remember, income in respect of decedent appears to come under the general rule on imputation of activities from agent or employee to principal n18 which means that whatever the agent does is treated as though it had been done by the principal. Yet, for purposes of liability for self-employment tax, imputation by an agent or principal involving a lease is blocked. n19

Accrued Interest on Government Bonds. Interest on Series E bonds (as well as other series permitting accrual of interest) is also income in respect of decedent. n20

If Series E bonds are redeemed by the estate, the interest amount is includible in the gross income of the estate as income in respect of decedent. n21 However, the executor may elect to report the interest increment on the Series E bonds on the final return of the decedent even though the decedent held the bonds uncashed at death. n22

Bonds with accrued interest could also be held uncashed with the ultimate beneficiary reporting the interest income. n23 In a 1986 Tax Court case, n24 all interest, including interest accrued before the decedents death, was taxed to the co-owner (son) as beneficiary on redemption. n25 In that case, no election had been made by the decedent to report the

accrued interest as income. n26

Interest on certificates of deposit attributable to the period ending with the date of decedent's death but not received as of the date of death is also income in respect of decedent. n27

Installment Contracts or Contracts for Deed. Installment contracts (or contracts for deed) also create income in respect of decedent n28 and are not eligible for a new income tax basis at death. In a 1997 case in the Federal Circuit, n29 installment notes received by married taxpayers on the sale of community property were income in respect of decedent and were not entitled to a new income tax basis at death.

Thus, a valid installment sale precludes an adjustment to income tax basis and assures that the successors to the contract will have to report the gain as the decedent would have done had he or she lived. If the basis in the property before sale equals or exceeds the selling price, this is not a problem. However, as is more generally the case, particularly with farmland, the income tax basis is often a relatively small fraction of the selling price so foregoing a new income tax basis at death comes with a substantial economic disadvantage.

Merely granting an option to purchase real estate does not convert the property into income in respect of decedent. n30

Pre-Death Sales of Property by Contract. Income under a deferred payment n31 or installment sale of grain or other commodities n32 is income in respect of decedent because of the pre-death sale. n33 Presumably, the contract proceeds would be collected and reported by the estate on Form 1041 or by the successor in interest.

Sales contracts for farm products entered into before death may not, however, produce income in respect of decedent *if a significant economic contribution remains to be made by the estate after death.* n34 In a 1981 Eighth Circuit case, n35 a rancher had sold calves before death with a minimum average weight specified. After death, the calves were delivered and weighed and were found to be too light. The estate kept the calves for several weeks, until the calves met the weight requirement. The calves almost certainly would have been IRD had the calves met the weight specifications; the fact that the calves were not heavy enough justified treating the calves as eligible for a new income tax basis at death. n36

That raises the question when has the pre-death sale of property proceeded to the point that the decedent has gained the right to the sale proceeds as of the date of death and assures treatment as income in respect of decedent? A 1990 private letter ruling provides useful guidelines as to when that has occurred by specifying two conditions that must be met (1) there must be a legally binding contract and (2) the decedent must have performed all of the *substantive* as opposed to *ministerial* acts required as preconditions of sale. n37 In one case, where the buyer would not accept title unless clouds on title were cured or a purchase price adjustment was made, the property was not income in respect of decedent. n38 In another case, a gas pipeline was discovered and caused a delay in closing as the resulting issues were resolved with the outcome that the property was not income in respect of decedent. n39

Prepaid Expenses. Prepaid rent or other prepayments for supplies in the pre-death period appear to be ineligible for a new income basis at death although that is not completely clear. A 1962 Tax Court case n40 sidestepped the question of whether prepaid rent was eligible for a new basis at death. n41 Prepayments for supplies represent income to which the decedent had a contingent claim at the time of death.

Qualified Retirement Plans. Distributions from qualified retirement plans constitute income in respect of decedent. n42

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n1 . *I.R.C. § 1014(a)*.

n2

[2]. EGTRRA of 2001, Pub. L. No. 107-16, § 542(a), 115 Stat. 38 (2001).

n3

[3]. *I.R.C. § 1022*.

n4

[4]. *I.R.C. § 691(a)*. See generally 1 Harl, *Farm Income Tax Manual* §§ 2.10[3], 3.20[4][1][i][F][VII] (2007 ed.).

n5

[5]. *Rev. Rul. 64-289, 1964-2 C.B. 173*. See *Davison v. United States*, 292 F.2d 937 (Ct. Cl.), cert. denied, 368 U.S. 939 (1961).

n6

[6]. *Id.*

n7

[7]. See discussion below.

n8

[8]. *I.R.C. § 1402(a)(1)*. See *Estate of Gavin v. United States*, 113 F.3d 802 (8th Cir. 1997) (no mention of whether lease was material participation or non-material participation in nature).

n9

[9]. *I.R.C. § 1014(a)*.

n10

[10]. *I.R.C. § 2032*.

n11

[11]. *I.R.C. § 1402(a)(1)*.

n12

[12]. *Rev. Rul. 58-436, 1958-2 C.B. 366*. Cf. *Ltr. Rul. 9043068*, August 2, 1990 (paintings owned by artist at death were not income in respect of decedent).

n13

[13]. See *Rev. Rul. 64-289, 1964-2 C.B. 173*.

n14

[14]. *I.R.C. § 2031(a)*.

n15

[15]. *Rev. Rul. 58-436, 1958-2 C.B. 366.*

n16

[16]. See 1 Harl, *Farm Income Tax Manual* § 2.10[5] (2007 ed.).

n17

[17]. *Rev. Rul. 64-289, 1964-2 C.B. 173.*

n18

[18]. See 5 Harl, *Agricultural Law* § 42.____ (2008). See also *Estate of Davis v. United States*, 68-2 U.S.T.C. 9483 (S.D. Ill. 1968) (son was trustee of trust and assisted in managing mothers other farms; mother did not materially participate and no discussion of level of activity by son in management role and

n19

[19]. *I.R.C. § 1402(a)(1)* (. . . material participation. . . as determined without regard to any activities of an agent of such owner or tenant. . .).

n20

[20]. *Ltr. Rul. 200004030*, November 2, 1999).

n21

[21]. *Ltr. Rul. 8407083*, November 17, 1983.

n22

[22]. *Rev. Rul. 68-145, 1968-1 C.B. 203.*] H or HH bonds issued for E or EE bonds may be similarly treated. [Ltr. Rul. 9232006, April 17, 1992 (accrued interest reported on decedents final return; full amount of income

tax for final year deductible on estate tax return as claim against estate).

n23

[23]. See *Apkin v. Commr*, 86 T.C. 692 (1986).

n24

[24]. *Id.*

n25

[25]. *Id.*

n26

[26]. *Id.* See also *Ltr. Rul.* 9024016, March 14, 1990 (interest included in income of co-owner in year bonds redeemed, disposed of or reached maturity unless *I.R.C.* § 454(a) election made; for bonds co-owned by decedent and joint owner, surviving joint owner could elect under *I.R.C.* § 454(a)).

n27

[27]. *Rev. Rul.* 79-340, 1979-2 C.B. 320.

n28

[28]. See *Holt v. United States*, 97-2 U.S.T.C. 50,929 (*Fed. Cir.*1997). Compare TAM 200624065, December 6, 2005 (consumer price index adjustments added to promissory note were stated interest but not included in IRD; were paid directly to beneficiaries rather than to estate).

n29

[29]. *Id.*

n30

[30]. *Rev. Rul. 71-265, 1971-1 C.B. 223* (income tax basis at death takes into account existence of option on property). See *Ltr. Rul. 9325029*, March 25, 1993 (same).

n31

[31]. *Rev. Rul. 58-162, 1958-1 C.B. 234*.

n32

[32]. *I.R.C. § 453(b)(2)(B)*.

n33

[33]. See *Ltr. Rul. 9023012*, March 6, 1990.

n34

[34]. *Estate of Peterson v. Commr*, 74 T.C. 630 (1980), *affd*, 667 F.2d 675 (8th Cir. 1981).

n35

[35]. *Id.*

n36

[36]. *Id.*

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[37]. *Ltr. Rul. 9023012*, March 6, 1990.

n38

[38]. *Estate of Napolitano v. Commr, T.C. Memo. 1992-316.*

n39

[39]. *Ltr. Rul. 200744001*, July 18, 2007.

n40

[40]. *C.G. Sloan v. Commr, 38 T.C. 203 (1962).*

n41

[41]. For a discussion of the arguments on both sides of the issue, see Harl, *Handling Prepaid Expenses at Death*, 18 *Agric. L. Dig.* 9 (2007). See also *Treas. Reg. § 1.691(a)-1(b)(3)*.

n42

[42]. *I.R.C. § 691(a)(2)*. See *Rev. Rul. 69-297, 1969-1 C.B. 131*. See also *Spuler, Jr. v. Commr, T.C. Summary Opinion 2001-8* (distributions from deceased fathers IRA includible in sons income). Compare *Eberly v. Commr, T.C. Summary Opinion 2006-45* (distribution from estate to son of decedent from retirement plan (TIAA/CREF) was not IRD; decedent had requested withdrawal before death so it was income to decedent).

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Dr. Harl has published widely including 28 books; more than 400 professional articles and bulletins; and more than 850 articles in farm and financial publications. He is author of the 15-volume treatise, *Agricultural Law* and the single volume *Agricultural Law Manual and Farm Income Tax Manual*; senior author of two *Tax Management Portfolios*--*The Family-Owned Business Deduction and Reporting Farm Income* and co-author of *Taxation of Cooperatives* and co-author of *Principles of Agricultural Law*.

He has received more than 30 major awards including the USDA Superior Service Award in 1987; the Presidents Award from the Iowa State Bar Association in 1991; Charles A. Black Award from the Council for Agricultural Science and Technology in 1997, for effectiveness in communicating with the public; the Distinguished Service to Agriculture award from the Chicago Farmers Club in 1999, the Wallace Farmer Iowa Master Farmer Award for Exceptional

Service to Agriculture in 2000; the Speaker of the Year Award by the National Society of Accountants in 2000; the Presidential Service Award from Iowa State University in 2002; and the Service to American and World Agriculture Award from the National Association of County Agricultural Agents in 2006.

Dr. Harl has served on six federal advisory bodies a Farm Tax Reform Task Force for the U.S. Department of the Treasury in 1967; the Commissioner's Advisory Group (Commissioner of Internal Revenue) in 1979-80; the USDA Farm Structure Task Force in 1980; the Office of Technology Assessment, Technical Advisory Committee, by Congressional Appointment, 1987-1995 (chair in 1993-94); the USDA Advisory Committee on Agricultural Biotechnology, 2000-2002; and the Commission on Federal Payment Limitations in Agriculture, 2002-2003.

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Court Flouts IRS and OKs Deduction for Cash Distribution Redemptive Dividends

2008 Emerging Issues 2594

Gerald M. Levinson: Court Flouts IRS and OKs Deduction for Cash Distribution Redemptive Dividends

By Gerald M. Levinson

July 24, 2008

SUMMARY: Employers redemption payments to an ESOP were essentially equivalent to dividend payments under IRC Sec. 302(b). Dividend payments to an ESOP by an employer that the plan in turn pays out to employees are also deductible by the employer, thereby providing a "double deduction."

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ARTICLE: The U.S. District Court for the District of Minnesota is the second court to defy the IRS by holding that an employer may deduct as dividends the payments it makes to its Employee Stock Ownership Plan (ESOP) to redeem its stock, where the redemption proceeds are then used by the ESOP to pay the account balances of terminating employees. The court reasoned that the employers payments to the ESOP were essentially equivalent to dividend payments under *IRC Sec. 302(b)*, and that dividend payments to an ESOP by an employer that the plan in turn pays out to employees are deductible by the employer under *IRC Sec. 404(k)* [*General Mills, Inc. v. U.S.*, No. 06-3547, U.S. District Court, D. Minn., Jan. 14, 2008]; *2008 U.S. Dist. LEXIS 3196*].

This holding is similar to the Ninth Circuits decision in *Boise Cascade Corp. v. U.S.* [*329 F.3d 751* (May 20, 2003); *2003 U.S. App. LEXIS 9642*] that a corporations payments to redeem its stock held by the ESOP component of its retirement plan were deductible as dividends paid under *IRC Sec. 404(k)*.

The Treasury Dept. and IRS vigorously oppose the conclusion reached by the courts in both cases, and the U.S. has appealed the judgment in the *General Mills* case to the Eighth Circuit Court of Appeals. A decision favorable to the U.S. in the appellate court would likely create a split between the circuits and open the issue to Supreme Court review.

The Facts in *General Mills*. General Mills, Inc. (GMI) maintained three employee retirement plans that it amended to include an employee stock ownership plan component. These ESOPs were created and operated as typical leveraged ESOPs. All of the ESOPs assets were held and owned by a single trust, which purchased shares of GMI common stock for the ESOPs and financed the purchases through loans from outside lenders ("ESOP loans"). The shares were initially held in a suspense account and were later released to plan participant ("Participant") accounts upon payment of principal and interest on the ESOP loans.

During the tax years at issue (1992 to 1995 and 1997), GMI redeemed shares of its common stock that were held by

the trust (Redemptive Dividends). The trust then used some of the proceeds from the Redemptive Dividends to satisfy portions of its cash distribution obligations ("Cash Distribution Redemptive Dividends") to terminating employees.

GMI argued that these payments constituted dividend payments to the ESOPs and, as such, were deductible by it under *IRC Sec. 404(k)*. That Code provision entitles an employer to deduct redemptive dividends that an ESOP pays out to employees in cash within 90 days of the close of the plan year.

The Legal Framework. For the Cash Distribution Redemptive Dividends to be deductible under *IRC Sec. 404(k)*, GMI must have (1) paid an "applicable dividend," (2) in cash, (3) on "applicable employer securities." The Court found that GMI satisfied all three requirements. IRS and GMI agreed that the Redemptive Dividends were essentially equivalent to dividends, and were paid to the Trust and distributed in cash to participants within 90 days after the close of the plan year in which they were paid. The dividends therefore qualified as "applicable dividends" under *IRC Sec. 404(k)(2)(A)(ii)*. Moreover, the IRS stipulated that GMI common stock qualified as "applicable employer securities" under *IRC Sec. 404(k)(2)(A)*. Therefore, the court concluded that GMIs claimed deductions satisfied the tax law and were allowable unless otherwise disallowed.

Court Rejects IRSs Arguments. While the IRS agreed that the amounts that GMI paid to redeem its stock should be treated as dividends, it argued that--even if the Cash Distribution Redemptive Dividends were deductible under *IRC Sec. 404(k)*--the deduction was disallowed by *IRC Sec. 162(k)* which bars a deduction for amounts paid by a corporation in connection with the reacquisition of its stock. However, GMI argued, and the Court agreed, that although the Cash Distribution Redemptive Dividends arose out of the same general circumstances as the Redemptive Dividends, they were not expenditures made "in connection with" the Redemptive Dividends, but rather arose as a result of the payment of the dividends to employees by the ESOP. Therefore, *IRC Sec. 162(k)* did not disallow the otherwise allowable *IRC Sec. 404(k)* deductions.

The IRS also claimed that *Rev. Rul. 2001-6 [2001-1 CB 491]* disallowed GMIs deduction under *IRC Sec. 404(k)*. The ruling is based on facts similar to those in both the *Boise Cascade Corp.* and *General Mills* cases. It concludes that the allowance of a deduction under *IRC Sec. 404(k)(1)* under the facts of both cases would constitute, in substance, an evasion of taxation," and provides that the "Secretary may disallow the deduction for any dividend if he determines that the dividend constitutes an evasion of taxes. However, the Court held that the ruling didnt disallow GMIs deduction because the ruling-- which was prepared and issued by the Office of the IRS Chief Counsel--authorized only the Secretary of the Treasury or his delegate to disallow the deduction, and there was no evidence that the Secretary internally delegated his authority in this regard to the Chief Counsel. Accordingly, the Court found that the Ruling could not be considered a determination by the Secretary.

The IRS also argued that the court should reject GMIs position because General Mills would receive a double deduction if it were allowed to deduct the Cash Distribution Redemptive Dividends under *IRC Sec. 404(k)*. In essence, the IRS claimed that the transactions between GMI and the ESOP should be treated as a single transaction for which GMI was entitled to a deduction, and that allowance of a deduction for Cash Distribution Redemptive Dividends would therefore provide GMI with a double deduction. The Court rejected this argument, noting that there were three separate transactions involved in the case -- two of which resulted in separate cash expenditures by GMI. First, GMI distributed shares of its common stock to the Trust in exchange for cash obtained from the ESOP loans. Second, GMI paid dividends on its stock and made other cash contributions to the Trust that the Trust used to pay off the ESOP loans. Third, GMI paid cash to the Trust to redeem the GMI common stock held by the Trust, some of which the Trust used to satisfy its Cash Distribution obligations. In effect, GMI argued that the three separate transactions should be treated as an integrated whole, so as to reflect that it incurred only a net loss from the second transaction, but it sought deductions for the second and third transactions. The court said the three transactions were better understood separately. When viewed in this light, GMI claims deductions for separate payments made in the second and third transactions. Therefore, a deduction under *IRC Sec. 404(k)* did not constitute a double deduction.

Practice Tip. According to the National Center for Employee Ownerships January 29, 2008 release, [t]he use of

dividends this way [to satisfy an ESOPs payment obligations] raises serious concerns among ESOP practitioners. First, it means companies get a deduction twice, once for contributing the dividend to repay the ESOP loan (as happened here) and again for redeeming the stock with another dividend. Worse, the employees now may not be able to take favorable tax treatment on these distributions by, for example, rolling them into other plans, if the IRS concludes the distributions are dividends. However, there's no indication that the IRS or Treasury intend to do so.

The *General Mills* and *Boise Cascade Corp.* decisions have not prompted the IRS to reverse its position that the allowance of a deduction for Cash Distribution Redemptive Dividends would, in effect, give an employer a double deduction for the same cost and constitute tax avoidance or evasion. In fact, in 2006 the IRS issued a final regulation [*Treas. Reg. Section 1.162(k)-1*] that disallows a deduction for any amount paid or incurred by a corporation in connection with the reacquisition of its stock. The regulation specifically states that such amounts include amounts paid by a corporation to reacquire its stock from an ESOP that are used in a manner described in [*IRC*] section 404(k)(2)(A). (Because the regulation is effective for amounts paid or incurred on or after August 30, 2006, it wasn't considered by the court).

However, in a February 4, 2008 release prompted by the decision in the *General Mills* case, the Morgan Lewis law firm speculated that [t]hese final regulations could be invalidated since their statutory support is questionable and two courts have now reached the opposite conclusion.

The deductibility of redemptive dividends used to fund an ESOPs payment obligations is therefore not assured. What then should an employer considering such a deduction do?

A Word to the Wise

According to the Morgan Lewis release, [a] corporation that is interested in claiming a tax deduction for costs associated with redeeming shares from an ESOP should consult with legal counsel with expertise in this area and proceed cautiously. The IRS has clearly stated its position as evidenced by its issuance of final regulations specifically disallowing the deduction *after* the *General Mills* ruling. This suggests that one district court decision will not, in itself, change the IRS's enforcement position or prevent disallowance of the deduction in other court jurisdictions.

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Harl on The Mystery of Mizell

2008 Emerging Issues 2574

Harl on The Mystery of Mizell

By Neil E. Harl

July 19, 2008

SUMMARY: The strange and mysterious saga of *Mizell v. Commissioner* has whipsawed the leasing of real property to family entities for well over a decade. A good case can be made that both sides in the controversy have been wide of the mark in their respective statutory interpretations.

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ARTICLE: Cite as: Harl, Neil E. *The Mystery of Mizell*. LexisNexis Expert Commentary, (*Insert date you accessed the document online*).

The strange and mysterious saga of *Mizell v. Commissioner* n1 has whipsawed the leasing of real property to family entities for well over a decade. n2 The long running disagreement over whether rents on leased realty to an entity in which the lessor is employed has featured a Tax Court opinion that was issued but never published, n3 settlement of a Tax Court case before trial for 33 percent of the assessment n4 and, a month later, issuance of a non-acquiescence in three separate cases that had been remanded to the Tax Court by the Eighth Circuit Court of Appeal. n5

A good case can be made that both sides in the controversy have been wide of the mark in their respective statutory interpretations.

The Tax Court Decision in *Mizell v. Commissioner*. The problem arose in 1995 in a Tax Court decision, *Mizell v. Commissioner*, n6 in which the taxpayer was farming in a general partnership with his sons but the 731 acres of land involved were rented to the general partnership under a rather unusual crop share lease. n7 In the course of an audit, the Internal Revenue Service took the position that the taxpayers involvement as a general partner in the family farm partnership *plus the taxpayers involvement under the lease* exceeded what was needed for self-employment tax to be due under the theory that both statuses by the taxpayer constituted an arrangement under the statute. n8 IRS was focusing attention on a passage in the 1956 amendment to *Section 1402(a)(1) of the Internal Revenue Code*. That subsection reads as follows

(a) The term net earnings from self employment means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed

(1) There shall be excluded rentals from real estate and from personal property leased with the real estate (including such rentals paid in crop shares) together with the deductions attributable thereto, unless such rentals are received in the course of a trade or business as a real estate dealer; except that the preceding provisions of this paragraph shall not apply to any income derived by the owner or tenant of land if (1) such income is derived *under an arrangement*, between the owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities on such land, and that there shall be material participation by the owner or tenant (as determined without regard to any activities of an agent of such owner or tenant). (Emphasis added) n9

Thus, the IRS was looking at the passage under an arrangement in subsection (1) and taking the position that arrangement meant everything the lessor (in this case Mr. Mizell) was doing--what he was doing as lessor of the land to the family general partnership and what he was doing as a general partner in the family general partnership. The Tax Court bought that argument n10 and the case was not appealed. The immediate reaction this was a partnership, it will not apply to a corporation and this was a share rent lease, it wont apply to cash rents.

Rulings and Cases Following Mizell. In less than six months after *Mizell*, IRS applied the same analysis to rental of land and personal property to a corporation, with the result that the husband and wife as officers and directors of a corporation and co-owners of the land cash rented to the corporation had self-employment income on the cash rents. n11 A few months later, IRS issued three Field Service Advices n12 with slightly different facts, but all reached a conclusion in accordance with the *Mizell* case.

In short order, three Tax Court cases were decided (it is reasonable to believe the taxpayers in the three FSAs did not like the response and chose to litigate). In *Bot v. Commissioner*, n13 the wife who rented land to the husbands sole proprietorship was found to be materially participating in the operation. In *Hennen v. Commissioner*, n14 the facts were similar. In *McNamara v. Commissioner*, n15 the husband and wife, as joint tenants, cash rented the land to the husbands corporation and had self-employment tax to pay on the cash rents. All three cases were appealed to the Eighth Circuit Court of Appeals.

On December 29, 2000, all three cases were reversed and remanded to the Tax Court. n16 The Eighth Circuit focused on the nexus between the lease and the farming operation and stated that the mere existence of an arrangement requiring and resulting in material participation . . . does not automatically transform rents received into self-employment income. n17 The Eighth Circuit was basically looking at the statute n18 but viewing the relevant passage as *derived* under an arrangement rather than under an arrangement.

The Court pointed out that rents consistent with market rates very strongly suggest that the rental arrangement should stand on its own as an independent transaction without self-employment tax being due. n19 That passage has become the guidance from the three cases on appeal and has influenced the Tax Court in subsequent decisions. Thus, in *Solvie v. Commissioner*, n20 the Tax Court found that the rental paid for use of a hog barn (calculated at \$21 per hog per rotation) was above a fair market rental with the payments, therefore, subject to self-employment tax. The Tax Court found that there was a nexus between the hog barn and the taxpayers material participation in the operation. In *Johnson v. Commissioner*, n21 the Tax Court found that the land rentals were fair market rentals and no self-employment tax was due.

A Close Analysis of *McNamara et al.* The problem with that guidance is that a reasonable rental payment for the use of the land or other real estate represents a return on the rented asset *and should not be subject to self-employment tax*. It is a *premium* rental that causes the problem. With a premium rental, the lessor is receiving a reasonable return on the land *and something more*. It is that something more that should be subject to self-employment tax inasmuch as it represents a payment to the lessor in addition to a reasonable rental in the nature of self-employment income and that should properly lead to self-employment tax liability. With that reasoning, rentals *below* a market rental rate should not pose a problem of self-employment tax liability, nor should *reasonable market rentals* be challenged.

Events After the Remand of *McNamara et al.* But back to the three cases which were reversed and remanded to

the Tax Court on December 29, 2000. n22 The Internal Revenue Service reportedly failed to show up in the Tax Court and the Tax Court entered a decision and issued an opinion *to the taxpayers* July 10, 2002 but that opinion *was never published formally*. n23 The Tax Court agreed that rents in the three cases were all fair market rentals.

Another case, this one from Nebraska, was docketed in the Tax Court but was dismissed. n24 That case would have been appealable to the Eighth Circuit Court of Appeals. Moreover, a case that would have been appealable to the Second Circuit Court of Appeals was also docketed in the Tax Court n25 involving an upstate New York apple producer but that case was dismissed in September of 2003 in a settlement with the Internal Revenue Service. The assessment of \$105,000 was settled for a reported \$35,000.

Interestingly, about a month later, on October 20, 2003, IRS entered a non-acquiescence in the appellate court cases of *McNamara, Hennen and Bot*. n26

Lessons From All of This. First, it should be noted that there have been no litigated cases since early 2004. The battlefield is eerily quiet.

Second, it should be noted that legislation has been introduced (but not passed) that would change the passage in the statute n27 from an arrangement to a lease agreement. n28

Third, the issuance of the non-acquiescence on October 20, 2003 by the Internal Revenue Service n29 signaled that the Service disagrees with the holdings in those cases and would likely not follow those decisions, at least not outside the Eighth Circuit area.

Fourth, and most importantly, the three decisions at the Eighth Circuit would be influential with other circuits and have been embraced by the Tax Court, n30 albeit in an unpublished Tax Court opinion (and not a Tax Court Summary Opinion). Thus, the holdings of the Eight Circuit constitute the best guidance available to date in the long running saga. That guidance is to beware of premium rentals of property to entities in which the lessor of the property is also involved in entity operations such that *the combined involvement equals or exceeds what is needed for material participation*. For risk averse taxpayers and practitioners, it is well to keep in mind that the Eighth Circuit has not yet narrowed the scope of the problem just to premium rentals.

As for specific planning options for those clients with two entity business plans, with one entity owning the land and the other entity carrying on the farming or ranching operation (and note that this problem is limited to those taxpayers producing agricultural or horticultural commodities n31) the following are offered as possible strategies in attempting to avoid a *Mizell* challenge

- . Convey to the spouse (who is not involved in the operation) the interests in assets to be leased and keep the spouses involvement under the lease well below material participation,

- . Transfer the assets to be leased to the operating entity to another entity (such as a limited partnership or limited liability company) but keep in mind that the regulations governing liability of members of such pass-through entities for self-employment tax are still only in proposed form n32 as a result of the freeze imposed by Congress in 1997 that expired formally on July 1, 1998, n33

- . Pay the additional self-employment tax,

- . Retire from the operating entity, or

- . Die.

Another option would be to restructure the business into a single entity with no leasing of the assets. For various reasons, that option is usually viewed less than favorably by the owners involved.

[Return to Text](#)

n1 . *T.C. Memo. 1995-571*.

n2

[2]. *I.R.C. § 1402(a)(1)*. See generally 2 Harl, *Farm Income Tax Manual* § 8.05[5] (2007 ed.); 5 Harl, *Agricultural Law* § 37.03[3][a][1] (2008); Harl, *Agricultural Law Manual* § 4.06[3] (2008).

n3

[3]. *Commr v. McNamara, T.C. Memo. 2002-___*, opinion issued July 10, 2002.

n4

[4]. *Fowler v. Commr*, T.C. Docket No.013920-01, September, 2003.

n5

[5]. AOD CC-2003-3, October 20, 2003, I.R.B. 2003-42.

n6

[6]. *T.C. Memo. 1995-571*.

n7

[7]. *Id.*

n8

[8]. *I.R.C. § 1402 (a)(1)*.

n9

[9]. *I.R.C. § 1402 (a)(1)*.

n10

[10]. *Mizell v. Commr, T.C. Memo. 1995-571*.

n11

[11]. *Ltr. Rul. 9637004*, May 1, 1996.

n12

[12]. *FSA 9917005*, December 10, 1998; *FSA 9917006*, December 10, 1998; *FSA 9917007*, December 10, 1998.

n13

[13]. *T.C. Memo. 1999-256*.

n14

[14]. *T.C. Memo. 1999-306*.

n15

[15]. *T.C. Memo. 1999-333*.

n16

[16]. *McNamara et al. v. Commissioner*, 236 F.3d 410 (8th Cir. 2000), non-acq., I.R.B. 2003-42.

n17

[17]. *Id.*

n18

[18]. *I.R.C. § 1402(a)(1)*.

n19

[19]. *Id.*

n20

[20]. *T.C. Memo. 2004-55*.

n21

[21]. *T.C. Memo. 2004-56*.

n22

[22]. *McNamara v. Commissioner*, 236 F.3d 410 (8th Cir. 2000), non-acq., I.R.B. 2003-42.

n23

[23]. *McNamara et al. v. Commissioner*, *T.C. Memo. 2002-____*.

n24

[24]. *Milton v. Commr*, T.C. Docket No. 13594-01.

n25

[25]. *Fowler v. Commr*, T.C. Docket No. 013920-01.

n26

[26]. AOD CC-2003-3, October 20, 2003, I.R.B. 2003-42.

n27

[27]. *I.R.C. § 1402(a)(1)*.

n28

[28]. S. 569, H.R. 1044, 106th Cong., 1st Sess. (1999); S. 1861, 106th Cong., 1st Sess. (1999); S. 2422, 106th Cong., 2d Sess. (2000); S. 312, 107th Cong., 2d Sess. (2002); S. 665, 108th Cong., 1st Sess. (2003); H.R. 5169, 108th Cong., 2d Sess. (2004).

n29

[29]. AOD CC-2003-3, October 20, 2003, I.R.B. 2003-42.

n30

[30]. *McNamara et al. v. Commr, T.C. Memo. 2002-___*, July 10, 2002).

n31

[31]. *I.R.C. § 1402(a)(1)*.

n32

[32]. *Prop. Treas. Reg. § 1.1402(a)-2(h)*.

n33

[33]. See Tax Reform Act of 1997, Pub. L. No. 105-34, § 935, *111 Stat. 788* (1997).

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Harl on Deducting Losses From Farm Cooperatives

2008 Emerging Issues 2531

Harl on Deducting Losses From Farm Cooperatives

By Neil E. Harl

July 19, 2008

SUMMARY: Recent years have been difficult ones for farm cooperatives with several, including some regional cooperatives, failing or seeking protection of the bankruptcy court.

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ARTICLE: Recent years have been difficult ones for farm cooperatives with several, including some regional cooperatives, failing or seeking protection of the bankruptcy court. n1 Because losses involving a cooperative are subject to unusual income tax treatment, due to the widespread memberships in cooperatives of various types and because losses on failed cooperatives are often substantial in size, the subject of income tax treatment of losses has assumed greater proportion in recent years as more cooperatives have encountered financial headwinds.

Losses Representing Retained Patronage or Qualified Written Notices of Allocation

One of the uniquenesses of the reporting of losses from a cooperative, as opposed to all other pass-through entities, is that losses involving interests in a cooperative that represent retained patronage dividends or, more broadly, the redemption of qualified written notices of allocation, at less than the stated amount on issuance produce an *ordinary* loss. n2 That's the case even though losses on the rest of the interest may be deductible under the worthless securities provision. n3 Losses under that provision of the Internal Revenue Code are ordinarily treated as capital losses, not ordinary losses. n4

Losses Attributable To Retained Patronage Dividends or Notices of Allocation. A notice of cooperative distribution is qualified if (1) 20 percent of the total dividend of which it is a part is paid in cash or by qualified check and (2) it is redeemable in cash within 90 days of issue *or the distributee has consented to report it as income*. n5 Consent may be in writing or by membership in an organization such as a cooperative, which has adopted a bylaw requiring such consent, or by endorsing and cashing a qualified check paid as part of a patronage dividend or distribution. n6 A qualified check is one that is imprinted with a statement that endorsement and cashing of the check constitutes consent on the part of the payee to report the accompanying notices of allocation as income. n7 Thus, the member of the cooperative agrees to pick up the entire tax obligation in exchange for receiving 20 percent of the

amount. The result is that the cooperative (or other eligible organization) has tax-free use of the other 80 percent until the notice amount is paid off (if it is).

A per unit retain allocation is given essentially the same tax treatment accorded patronage dividend allocations and other qualified written notices of allocation. n8

In the leading authority on losses associated with retained patronage dividends (and other forms of qualified written notices of allocation or per unit retains, *Rev. Rul. 70-64*, n9 a chicken farmer who acquired supplies from a local cooperative received a patronage dividend. Later, the farmer was advised that the cooperative could not repay the amount for which the cooperative had an obligation to distribute. The question was whether the loss on the portion of the farmers interest in the cooperative that represented the patronage dividend amount was an ordinary loss or a capital loss. The ruling holds that the loss, *to the extent of the amount which had been taxed to the farmer as a patron of the cooperative*, was an ordinary loss. n10 That portion of the farmers interest in the cooperative was not a capital asset. n11 The rest of the loss on the farmers ownership interest would be a loss on a capital asset.

Losses on Mere Investment in Cooperative Stock. For transactions that do not involve allocated patronage dividends or other notices of allocation, but instead involve the taxpayers investment in cooperative stock, gains or losses are capital gains and capital losses n12 not ordinary gains and ordinary losses. Investments in newly formed cooperatives, such as those engaged in biofuels production that have not made distributions, fall into that category.

For farmers who associate with a cooperative to obtain supplies or to market their products and commodities, is it possible to argue that the ownership interest represented an asset *used in the trade or business*? If that were the case, net gains would be capital gains and net losses would be ordinary losses, which would be highly advantageous to cooperative members. n13 The problem with that reasoning is that the statute limits such treatment to property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year. n14 Stock or any other ownership interest in a cooperative cannot meet either test. Cooperative stock is not an asset used in the trade or business.

Gains or Losses From the Sale of Facilities

A further question relates to the proper characterization of gains and losses on equity traceable to the sale of capital assets by the cooperative. That question was addressed by a 1999 Tax Court decision, *Farmland Industries v. Commissioner*, n15 The issue in that case was the proper classification of the gain from the sale of a production plant. The Tax Court held that the proper classification test was whether each item of gain or loss was realized in a transaction that either (1) directly related to the cooperatives enterprise or (2) facilitated the cooperatives activities on behalf of its patrons. n16 If either branch of that test is met, the gains or losses are ordinary gains or losses. n17 If that test is not met, a write-down of equity produces a capital loss.

When are Losses in a Cooperative Deductible?

The question of when losses are deductible depends upon whether the loss is characterized as arising from a worthless security n18 or the loss relates to a bad debt. n19 That determination can have important implications for the handling of the loss.

Losses on Worthless Securities. Neither the statute nor the regulations provide clear guidance on whether stock in a cooperative is subject to treatment as a worthless security. n20 However, the Tax Court has allowed cooperative losses to be deducted under the worthless securities rules. n21

Under the worthless securities rules, the cost or other basis is deducted in the year the stock becomes worthless. n22 The regulations require that the security be wholly worthless at any time during the taxable year to be deductible as a loss. n23 It is clear that no deduction is allowed for partially worthless stock. n24

A loss from worthless stock that is a capital asset is generally subject to the limitations on capital losses. n25 If any security which is not a capital asset becomes wholly worthless during the year, the loss is an ordinary loss. n26 Therefore, it would seem that stock in a cooperative which was acquired as an investment, and which does not involve retained patronage, is a capital asset and is subject to treatment as a worthless security. n27

Whether an interest in a cooperative representing retained patronage is subject to the worthless securities rules depends upon whether the interest is a security. n28 The Internal Revenue Service, in *Rev. Rul. 70-64*, n29 which allowed ordinary loss treatment on such an interest, held that an interest in a cooperative representing or including retained patronage *is not considered a capital asset*. That ruling made it clear that the ordinary loss allowed in that ruling was deductible under the worthless securities provision which would indicate that the interest involved was not a capital asset. Keep in mind that *Rev. Rul. 70-64* n30 was issued 18 years before the United States Supreme Court chastised taxpayers and the Internal Revenue Service alike for ignoring the statutory definition of capital asset which is that everything is considered to be a capital asset except for assets specifically excluded from the definition. n31

In light of the requirement that, to be deductible, losses on worthless securities must be wholly worthless, n32 losses involving a cooperative in reorganization bankruptcy (Chapter 11) would seem not to be deductible until there is a formal determination that the securities are, indeed, worthless.

Losses From Bad Debts. If an interest in a cooperative is not considered subject to the worthless securities rules, perhaps on the grounds that an interest in a cooperative that represents retained patronage is not a security within the meaning of the worthless securities provision, any loss may be allowable as a bad debt deduction. n33 The bad debt deduction provision and the worthless securities provision are mutually exclusive in that the bad debt deduction provision *is specifically made inapplicable to a debt which is evidenced by a security as defined in I.R.C. § 165(g)(2)(C)*. n34 That definition of security embraces a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. n35

If characterized as a bad debt, a deduction is available if the debt becomes worthless during the year. n36 For a partially worthless *business* bad debt, a deduction is allowed not in excess of the part charged off within the taxable year. n37 However, non-business bad debts must be totally worthless to be deductible; partially worthless nonbusiness bad debts are not deductible. n38

Nonbusiness bad debts include debts *other than* debts created or acquired in connection with a trade or business of the taxpayer or a debt the loss from the worthlessness of which is incurred in the taxpayers trade or business. n39 It would appear that losses on interests in a cooperative, representing retained patronage, may be classified as business bad debts *if properly classified as a bad debt*. n40 While partially worthless bad debts are deductible as business bad debts, it is necessary to show that the deductible amount was charged off during the year. n41

Bankruptcy is generally good evidence that at least part of a debt is worthless. n42 As stated in the regulations

In bankruptcy cases a debt may become worthless before settlement in some instances; and, in others, only when a settlement in bankruptcy has been reached.

For a cooperative in reorganization bankruptcy, a bad debt deduction may not be claimable until formal action is taken by the bankruptcy court declaring that the debt has been charged off. n43

[Return to Text](#)

n1 . See 2 Harl, *Farm Income Tax Manual* § 4.05 (2007 ed.); Harl, Handling Gains and Losses on Cooperative Stock, 13 *Agric. L. Dig.* 1 (2002).

n2

[2]. *Rev. Rul. 70-64, 1970-1 C.B. 36*. See Harl, Handling Gains and Losses on Cooperative Stock, 13 *Agric. L. Dig.* 1 (2002).

n3

[3]. *I.R.C.* § 165.

n4

[4]. *Treas. Reg.* § 1.165-5(b), (c).

n5

[5]. 1 Harl, *Farm Income Tax Manual* § 2.21[1][e] (2007 ed.).

n6

[6]. *Id.*

n7

[7]. *Id.*

n8

[8]. I.R.C. §§ 13821388.

n9

[9]. 1970-1 C.B. 36.

n10

[10]. *Id.* See Ltr. Rul. 200341017, July 3, 2003 (federated cooperative could utilize its patronage source losses by canceling an equal amount of currently outstanding qualified notices of allocation; no taxable income to cooperative upon cancellation of patronage equity).

n11

[11]. *Id.*

n12

[12]. I.R.C. §§ 1221, 1211.

n13

[13]. I.R.C. § 1231 (a).

n14

[14]. I.R.C. § 1231(b)(1).

n15

[15]. T.C. Memo. 1999-388, acq., 1999-1 C.B. 920.

n16

[16]. *Id.*

n17

[17]. *Ltr. Rul. 200252027*, September 30, 2002 (sale of business by cooperative produced patronage-sourced income). See *Ltr. Rul. 200314002*, December 4, 2002 (sale of stock of corporate holdings by telephone cooperative resulted in patronage-sourced income).

n18

[18]. *I.R.C. § 165(g)*.

n19

[19]. *I.R.C. § 166(a)*.

n20

[20]. See *I.R.C. § 165*.

n21

[21]. *Martin v. Commr*, 38 B.T.A. 1270, non-acq.; *Peake v. Commr*, 10 T.C.M. 577 (1951).

n22

[22]. *I.R.C. § 165(g)(1)*.

n23

[23]. *Treas. Reg. § 1.165-5(c)*. See *Wagner v. United States*, 03-1 U.S.T.C. 50,238 (M.D. Fla. 2003) (stock not completely worthless during year). See also *Geddis v. Commr*, T.C. Memo. 2005-191 (capital loss carryforward disallowed; failed to substantiate and failed to show stock became totally worthless).

n24

[24]. *Id.*

n25

[25]. *Treas. Reg. § 1.165-5(c).*

n26

[26]. *Treas. Reg. § 1.165-5(b).*

n27

[27]. *Treas. Reg. § 1.165-5(c).*

n28

[28]. *I.R.C. § 1221(a).*

n29

[29]. *1970-1 C.B. 36.*

n30

[30]. *1970-1 C.B. 36.*

n31

[31]. *Arkansas Best Corp. v. Commr*, 485 U.S. 212 (1988).

n32

[32]. *Treas. Reg. § 1.165-5(c)*.

n33

[33]. *I.R.C. § 166(a)*.

n34

[34]. *I.R.C. § 166(e)*.

n35

[35]. *I.R.C. § 165(g)(2)(C)*.

n36

[36]. *I.R.C. § 166(a)(1)*.

n37

[37]. *I.R.C. § 166(a)(2)*.

n38

[38]. *Treas. Reg. § 1.166-5(a)*. See, e.g., *Scagliatta v. Commr, T.C. Memo. 1996-498* (taxpayer expected to receive some distribution from bankruptcy estate; not worthless in year at issue).]

n39

[39]. *I.R.C. § 166(d)(2)*.

n40

[40]. See *I.R.C. § 166(d)(2)*.

n41

[41]. *I.R.C. § 166(a)(2)*.

n42

[42]. *Treas. Reg. § 1.166-2(c)*.

n43

[43]. *I.R.C. § 166(a)(2)*.

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He has received more than 30 major awards including the USDA Superior Service Award in 1987; the Presidents Award from the Iowa State Bar Association in 1991; Charles A. Black Award from the Council for Agricultural Science and Technology in 1997, for effectiveness in communicating with the public; the Distinguished Service to Agriculture award from the Chicago Farmers Club in 1999, the Wallace Farmer Iowa Master Farmer Award for Exceptional Service to Agriculture in 2000; the Speaker of the Year Award by the National Society of Accountants in 2000; the Presidential Service Award from Iowa State University in 2002; and the Service to American and World Agriculture Award from the National Association of County Agricultural Agents in 2006.

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Biotechnology, 2000-2002; and the Commission on Federal Payment Limitations in Agriculture, 2002-2003.

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Harl on Self-Employment Tax Liability for Conservation Reserve Program Land

2008 Emerging Issues 2532

Harl on Self-Employment Tax Liability for Conservation Reserve Program Land

By Neil E. Harl

July 16, 2008

SUMMARY: When tax historians write about the first decade of the Twentieth Century, no tax issue will rank higher on the list of what should never have happened than the issue of whether all payments to those participating in the Conservation Reserve Program (CRP) must be subject to self-employment tax.

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ARTICLE: When tax historians write about the first decade of the Twentieth Century, no tax issue will rank higher on the list of what should never have happened than the issue of whether all payments to those participating in the Conservation Reserve Program (CRP) must be subject to self-employment tax. [*I.R.C. § 1402*. See generally 2 Harl, *Farm Income Tax Manual* § 8.05[1][d][ii] (2007 ed.); 5 Harl, *Agricultural Law* § ____ (2008); Harl, *Agricultural Law Manual* § ____ (2008), See also Harl, *IRS Notice on SE Tax for CRP Payments*, 18 *Agric. L. Dig.* 1 (2007).] What was well-settled and accepted law for 15 years was thrown into virtual chaos by an ill-advised move by the Internal Revenue Service in 2003 that was well outside the realm of *enforcing* tax law and was clearly within the realm of *making* tax law. [See *CCA Ltr. Rul.* 200325002, May 29, 2003.] That unfortunate move was made even worse by the issuance of *Notice 2006-108 [2006-2 C.B. 1118]*, obsoleting *Rev. Rul. 1960-32, 1960-1 C.B. 23.*] which threatened the issuance of a proposed revenue ruling, obsoleted a key revenue ruling that had served as a precedential beacon for nearly a half century, misused judicial pronouncements of the United States Supreme Court and continued its attempt to redraw the line between what is investment activity and what is a trade or business.

Background of the Controversy

Nature of the CRP Program. The Conservation Reserve Program, enacted in 1985, [*Food Security Act of 1985, Pub. L. No. 99-198, 99 Stat. 1508 (1985).*] is a highly successful environmental program focusing on conserving soil and water resources on vulnerable land, with the first land bid into the program in the spring of 1986. Under the program, the Secretary of Agriculture is authorized to enter into long-term contracts (typically 10-years) with owners and tenants of highly erodible cropland to conserve soil and reduce runoff by implementing a conservation plan approved by the local conservation district.

Typically, the land is seeded down with the landowner agreeing to establish and maintain a suitable vegetative cover for the land to prevent runoff and reduce erosion.

The program was enacted with no specific guidance from the Congress as to how payments should be taxed for income tax or self-employment tax purposes.

Authority Before 2003. Over the years, it has been clearly established that most government payments are includible in gross income and various cases and rulings have established that the payments are subject to self-employment tax *if the arrangement constitutes a trade or business* [I.R.C. § 1402(a).] with some authorities mentioning material participation. [Rev. Rul. 60-32, 1960-1 C.B. 23.]

In Rev. Rul. 60-32, [1960-1 C.B. 23.] payments under the soil bank program were held to be includible in net earnings from self-employment if the landowner was materially participating as operator or as a materially participating landlord. After enactment of the CRP program, the Associate Chief Counsel, Technical, of the Internal Revenue Service, stated that where the farm operator or owner was materially participating in the operation of the farm, CRP payments constitute receipts from farm operations and were to be included in net earnings from self-employment. [Taxpayer letter from Peter K. Scott, Associate Chief Counsel, Technical, March 10, 1987.] The Commissioner of Social Security indicated agreement with that position. [Letter dated April 27, 1987 to the Administrator of the Agricultural Stabilization and Conservation Service, United States Department of Agriculture.]

In a 1988 private letter ruling, [Ltr. Rul. 8822064, March 7, 1988.] the IRS position was that, for a retired landowner who was not materially participating, payments received under the CRP would not be considered net income from self-employment. In the facts of that ruling, there was no tenant involved. IRS and the Social Security Administration had initially seemed to be taking the position that someone must be materially participating but the 1988 letter ruling ignored that point and, by implication, quashed the argument.

The Tax Court, in 1996, [Ray v. Commr, T.C. Memo. 1996-436.] held that, if land which had been bid into CRP had a direct nexus with an ongoing farm operation in which the taxpayer was actively involved, the CRP payments were properly subject to self-employment tax. That approach also meant that a mere investor, who was not materially participating in the operation and who was not running a farm operation with a direct nexus or connection to the CRP land, would not have self-employment tax liability. [See Ltr. Rul. 9637004, May 1, 1996 (husband and wife as directors and officers of family ranch corporation materially participating in overall operation).]

In 1998, the Tax Court [Wuebker v. Commr, 110 T.C. 431 (1998).] held that CRP payments were rental payments, citing to Congressional language to that effect, and were not subject to self-employment tax. However, that case was reversed by the Sixth Circuit Court of Appeal in 2000. [Commr v. Wuebker, 205 F.3d 897 (6th Cir. 2000).]

The IRS Attempt in 2003 to Make New Law

In a Chief Counsels letter ruling dated May 29, 2003, [CCA Ltr. Rul. 200325002, May 29, 2003.] IRS took the position, directly contrary to the 1988 letter ruling, [Ltr. Rul. 8822064, March 7, 1988.] that a landowners activities under a CRP contract, however minor those activities might be, amount to a trade or business and the payments must be reported on Schedule F, not Schedule E or Form 4835. That is the Chief Counsels position for retired landowners, those who are disabled and those who are mere investors, along with those conducting a farming business that bears a direct connection with the CRP land.

Reaction to the 2003 Chief Counsels Ruling

Attempts to get the attention of IRS. The response to the 2003 Chief Counsels ruling [CCA Ltr. Rul. 200325002,

May 29, 2003.] was uniformly negative, as expected. Rep. Earl Pomeroy of North Dakota organized a session on March 26, 2004, in Bismarck, North Dakota but IRS staffers in attendance were unwilling to talk freely. Another session organized by Rep. Pomeroy in Washington, D.C. on June 8, 2004, involved Mark Everson, then Commissioner of the Internal Revenue Service and four Service staff. At the end of that meeting, Commissioner Everson agreed that IRS should and would try to harmonize the conflicting rulings and other authorities. Sixteen months later, IRS admitted that they had lost the file including a stack of items provided after the June 8, 2004 session in Washington (which was promptly replaced).

Notice 2006-108. On December 5, 2006, the Internal Revenue Service issued *Notice 2006-108 [2006-2 C.B. 1118, obsoleting Rev. Rul. 1960-32, 1960-1 C.B. 23.]* stating that merely participating in the CRP is a trade or business and self-employment tax was due. Thus, all CRP participants including those who were retired, disabled or were mere investors would have the 15.3 percent self-employment to pay on CRP payments. The position of IRS was little changed from the 2003 Chief Counsels Advice. [CCA Ltr. Rul. 200325002, May 29, 2003.] Comments were invited through March 19, 2007 on *Notice 2006-108* and on the proposed revenue ruling. [Id.]

The key issue, as *Notice 2006-108* maintains, is whether and under what circumstances . . . participation in a CRP contract is a trade or business. There is no authority in existence at any level (other than *Announcement 83-43 [I.R.B. 1983-10, 28.]*) which was thoroughly discredited as wrong when it was issued in 1983 in connection with the Payment-in Kind federal farm program of that year and stands no higher today) that retired, disabled or mere investors are liable for self-employment tax on payments from a federal farm program. The IRS position would reduce the language in the statute [I.R.C. § 1402(a).] that liability for self-employment tax requires a . . . trade or business carried on by such individual. . . . to a meaningless passage. The passage trade or business would include all activities or ventures entered into as a business as well as investment activities and arrangements involving retired or disabled taxpayers *regardless of the level of involvement in the activity.*

Meaning of Trade or Business. The regulations issued under Section 1402 [*Treas. Reg. § 1.1402(c)-1.*] state that, for the purpose of the tax on self-employment income, the term trade or business has the same meaning as the term trade or business has acquired for purposes of deductibility of trade or business expenses. [I.R.C. § 162.] *Notice 2006-108 [2006-2 C.B. 1118.]* singles out one of the many cases litigated under that provision, *Commissioner v. Groetzinger*, [480 U.S. 23 (1987).] in support of the IRS position that merely signing up for CRP constitutes a trade or business. The Supreme Court, in that case, stated the resolution of this issue (meaning of trade or business) requires an examination of the facts of each case. The Court went on to point out that the difficulty rests in the Codes wide utilization in various contexts of the term trade or business, in the absence of an all-purpose definition by statute or regulation, and in our concern that an attempt judicially to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Code. We leave repair or revision, if any be needed, which we doubt, to the Congress where we feel, at this late date, the ultimate responsibility rests.

It is helpful to note the facts in *Groetzinger*. Groetzinger was a gambler who devoted 60 to 80 hours weekly to pari-mutuel wagering on dog races with an objective of earning a living from the gambling activity. The taxpayer was at the track six days per week for 48 weeks in the year in question. His betting was more than a standard full-time job. The taxpayer had no other employment and gambled solely for his own account. The Tax Court, the Seventh Circuit Court of Appeals and the United States Supreme Court all held that Groetzinger was in the trade or business of gambling.

The language relied upon by IRS in the drafting of *Notice 2006-108 [2006-2 C.B. 1118.]* and the proposed revenue ruling), that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayers primary purpose for engaging in the activity must be for income or profit, is dicta and does not reflect the holding in the case. The drafter conveniently overlooked the language at the beginning of that paragraph of the Courts opinion in which the Court stated , of course, not every income-producing and profit-making endeavor constitutes a trade or business. The Court followed that sentence by stating , the income tax law, almost from the beginning, has distinguished between a trade or business, on the one hand, and transactions entered into for profit

but not connected with . . . business or trade. .Thats what is missing from *Notice 2006-108 [2006-2 C.B. 1118.]* any recognition that a transaction entered into for profit could fall short indeed fall *far* short--of being a trade or business.

Informally, this commentator has learned that all 32 of the comments received on *Notice 2006-108 [2006-2 C.B. 1118.]* were opposed to the IRS position on the matter. In February of 2007, The IRS Commissioner, in a letter to senators supporting a statutory amendment to treat CRP payments as rent or to exclude some categories of CRP payments from self-employment tax, stated that the IRS would not change its position unless Congress mandated a different interpretation. That pronouncement was made well before the end of the comment period which ended March 19, 2007.

Proposed Legislation

Legislation has been introduced since 2000, when the concern was over the case of *Commissioner v. Wuebker*, [205 F.3d 897 (6th Cir. 2000).] to treat CRP payments as rent for self-employment tax purposes. [S. 2422, S.2344. H.R. 4212, 106th Cong., 2d Sess. (2000); S. 315, 107th Cong., 1st Sess. (2001); S. 665, S. 1316, 108th Cong., 1st Sess. (2003); H.R. 5169, 108th Cong., 2d Sess. (2004); S. 1155, 110th Cong., 1st Sess. (2007).] In late 2007, a group of farm tax provisions that had been in another tax bill but were stripped out were added to H.R. 2419, the 2008 farm bill. Section 12202 would eliminate the self-employment tax on CRP payments for those receiving social security payments, effective after 2007. That legislation has not passed.

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Zanglein on ERISA Conflict of Interest Cases

2008 Emerging Issues 2504

Jayne Zanglein on *MetLife v. Glenn*: Supreme Court Confirms a Combination of Factors Approach in ERISA Conflict of Interest Cases

By Jayne Zanglein

July 7, 2008

SUMMARY: When a benefit plan gives discretion to the plan administrator or fiduciary to consider a grant of benefits that it will pay, the administrator is therefore operating under a conflict of interest. That conflict of interest must be weighed as a factor as part of a case-by-case approach in determining whether there is an administrative abuse of discretion.

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ARTICLE: Introduction n1

The Supreme Court recently issued its opinion in *Metropolitan Life Ins. Co. v. Glenn*, 128 S. Ct. 1117 (2008), in which the plaintiff asked the Court to decide the appropriate standard of review in an ERISA benefits denial case where the plan administrator has a conflict of interest. The Court issued a 7-2 decision, with Justice Breyer writing for the majority, Justices Scalia and Thomas dissenting, Justice Roberts partially concurring, and Justice Kennedy concurring in part and dissenting in part. The majority held that a conflict of interest is one factor to be weighed in deciding whether an insurer or employer has abused its discretion. In essence, the Court adopted a combinations of factors approach in conflict of interest cases.

Facts

Wanda Glenn was working as a sales manager at Sears, Roebuck, when she was diagnosed with cardiac and stress-related problems. Her job entailed working 40-50 hours per week, training and supervising 20-30 sales associates, standing, climbing, reaching, stooping, and lifting. *Glenn v. MetLife*, 461 F.3d at 662 (6th Cir. 2006).

In 2000, Glenn experienced prolonged chest tightness, shortness of breath, increasing fatigue by the end of the day, and edema in her legs from prolonged standing at work. *Id.* In April 2000, her physician determined that she could no longer work any job that involved physical or psychological stress. Glenn filed a claim for disability benefits with

MetLife.

The Sears disability plan defined total disability differently depending on whether the participant was filing an initial claim for disability benefits or whether the participant had already received benefits for 24 months. The plan provided that a participant is totally disabled during the first 24 months if she is completely and continuously unable to perform each of the material duties of her regular job. *Id.* After the first 24 months, she is disabled if she is completely and continuously unable to perform the duties of any gainful work or service for which she is reasonably qualified taking into consideration her training, education, experience, and past earning. *Id.* In June 2000, MetLife approved Glenns initial claim for long-term disability benefits.

In August 2000, Glenn filed for Social Security disability benefits at the request of the plan administrator, who directed her to Kennedy & Associates, a law firm specializing in obtaining such benefits. *Id.* The Social Security Administration initially denied Glenns claim but later held that Glenn was disabled as of April 30, 2000. Because the Sears plan required an offset of Social Security benefits, MetLife demanded and received reimbursement of \$13,502.50 from Glenn.

Glenns physical condition improved and in March 2002 her doctor filled out a MetLife long-term benefits evaluation form where he indicated that she was able to work in a sedentary physical exertion level occupation. *Id.* at 664. The purpose of the form was to assess capacity for full time work. Glenns treating physician signed the form on June 12, 2002, without indicating whether he was releasing Glenn to return to work or what restrictions might apply to her going back to work. Six days later, Glenn visited her doctor with additional complaints and the doctor concluded: I do not believe she will handle any kind of stress well at her work and she would better off being on disability rather than returning to her job. Dr. Patel reiterated this in a letter dated July 22, 2002. *Id.* at 664.

In August 2002, MetLife reviewed the March 2002 MetLife form, and informed Glenn that her long-term benefits would be terminated in September because there is no supportive medical documentation for her disability. *Id.* MetLife did not mention the treating physicians July 22, 2002 letter that specifically stated that Glenn was not able to return to work. *Id.*

In May 2003, MetLife informed Glenn that if she wished to continue receiving long-term disability benefits, she must meet the second definition for total disability: she must be incapable of performing the material duties of any gainful occupation defined by the plan. *Id.* at 663. MetLife stated that in making a decision as to whether Glenn was disabled, it would review Glenns vocational information, medical information and [Glenns] specific restrictions and limitations that are supported by objective medical evidence. *Id.*

Glenn appealed the denial of disability benefits and her treating physician supported her claim by restating, in writing, his conclusion that Glenn should not work because she is completely disabled. *Id.* at 665.

MetLife referred the case to an Independent Physicians Consultant Board. The independent doctor stated that Glenn was unable to do any exertional physical activity but should try a sedentary job on a trial basis. *Id.* MetLife issued a final denial of disability benefits.

Glenn filed suit under ERISA Section 502(a)(1)(B). The district court ruled in favor of MetLife. Glenn appealed.

Sixth Circuit Opinion

The Sixth Circuit reviewed, for abuse of discretion, the administrators determination that Glenn was not disabled. *Id.* at 666. The court found that MetLife suffered from a conflict of interest because it had the authority to decide eligibility for benefits and, at the same time, it had the responsibility to pay those benefits. *Id.* The court concluded that [t]his dual function creates an apparent conflict of interest. *Id.* However, the court found that the district court did not give weight to this conflict of interest in reaching its decision. The court remanded the case to the district court to consider the effect of the conflict.

In addition, the Sixth Circuit held that the district court did not take into account that MetLife had told Glenn to apply for Social Security benefits, and then denied her benefit under the plan despite the fact that Social Security found her to be disabled. The court held that MetLifes inconsistent positions raised a red flag: MetLife reaped the benefit from Glenns Social Security award (by offsetting this amount against her plan benefits) and then terminated her long-term disability benefits under the plan (disregarding the Social Security award). The court held that the district court should have regarded this inconsistency as a significant factor when deciding whether to uphold the administrators decision. *Id.* at 669.

The court was perplexed by MetLifes failure to give any weight to the treating physicians letters in which he repeatedly stated the seriousness of Glenns condition and the fact that she was not capable of returning to work, sedentary or otherwise. *Id.* at 670 671. In addition, the court criticized the administrator for crediting the portion of the treating physicians report that was favorable to MetLife while disregarding the portion that favored Glenn. The court found that the omission of this critical information could support Glenns claim that MetLifes decision was arbitrary and capricious. *Id.* at 672.

The Sixth Circuit noted that in deciding whether a plan administrators decision is arbitrary and capricious, a reviewing court must review of the quality and quantity of the medical evidence and the opinions on both sides of the issues. Otherwise, courts would be rendered to nothing more than rubber stamps for any plan administrators decision as long as the plan was able to find a single piece of evidence--no matter how obscure or untrustworthy--to support a denial of a claim for ERISA benefits. *Id.* at 674 (quoting *McDonald v. Western-Southern Life Ins. Co.*, 347 F.3d at 172 (6th Cir. 2003)). The court held that MetLifes decision to deny long-term benefits to Glenn was arbitrary and capricious. *Id.* The Sixth Circuit reversed and remanded the case to the district court to reinstate Glenns long-term disability benefits.

On remand, the district court reinstated Glenns benefits. *Glenn v. Metlife*, 2007 U.S. Dist. LEXIS 1421 (S.D. Ohio, Jan. 8, 2007). In the meantime, the plaintiff filed a petition for certiorari.

Writ of Certiorari. The U.S. Supreme Court granted certiorari on the following issue:

If an administrator that both determines and pays claims under an ERISA plan is deemed to be operating under a conflict of interest, how should that conflict be taken into account on judicial review of a discretionary benefit determination?

Oral Argument. The Supreme Court held oral arguments on April 23, 2008. *Metropolitan Life Ins. Co. v. Glenn*, 2008 U.S. LEXIS 5030 (Apr. 23, 2008).

Within a minute after MetLifes counsel began oral argument, the Court was engaged in a lively discussion on how to define a conflicted fiduciary. Justice Scalia defined a conflicted fiduciary as someone who has two loyalties, whether or not he allows the one loyalty to distort his judgment. *Id.* Justice Ginsburg asked MetLifes counsel why the Court should not view with suspicion the fact that MetLife demanded that Glenn file for Social Security disability benefits, and when she did, MetLife reduced Glenns benefits by the amount of the Social Security benefits and denied her disability benefits. *Id.* Justice Scalia asked MetLifes counsel whether a perfectly reasonable decision becomes unreasonable simply because you have a conflict. *Id.* He answered his own question stating, it seems to me that that ought to be looked at with suspicion, whether or not the person making the decision has a conflict. [In *Firestone*, we] said that a conflict of interest should be weighed as a factor. If that means anything, it seems to me it means that sometimes that weight will make the difference. *Id.*

After Glenns attorney presented his argument, Justice Souter summarized three hypotheticals for the Court to

consider:

In scenario number one, the evidence is that the person making the benefits decision says let's let this person suffer so that we can keep the money. That is the easy case

In case number two, there is a decision within the zone of reasonableness, but instead of being in the center of the zone of reasonableness, it's close to the edge. A decisionmaker could look at that decision and say if there is no reason to be suspicious about it, it's still within the zone of reasonableness, and I don't think there is a conflict. But if the decisionmaker knows that there is this kind of structural conflict, the decisionmaker can say look, I wasn't born yesterday; the reason it's so close to the edge is that they were giving way to their own self-interest in the conflict, and I'm going to decide for the beneficiary and against the company.

Case number three is the case of the person right on the fence. The decisionmaker says, I've looked at everything there is to look at and I cannot decide for sure what this is, whether it was a legitimate decision or a conflicted one in the--in the decisionmaker's favor, unless I take into consideration the fact that there is this structural conflict.

Now, in case number two, it's close but the fact of the conflict is regarded as, itself, as substantive evidence and it results in a decision for the beneficiary.

In case number three, the evidence is in equipoise, and to get off equipoise, the conflict rule is taken as the tiebreaker.

Thus, in the event of structural conflict where the decision is close to the edge of reasonableness, the court should regard the conflict as substantive evidence. Where, however, the decisionmaker is on the fence, the conflict is the tie breaker.

Justice Kennedy asked whether the standard of review should be greater if the insurer does not have firewalls between the profit side and the claims processing side. *Id.* He asked whether the rule should be different for insurers than for self-funded plans.

Ending on a light note, Justice Scalia criticized the United States amicus argument, stating that You're arguing for a second standard of review that is so vague I don't know what it means. Why not just say that the district court, when there is a conflict of this sort, has to spend two more hours considering the case? *Id.*

Majority Opinion Adopting a Combination of Factors Approach. On June 19, 2008, the Supreme Court issued its decision. Justice Breyer delivered the majority opinion, holding that where the entity that administers the plan, such as an employer or an insurance company, both determines whether an employee is eligible for benefits and pays benefits out of its own pocket, [that] dual role creates a conflict of interest; that a reviewing court should consider that conflict as a factor in determining whether the plan administrator has abused its discretion in denying benefits; and that the significance of the factor will depend upon the circumstances of the particular case. *Metropolitan Life Insurance Company v. Glenn*, 2008 U.S. LEXIS 5030, at *6 (2008).

The majority focused on the fact that where an employer funds a plan and determines eligibility for benefits, every dollar provided in benefits is a dollar spent by . . . the employer; and every dollar saved . . . is a dollar in [the employer's] pocket. The employer's fiduciary interest may counsel in favor of granting a borderline claim while its immediate financial interest counsels to the contrary. (quoting *Bruch v. Firestone Tire & Rubber Co.*, 828 F.2d at 144 (3d Cir. 1987)). Thus, a reviewing court must factor into its decision this conflict of interest.

The Court rejected MetLife's argument that the settlor's approval of the conflict supports a less stringent standard of review. The Court stated that the employer's endorsement of the conflict does not change the legal need for a judge later

to take account of that conflict in reviewing the trustees discretionary decisionmaking. *Id.* at *14.

The majority acknowledged that [t]he answer to the conflict question is less clear where (as here) the plan administrator is not the employer itself but rather a professional insurance company. However, ERISA imposes higher-than-marketplace quality standards on insurers.

Turning to the question of how the conflict should be factored into the decisionmaking process, the majority rejected the argument that it converts *Firestones* standard from deferential to de novo where the plan confers the administrator with discretion. The Court voiced concern with a potential reversal of *Firestone* that would impose near universal de novo review over the lions share of ERISA plan claims denials. Nor was the majority willing to adopt a one-size-fits-all approach: Benefits decisions arise in too many contexts, concern too many circumstances, and can relate in too many different ways to conflicts which themselves vary in kind and in degree of seriousness--for us to come up with a one-size-fits-all procedural system that is likely to promote fair and accurate review. Indeed, special procedural rules would create further complexity, adding time and expense to a process that may already be too costly for many of those who seek redress.

Instead, the Court held that *Firestone* dictates that when judges review the lawfulness of benefit denials, they will often take account of several different considerations, of which a conflict of interest is one. Under this combination of factors approach, any one factor has the potential to be a tie breaker. A factor is accorded greater importance where circumstances suggest a higher likelihood that it affected the benefits decision, including, but not limited to, cases where an insurance company administrator has a history of biased claims administration. It should prove less important (perhaps to the vanishing point) where the administrator has taken active steps to reduce potential bias and to promote accuracy, for example, by walling off claims administrators from those interested in firm finances, or by imposing management checks that penalize inaccurate decisionmaking irrespective of whom the inaccuracy benefits. The majority held that the Sixth Circuit properly weighed factors that indicated that MetLife was conflicted, such as encouraging Glenn to apply for Social Security benefits and then ignoring the agency's decision.

The Scalia-Thomas Dissent: Just Follow the *Restatement*. Justices Scalia and Thomas dissented, pointing out that the majority's opinion was too broad, in that it held that not only an insurer who decides claims, but an employer who administers the plan, has a conflict of interest. The dissent says: I would not resolve this question until it has been presented and argued, and the Courts unnecessary and uninvited resolution must be regarded as dictum. The dissent objected to the majority's totality of the circumstances test because it makes each case unique, and hence the outcome of each case unpredictable. Instead, the dissent would adopt the test used in trust law: Under that law, a fiduciary with a conflict does not abuse its discretion unless the conflict actually and improperly motivates the decision.

Justice Scalia criticizes the majority opinion, which reveals the Justices fondness for a judge-liberating totality-of-the-circumstances test. He notes that the majority opinion is painfully opaque, despite its promise of elucidation. Further, Justice Scalia observes that In the final analysis, the Court seems to advance a gestalt reasonableness standard (a combination-of-factors method of review, the opinion calls it, by which a reviewing court, mindful of being deferential, should nonetheless consider all the circumstances, weigh them as it thinks best, then divine whether a fiduciary's discretionary decision should be overturned. Notwithstanding the Courts assurances to the contrary, that is nothing but de novo review in sheeps clothing.

Justice Scalia would have followed the letter of the *Restatement (Second) of Trusts*, which lists four categories of abuse of discretion and then lists the factors relevant to each. The third category--improper motive--is the only category in which a conflict is listed as a relevant factor. According to the dissent, a trustees conflict of interest is relevant (and only relevant) for determining whether he abused his discretion by acting with an improper motive. It does not itself prove that he did so, but it is the predicate for an inquiry into motive, and can be part of the circumstantial evidence establishing wrongful motive. Justice Scalia observes that contrary to the majority's opinion, the *Restatement* does not suggest that [the factors] should all be chunked into a brown paper bag and shaken up to determine the answer. Instead, under the *Restatement*, each factor alone can be determinative, without the necessity of weighing other factors.

Significance. Although the Justices spent much time in oral argument trying to develop a two-step rule that could be universally applied, the Justices abandoned this effort and simply adopted the dictum of *Firestone*, in which the Court previously stated: [o]f course, if a benefit plan gives discretion to an administrator or fiduciary who is operating under a conflict of interest, that conflict must be weighed as a facto[r] in determining whether there is an abuse of discretion. *Firestone*, 489 U.S. at 115 (quoting *Restatement (Second) of Trusts* § 187, Comment d). The Court gave no new guidance on how to weigh that factor except to say that a conflict is given less weight (or perhaps no weight at all) if the administrator has implemented firewalls or imposed management checks that penalize inaccurate claims decisionmaking. As a result, the Courts of Appeals will continue to take different approaches in weighing conflicts as a factor in abuse of discretion cases.

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n1 The author wishes to thank Nathaniel Woollens for his contributions to this article.

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Dialani on Taxation of Income From the Sale of IP by a Foreign Company in India

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Jyoti Dialani on Taxation of Income From the Sale of Intellectual Property by a Foreign Company in India

By Jyoti Dialani

July 7, 2008

SUMMARY: According to a recent ruling by the Authority for Advanced Rulings, a transaction between two foreign entities which has an impact on Indian business by reason of a presence of capital assets in India will give rise to tax liability under Indian tax law on the gains from such a transaction to such foreign entity.

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ARTICLE: Tax Department casts microscopic eye on cross-border deals impacting Indian markets

An Australian beer company with a global presence has recently been adversely hit by a ruling pronounced by the Authority for Advanced Rulings n1 (AAR) in India dated May 9, 2008. On a query raised by the beer company in an application, the AAR has ruled that the Australian company will have to pay tax on its income from the transfer of its brand and trademarks in India to a UK-based company. This ruling has come on the application filed by the Australian company on an issue concerning taxability in India of the receipt arising to it from the transfer of its right, title and interest in and to the Trademarks, its Brand Intellectual Property (Brand IP) and grant of exclusive perpetual license of Brewing Intellectual Property (Brewing IP) to a UK-based company. Interestingly, Fosters Australia has been held liable to tax in India in a transaction which is between two foreign companies, involving assignment of certain rights and assets under the main Sale and Purchase Agreement to an Indian company, nominated as transferee by the Purchaser UK-based company.

This ruling will surely strengthen the long growing stance of the Income-tax department in India, who seems to be paving its way for some time now to target cross-border transactions involving acquisitions of Indian companies or impacting Indian markets. The Income-tax Department has lately been keeping a watchful eye on all offshore transactions seeking to bring them under the tax net as it holds a view that transactions between two offshore entities can be taxed, as long as the business pertains to the Indian market. This is also evident from the trend being followed and the actions of the department taken by way of sending show cause notices initiating process of inquiry and also raising tax demand notices in transactions with stakes of billions of dollars in India between certain telecommunications companies. As a result of the current momentum visible in the department with respect to assessing probabilities of tax liabilities of such foreign companies in India, certain companies wait with bated breath. For decisions which are

pending before the judicial authorities, in the event a view is taken against them, they could well end up paying billions of dollars by way of tax to the Indian Government.

The ensuing commentary will travel through the facts of the present case. Apart from the ruling which will be examined in detail, the commentary will also delve into certain developments in the cases of some other similar offshore transactions which have come under the tax scanner and may face a tax demand of billions of dollars. These actions taken by the Income-tax department have created an unstable climate in the country and affected the overall confidence of foreign companies planning on cross-border acquisitions of companies in India or having a business impact in India. This in turn could lead to serious implications on such transactions affecting India.

AAR Ruling: Facts of the case

The AAR's ruling, n2 which has stirred up controversy and provided an impetus to the Income-tax department in its attempt to widen its tax net to include most cross-border deals having any connections with India, is in response to an application filed by the Australian beer products company called Fosters Australia Limited (Fosters Australia), a 100% subsidiary of Fosters Group, Australia. The ruling is on an issue surrounding tax liability of the Australian company on the sale of its Indian arm, Fosters India Limited, to a UK-based company called SAB Miller. Fosters Australia owns various brands including Fosters brand in relation to beer products which comprises trademarks, logos, devices, brand guidelines, advertising material, technology and know-how including recipes and brewing specifications.

The company grants licenses in respect of Fosters brand to parties in various countries including India. These licenses authorize the licensees to sell, market and distribute and sometimes brew, process and package Fosters beer within a particular territory. Fosters Australia also holds certificates of registration of trademarks pertaining to Fosters brand and it has been continuously using the Fosters brand since its registration. In India, Fosters Australia had registered the Fosters trademark and F logo in 1993. Fosters Australia had entered into a Brand License (BL) Agreement with Fosters India Limited (Fosters India) in October 1997 where it had granted to Fosters India an exclusive license to brew, package, label, and sell Fosters Lager (beer) and an exclusive right of user of the trademarks within the territory of India. Fosters India was also authorized to use the Mark (Fosters) as part of its corporate name. In accordance with the agreement, Fosters India utilized the rights for a consideration, which was offered for tax as royalty income in India by Fosters Australia.

Dismin Investment Pty Ltd. (Dismin), a company belonging to Fosters Group, was the registered owner of the sale shares comprising 100% issued share capital of FBG Holdings India Limited, a Mauritius company, which is a subsidiary of Dismin. The said Mauritius company held majority shares in Fosters India and the remaining shares were held by its related company, Austindia Private Ltd.

On August 4, 2006, Australia entered into a contract for the transfer of shares and other intangible assets in the nature of intellectual property to SAB Miller, UK under an agreement called India Sale and Purchase Agreement (S&P Agreement) for a consolidated consideration of \$120 million.

Subsequent to the S&P Agreement, the BL Agreement between Fosters Australia and Fosters India was terminated in accordance with a specific clause in the S&P Agreement read with the BL Agreement which resulted in the vesting back to Fosters Australia of the exclusive rights over Trademarks, Brand IP and Brewing IP. There was a debate during the proceedings regarding the date of termination of the BL Agreement as to whether it was the date of the S&P Agreement or after the Deed of Assignment discussed below.

As a part of the transaction and a sequel to it, a Deed of Assignment was executed on September 9, 2006, between Fosters Australia, and SKOL Breweries Ltd. (SKOL), an Indian company nominated by SAB Miller as transferee under the main S&P agreement. This transfer by Fosters Australia of its shares, right, title and interest in and to the trademarks and Foster's brand intellectual property was at a nominal consideration of \$100 million and no further royalty or fee

was payable. This deed was executed in Melbourne, Australia. By this deed, Fosters Australia had assigned and conveyed all its right, title and interest in the trademarks, all intellectual property rights relating to the Fosters brand in India in favor of the assignee free from all encumbrances, and also granted to SKOL an exclusive, perpetual and irrevocable license relating to Fosters Brewing IP for the purpose of brewing, packaging and marketing of Fosters beer within the territory of India along with a right to sub-license such right to any licensees of Fosters brand.

Queries raised in the application before the AAR

Fosters Australia, the applicant in the current case, had framed the following two questions before the AAR:

i) Whether the receipt arising to Fosters Australia, under the Brand License Agreement and the Deed of Assignment, from the transfer of its right, title and interest in and to the Trademark and Brand IP and grant of exclusive perpetual license of Brewing IP is taxable in India under the provisions of the Income-Tax Act, 1961 (the Act) and the Double Taxation Avoidance Agreement between India and Australia (the DTAA).

ii) In the event of the receipt being held as taxable in India, whether Fosters Australia is justified in contending that tax should be computed based on the consideration as per an independent valuation obtained by it.

Although the aforesaid case pertains to an Australian company having transferred its rights to a UK company with further assignment of those rights to an Indian company impacting Indian business markets and the relevant provisions are the India-Australia DTAA, the analogy drawn in the ruling will also apply to a company situated in any other country entering into a similar transaction affecting Indian territory.

Contentions raised by Fosters Australia

Fosters Australia pointed out to the AAR that prior to the crucial S&P agreement of August 4, 2006, it had entered into the BL Agreement in October 1997 with Fosters India granting brewing license to the latter and also granting an exclusive right of user in the territory of India of its trademarks. It highlighted the fact that it has been paying taxes under the Indian Income-tax Act for the royalty amounts received under the said agreement from Fosters India. Further, it was submitted that the BL agreement was terminated in accordance with the S&P Agreement of September 2006. Consequently, the exclusive rights over Trademarks, Brand IP and Brewing IP vested back with Fosters Australia situated in Melbourne.

A controversial question arising out of a brief layout of the facts chronicled is whether the Trademarks and Fosters Brand and Brewing IP rights owned by Fosters Australia and conveyed/assigned to the Indian company, SKOL, can be said to be capital assets situated in India and the consideration received in connection therewith is liable to be treated as income that accrues or arises in India. Fosters Australia strongly contended that the transfer of trademarks and other intellectual property rights amounted to a transfer of capital assets and since the situs of such assets were located outside India, the consideration arising from such a transaction should not be subjected to tax in India.

It was further submitted that items of intellectual property covered by the S&P Agreement have no location in India and the situs in the case of such intangible assets would be the place of fiscal residence of the owner. The Supreme Courts decision in *20th Century Finance Corporation Ltd. v. State of Maharashtra*,ⁿ³ which was heavily relied on, held that the place where the contract is executed and put into effect is the situs of an intangible in the nature of goods. It was argued that intangible assets have no specific geographical location and no situs apart from the domicile of the owner. Relying on the AARs decision in *In re Pfizer Corporation, Virginia*ⁿ⁴ Fosters Australia submitted that the rights and interests in the Trademarks, Brand IP and Brewing IP conferred on Fosters India ceased and got restored and vested with it in Australia when it became the sole repository of all those assets as a consequence of the termination of

the BL Agreement of October 10, 1997. Therefore, the transferred assets could not be held to be located in India when they got divested from the Indian business and vested with Fosters Australia in Australia prior to the crucial Agreement dated April 8, 2006, taking effect. Therefore, situs of the assets on the date of the S&P Agreement was outside of India. Further, since both the assets and the place of execution of the contracts were outside India, the provisions of section 9(1) (i) of the Indian Income-tax Act were not attracted to the transaction in the present case.

Going a step further, Fosters Australia argued that trademark is a right which comes into existence not because of its registration but because of its usage and hence, it has an independent existence with registration merely providing further protection under the law. Based on this argument, it was contended that the registration of trademark has no impact on the aspect of situs or location.

Arguments advanced by the Revenue

On behalf of the Revenue, it was argued that Fosters Australia was liable to pay tax in India on the gains arising from the transfer as the income had arisen in India. The Revenue contended that the physical assets used by the Fosters group to produce the Fosters brand beer in India along with trademarks in relation to the business in India were sold under the main S&P agreement. Also, an exclusive and irrevocable license relating to Brewing IP rights was given to the transferee in the transaction. A vital fact which was emphasized was that, effectively, Fosters India was held by Fosters Group, Australia through the cobweb of its subsidiaries. Although the shares and Trademarks and Fosters Brand IP were shown to be sold by two different entities, it was submitted that effectively and in substance, Fosters Group, Australia had transferred the ownership of its Indian company (i.e., Fosters India) including its tangible as well as intangible assets.

The Revenue also argued that the termination of the earlier BL agreement was only after the sale of shares, trademarks, etc., under the said agreement and, accordingly, the exclusive rights over the Trademarks, Brand IP and Brewing IP could not be held to revert back to Fosters Australia before the transfer. Therefore, the Revenue demolished Fosters Australias main argument that the assets reverted back to Australia and hence the situs was no more India as on the date of the transfer.

The Revenue also distinguished the decision in *In re Pfizer Corporation, Virginia*, above, which was relied on by Fosters Australia. It was submitted that the Trademarks, being registered in India, was a strong indicator that the rights in the Trademarks existed in the territory of India. Therefore, it was submitted that such intangible capital assets, being Trademarks and Brand I.P, having been transferred by Fosters Australia and the sale of shares being integrally connected with it, the income accruing on the transfer of such assets was liable to capital gains tax in India as per the provisions of section 9(1) of the Act in the hands of Fosters India..

On the alternative query of Fosters India that only part of the consideration attributable to India is liable to be taxed, the Revenue submitted that since the entire business in India was transferred, the entire consideration was liable to be taxed in India only.

Crucial question

Based on rival submissions, the AAR narrowed down the controversy to a small question which was whether the income shall be deemed to accrue or arise in India within the meaning of section 9(1)(i) of the Income-tax Act, 1961 (the Act).

Section 9(1) of the Act

Section 9 (1) of the Act reads as follows:

9. (1) The following incomes shall be deemed to accrue or arise in India:

(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or from any asset or source of income in India or *through the transfer of capital asset situate in India*.

(ii)

Section 9(1) provides that the income specified in various sub-clauses thereof shall be deemed to accrue or arise in India. Therefore, the income arising from the transfer of capital assets situated in India is deemed to be taxable income under the provisions of the Act.

Highlights of the ruling

Analyzing the above provision, the AAR held that the deeming fiction has been introduced to bring within the net of taxation the income arising from a transfer of capital assets if they are situated in India with a view to avert any debate on the situs of the transfer. Therefore, the situation of capital assets in India assumes importance having regard to section 9(1)(i) of the Act. The AAR observed that if the transfer is of a capital asset situated in India, the charge to tax is attracted by virtue of section 9(1)(i) of the Act and that even if the actual process of transfer by way of execution of transfer documents had taken place outside India, it was not material to the case to determine the taxability or to obviate the tax liability of such a non-resident transferor company in India. Going further, the AAR also opined that no benefit can be claimed even under the DTAA by Fosters Australia in the case if the transfer is in respect of the capital assets situated in India.

Capital asset

The AAR then went on to examine the concept and meaning of capital asset within the context of the facts of the case and under the provisions of section 9(1) of the Act. The term capital asset has been defined under section 2(14) of the Act to mean property of any kind held by an assessee whether or not connected with his business or profession. The AAR observed that going by the definition provided in the Act, the term capital asset has been assigned a wide meaning. *Property of any kind*, therefore, can include intellectual property as it is a type of intangible property. Trademarks, brands, goodwill, and technical know-how relating to the manufacture of goods also qualify to be treated as capital assets within the meaning of the definition provided.

In support of its view, the AAR cited the decision in the case of *In re Pfizer Corporation, Virginia*, above, where it was held that the transfer of technology information in the form of dossier was a transfer of capital asset. The technology information which was transferred in the given case related to the manufacture of certain nutritional products. Section 55(2) of the Act, which deals with the cost of acquisition of capital assets, provides that goodwill, trademarks or brand names associated with a business and other incorporeal rights mentioned therein are treated as capital assets under the Act for the purpose of capital gains. Accordingly, the AAR ruled that the items falling broadly under the description of intellectual property, the subject matter of transfer under the S&P Agreement in the case, are to be treated as capital assets.

The AAR also clarified that there was no dispute in the case on whether the transaction constituted a transfer, which Section 2(47) of the Act defines as Transfer in relation to a capital asset includes sale, relinquishment of the asset and the extinguishment of any rights therein.

Situs of Assets

Crucial question on situs of assets transferred in the case

The AAR framed a pertinent question to be addressed to decide the case which was whether the capital assets transferred by and through the S&P Agreement read with the deed of assignment are situate in India -- an expression that is employed in section 9(1)(i) of the Act.

Findings of the AAR

The AAR made an observation that going by the explicit mandate of section 9(1) of the Act, income arising from the transfer of capital asset situated in India by a non-resident is deemed to be his income liable to be taxed in India.

On situs of assets

The AAR made an outright rejection of the contention raised by Fosters Australia that the capital assets were not located in India on the relevant date of transfer. The AAR also did not accept the theory put forward by Fosters Australia that the intangible assets transferred have no particular geographical location and that they have no situs apart from the domicile of the owner as there was no legal principle to support such a broad proposition. The other proposition that the place of execution of contract determines the situs was also held to be untenable. It was held that the intellectual property comprised of Fosters Trademarks and Brand IP can be said to be located in India where the business of Fosters India was being carried on in conjunction with Fosters Australia. The AAR also highlighted some important facts related to the case such as the fact that intellectual property was being put to use in India after the 1997 BL Agreement, the registration of Fosters F. logo in July 1993, the use of four trademarks including Fosters F. logo along with the Fosters brand by Fosters India by virtue of an exclusive license granted as per the said agreement. Another important fact which was pointed out by the AAR was the grant of an exclusive license to brew, package, label and sell Fosters lager beer in Indian territory.

Certain other characteristics of the contracts were that Fosters Australia had control over advertising, marketing and distribution, quality control, etc. Also, it was clear from the contracts that Fosters Australias (CUBs) approvals in respect of various matters concerning the brewing and packaging plants, labeling and packaging of containers, etc., were required. Besides, a restriction was imposed on the sale of other Australian Beer. The AAR then noted that all these steps were taken to ensure that the Fosters brand beer along with its trademarks and logos acquire a high reputation in the market and build considerable goodwill. Therefore, the trademarks registered in India together with the other features of Fosters brand had generated appreciable goodwill in the Indian market which was nurtured in India by the efforts of Fosters Australia and Fosters India till the date of the agreement entered into in 2006.

The AAR observed that Fosters Australias business presence in India manifested itself with the tie-up it had with Fosters India which made use of the intellectual property rights granted by it. The intangible assets comprising the Fosters trademarks and brand were in use for nearly a decade in India by the crucial date of transfer of the said capital

assets. Thus, the Trademark/Brand IP also had its location in India apart from the place of domicile of the owner. Such a brand presence did have an impact on the business being carried out in India by Fosters India under the exclusive license granted by Fosters Australia. The only consequence of the transfer was that the intangible property that was being used by Fosters India till the date of transfer would be used and enjoyed by SKOL Breweries from the date of the transfer. Therefore, the location of the intangible assets had never shifted. The argument of Fosters Australia that with the termination of BL Agreement, the Trademark and Brand IP got restored to and vested back with it in Australia was not accepted. The AAR held that the shifting of situs cannot be established by mere symbolic delivery of counter-parts of trademarks outside India in terms of the S&P Agreement. The predominant component of trademark and brand is goodwill associated with them which cannot be said to have perished in India and shifted its location back to Australia at the time of completion and assignment.

On situs with reference to registration of trademark

The AAR noted the Supreme Courts decision in the case of *CIT v. Finlay Mills Ltd.*,ⁿ⁵ which held that the registration of trademark does not create an asset and that registration merely confers statutory remedies for its effective protection. However, the AAR also observed that registration of Fosters Australias trademark in India was one of the relevant factors pointing to the roots it had taken and the recognition it had gained in India. The trademark of Foster entered India for the first time in 1993 by virtue of its registration and it gained its vigor under the aegis of the 1997 agreement. Further, Fosters trademarks and brand were being used by Fosters India for about a decade pursuant to the license granted to it in 1997. The AAR noted that by entering into the BL Agreement, Fosters Australia became a collaborator with Fosters India in its business and was receiving royalty from Fosters India for the license granted to the latter for making use of Fosters trademarks as well as the Brewing Manual, while retaining its proprietary rights over the goodwill. Therefore, over a period of time, the circulation of the beer bearing the imprint of Fosters trademark and brand and the goodwill generated in the Indian market established the presence of Fosters in Indian territory which was also in existence on the date of transfer. This commercial exploitation of the trademarks and brand aided by the marketing and advertising efforts of Fosters India resulted in the creation of a valuable intangible asset in India. As a natural consequence of the facts, the AAR inferred that the assets in the form of trademark, brand and goodwill were situated in India when the transfer took place in 2006. The mere ownership of the intellectual property assets, viz., trademarks, brand and goodwill by Fosters Australia had no bearing on the inference so drawn.

The AAR also commented on the absence of any legal principle that the situs of intangible assets always go with ownership and they have no situs other than the country of fiscal residence of the owner. The AAR then went on to cite decided cases of USA and UK courts which have supported the proposition that the intangible assets or incorporeal property can have more than one situs. The decisions have established a principle that goodwill is territorial in the sense that it exists at a place where the related business exists. Trademark and goodwill being intertwined, the same principle would apply to both.

On the theory of assets reverting back to Australian territory before S&P Agreement

Fosters Australia had advanced a theory of reverting back intellectual property assets to it prior to the two crucial agreements which was totally rejected by the AAR. The AAR pointed to a specific clause of the BL Agreement which provided for termination by written notice in the event of a transfer of controlling interest in Fosters India. Since Fosters Australia had not given any such written notice, it could not take a plea of operation of the said clause. The AAR also observed that from the chronology of events it was clear that the termination of the BL Agreement had taken place simultaneously with the effective transfer of share and intellectual property items, that is, in September 2006, which was the completion date of the S&P Agreement. There was no hiatus between the two. The termination and transfer were simultaneous. Therefore, the stand taken by Fosters Australia that the BL Agreement terminated sometime prior to the

S&P Agreement and the rights were extinguished prior to the completion date of the S&P Agreement was held to be baseless.

On the Applicability of Decisions Relied On By Fosters Australia

Decision in the case of *In re Pfizer Corporation, Virginia* (above)

On the *Pfizer* ruling relied upon by Fosters Australia, the AAR distinguished the case on the point that in that case, technical information in the form of dossier for the manufacture of certain food supplement products by the group company of Pfizer in India was transferred to another company, namely, EAC Denmark, and the transfer of dossier took place in Bangkok. Before the event of transfer took place, EAC Denmark and Pfizer, India entered into an agreement whereby the former paid a substantial amount as consideration for the early termination of the license granted to the Indian company to manufacture the product with the trademarks registered in India. The AAR observed that such an agreement to procure the early termination of the license for valuable consideration was absent in the case. Besides, it also noted that the termination of the BL Agreement by Fosters Australia was not antecedent to the S&P Agreement.

The AAR had dismissed the plea of prior termination of the BL Agreement dated September 12, 2006, after examining the merits. Also, the clause regarding termination by written notice was also not operational and could not be used as a plea by Fosters Australia. The AAR had held that the termination and transfer were simultaneous as there was no basis to hold that the BL Agreement terminated sometime prior to the S&P Agreement and the rights were extinguished prior to the completion date of the S&P Agreement. The theory of reverting back intellectual property assets to Fosters Australia prior to the said two agreements was rejected by the AAR. Therefore, the *Pfizer* case was not applicable to the case as the same was distinguishable on facts. Also, the *Pfizer* case involved the transfer of dossier containing the technical information regarding the manufacture of product (similar to the Brewing Manual in the present case) and the transfer of other intellectual property rights was not involved. Based on these distinguishing facts, the AAR held that the *Pfizer* case could not be applied to the case of Fosters Australia.

Decision in the case of *20th Century Finance Corporation Ltd. v. State of Maharashtra* (above)

The important observation of the Supreme Court relied upon by Fosters Australia is:

Where the party has entered into a formal contract and the goods are available for delivery, irrespective of the place where they are located, the situs of such would be where the property in goods passes, i.e. where the contract is entered into. (Para 25)

Fosters Australia had submitted that the above decision settles the issue as regards the situs and as per the law laid down in that case, the situs of intangible goods gets located at the place where the contract is executed. Accordingly, applying the facts of the case to its case, it submitted that since the contract was executed in Australia, the situs of the intangible assets did in fact get relocated to Australia. It was also submitted that the Trademarks, Brand IP and Brewing IP involved in its case were not merely intangible properties but also goods. Accordingly, both the goods and the place of contract in the case of Fosters Australia were outside India and not liable to be taxed under the Indian Income-tax Act. However, this plea was also struck down in disagreement by the AAR on the basis that the Supreme Court in that case had dealt with an entirely different issue. The question in that case was about the State in which the transfer of right to use the goods within the meaning of the relevant sales-tax law took place. The Supreme Court had expressed a view that situs would be where property in specific goods in deliverable state passes and that irrespective of the location of goods, the property passes at the place where the contract is executed. However, the concept of transfer of right to

use the goods or passing of property in goods was absent in the present case. The prime issue concerned the question of location of capital assets in the form of intellectual property. Accordingly, the AAR held that the *20th Century* case was inapplicable to the case of Fosters Australia and could not be relied on.

On Trademarks and Brand IP

The AAR held that the intellectual property in the form of Fosters trademarks and brand were an integral part of the business of Fosters India that was being carried on together with the goodwill they generated by reason of such user and hence, it can be said to be situated in India within the meaning of the explanation to section 9(1) of the Act.. It further emphasized a view that the situs of these intellectual property assets should not be traced and confined only to the place where the contract (India S&P Agreement) was entered into and acted upon by the parties. Since on the relevant date of transfer they were very much present in India, and the transfer of such assets took place concurrent with the transfer of controlling interest in Fosters India to SAB Miller, it could at best be inferred that their location in Australia is only notional or fictional. It also held that the mere fact that the trademarks and names originated and were initially registered in Australia was not material to establish their situs in Australia.

On transfer of Brewing IP

The AAR observed that the core of Brewing IP was the Brewing Manual which was the product of Fosters Australias research and development efforts. It contained the formula and technical aspects relating to the brewing and packaging of Fosters lager beer. The Brewing Manual, though a trade intangible, was also in the nature of goods. The AAR drew attention to a clause in the S&P Agreement which created an obligation on Fosters Australia to deliver to the purchaser all hard copies of Brewing Manual and other manuals within the possession of Fosters India. The operation of this clause would mean that Fosters Australia would be divested of its custody and use and the Brewing Manual was physically made available to the nominee of the purchaser on the completion date stipulated in the S&P Agreement. As Fosters Australia terminated its business ties with Fosters India as a sequel to the S&P agreement, the situs of Brewing IP in the form of Brewing Manual shifted to Fosters Australias corporate headquarters in Australia. Since the Brewing Manual was intellectual property with a physical identity it had been removed from the custody of Fosters India and handed over to the purchaser within Australia on the completion date of the S&P Agreement. Therefore, the capital asset in the form of Brewing Manual and the intellectual property rights associated with it was held to be not situated in India on the effective date of transfer as it reverted back to Fosters in Australia and the same was made over the purchasers nominee, SKOL Breweries, which acquired the controlling interest over Fosters India. Thus, income attributable to such intellectual property could not be taxed in India. In arriving at this conclusion, the AAR drew support from a Supreme Court decision in the case of *Associated Cement Companies Ltd. v. Commissioner of Customs*, n6 which held that the appellants had paid for technical advice on information technology, which was an intangible asset, but the moment the information or advice is put on a media, in the form of paper or diskettes or any other thing, it becomes chattel.

On the contention regarding apportionment

On the alternative submission of Fosters Australia in the event the consideration is held as taxable, that only that part of the income which is attributable to India should be liable to tax as the property is situated simultaneously in more than one jurisdiction, the AAR held that since the transfer of capital assets comprising of Trademarks and other Brand IP can be subjected to tax in India, the tax liability could only be in respect of the said two items. Therefore, it

observed that the assessing authority will have to quantify the consideration attributable to the two items. However, it also held a view that there was no legal basis for apportionment on the ground that the situs of the property transferred is fictionally at another place. When once the income is deemed to accrue or arise in India on account of a transfer of capital assets situated in India, the entirety of consideration received in respect of such transfer should be treated as gross income. This, the AAR observed, was irrespective of the fact that the property could be notionally treated to be existing also at the place where the owner resides.

On the plea of independent valuation

As regards the contention of Fosters Australia that tax should be computed based on the consideration as per the independent valuation obtained by it, the AAR took a view that an independent valuation report could certainly be relied upon by it but it was for the concerned Income-tax authority to examine it on the true and correct value and apply factors that have material bearing on quantification of the consideration pertaining to the taxable items.

Tax avoidance or tax evasion?

On the point raised by the Revenue that the various transactions including the sale of shares of FBG Holdings India should be regarded as a single integrated transaction, the AAR declined to comment on tax implications arising on the transaction. The AAR observed that due to the inadequacy of information and sufficient material on the subject, it could not arrive at a definitive conclusion. The question whether any subterfuge or colorable device was adopted in routing the deal through the media of various group companies was not commented upon as it involved getting into nuances of sale of shares which issue was not placed before the AAR.

What does this ruling entail?

Simply put, the income arising to Foster's Australia from the transfer of its right, title and interest in and to the trademarks and Foster's brand intellectual property is taxable in India. Although rulings of AAR are not considered binding precedents and are applicable to the case of the applicant in a specific case, they do have persuasive value over assessing and judicial authorities and hence, can influence the course to be taken by the Income-tax department in future assessments of foreign companies in similar transactions as well as pending litigations on similar legal issues. This in turn could have serious implications over the inflow of foreign investments into India as non-resident investors are keeping a close eye on developments in this region.

Ripples of the ruling to impact other players in Indian markets

This ruling of the AAR has further added strength to the Income-tax Departments case of taxing offshore deals involving foreign parties. The Income-tax Departments argument is that while the deal is between parties who are not residents of India, so long as it impacts Indian business markets, the deal is taxable and the parties involved are liable to pay tax in India on the gains arising from such transactions. A similar case in point is that of a UK-based telecommunications company, Vodafone, who is facing a tax demand of about \$2 billion on the recent Vodafone-Hutch deal. Also, a recent development is the interest of the Department in taxing participatory notes (PN) trades between foreign institutional investors (FII) and foreign entities, with no direct access to the Indian stock market.

A recent decision of the Department to tax capital gains earned by an American arm of AT&T has stirred up a

major debate on the taxability of capital gains earned from the sale of shares of a foreign holding company whose principal assets consist of underlying shares in an Indian company. The current position with regards to Vodafone and GE cases is that they have been seeking relief from stay of similar proceedings in the Mumbai and Delhi High Courts, respectively, although no tax demands have been raised so far and they have been served with notices by the Department for details on information regarding the deals. The case of AT&T has put it in a worse off position than Vodafone and GE as tax demands have already been raised in the case of the former. Tata Industries, which was served a Rs 45 crore (approximately \$11 million) tax demand notice by the Department for purchasing the stakes from AT&T has paid the demanded amount but it also intends to take legal remedial action against the demand.

Close on the heels of the various notices and tax demands, the Income-tax Department has sent a notice under section 133 (6) of the Act to the countrys largest private iron ore exporter, Sesa Goa, seeking details of its acquisition by a UK-based mining company, Vedanta Resources. Vedantas \$981 million acquisition of Indian Sesa Goa is now under the scanner of the Income-tax Department. By sending this notice, the Department is empowered to call for information from the party being served with the notice.

Conclusion

This ruling and the steps being taken by the Income-tax Department in India has resulted in a lot of controversy with regards to the legal position and also led to the initiation of legal actions in the form of writ petitions and injunctions before the courts. This will create a long drawn legal battle between such non-resident companies and the Indian Income-tax Department which will generate a lot of interest and impact other potential and existing investors in the Indian markets.

Return to Text

n1 . An authority constituted by the Central Government under S.245-O of the Act for giving determinations called advanced rulings in relation to a transaction undertaken or proposed to be undertaken by a non-resident applicant on issues pertaining to tax liabilities on proposed transactions.

n2

[2]. AAR No. 736 of 2006. Full text of the ruling is hosted by the official website of the AAR at http://rulings.co.in/ruling/show_ruling/40.html.

n3 . *20th Century Finance Corporation Ltd. v. State of Maharashtra* (2000) 6 SCC 12.

n4

[4]. *In re Pfizer Corporation, Virginia (2004) 271 ITR 101*; 141 Taxman 642 (AAR). Full text of the ruling can be found at http://rulings.co.in/ruling/show_ruling/131.html.

n5 . *CIT v. Finlay Mills Ltd. (AIR 1951 SC 464)*.

n6

[6]. *Associated Cement Companies Ltd. v. Commissioner of Customs (2001) 4 SCC 593*.

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Levinson on final IRS regulations on the HSA conundrum

2008 Emerging Issues 2496

Gerald M. Levinson on Final IRS Rules Concerning the HSA Conundrum And Accelerated Employer Contributions

By Gerald M. Levinson

July 7, 2008

SUMMARY: A Health Savings Account allows an eligible individual to put money aside to cover future medical expenses in a tax-advantaged way. The IRS recently issued final regulations to provide guidance to employers who make contributions to an HSA to ensure that such contributions are comparable for all employees.

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ARTICLE: A Health Savings Account (HSA) allows an eligible individual to put money aside to cover future medical expenses in a triple tax-advantaged way. Provided the HSA satisfies certain conditions set forth in IRC Section 223, contributions to the HSA will be tax deductible (even if the individual doesn't itemize deductions), will accumulate and earn interest in the HSA tax free, and withdrawals will be exempt from tax if they're used to pay qualified medical expenses.

Any adult can contribute to an HSA if they have coverage under an HSA-qualified high deductible health plan (HDHP), defined as a health plan with an annual deductible that, for 2008, is not less than \$1,100 for self-only coverage or \$2,200 for family coverage (increasing to \$1,150 and \$2,300, respectively, for 2009). Additionally, the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) required to be paid under the plan cannot exceed \$5,600 for self-only coverage or \$11,200 for family coverage (these amounts increase to \$5,800 and \$11,600, respectively, for 2009).

In addition to HDHP coverage, an individual contributing to a HSA can have no other first-dollar medical coverage (other types of insurance such as specific injury insurance or accident, disability, dental care, vision care, or long-term care insurance are permitted), cannot be enrolled in Medicare, and cannot be claimed as a dependent on someone else's tax return.

Contributions to the HSA can be made by the employer or the individual, or both. If made by the employer, the contribution is not taxable to the employee (excluded from income and wages). If made by the individual, it is an above-the-line deduction, meaning the deductions taken before the person's adjusted gross income (AGI) is determined. HSA contributions can also be made by others on behalf of the individual and deducted by the individual.

Total HSA contributions are limited annually. For calendar year 2008, contributions for an individual with self-only

coverage under a HDHP are limited to \$2,900, and to \$5,800 for family coverage under the plan. For 2009, these amounts increase to \$3,000 and \$5,950, respectively.

The Comparability Requirement

Employers are not required to contribute to employees' HSAs. However, if they do, they must make comparable contributions to the HSAs of all comparable participating employees. Employer contributions are comparable if they're the same dollar amount or same percentage of the annual deductible under the worker's HDHPs. Comparable participating employees refers to all HSA-eligible employees covered by a HDHP that have the same category of coverage (generally, either self-only or family coverage), and have the same category of employment (part-time, full-time, or former employees).

The comparability rules do not apply to contributions made through a cafeteria plan. If an employer fails to make comparable contributions to the HSAs of its employees during a calendar year, an excise tax equal to 35% of the aggregate amount contributed by the employer to the HSAs of its employees during that calendar year is imposed on the employer. All or a portion of this excise tax may be waived if the failure to comply is due to reasonable cause and not willful neglect, and the payment of the excise tax would be excessive relative to the failure of compliance.

Employees Who Fail to Set Up HSAs by Year End

Final IRS regulations, effective April 17, 2008 [*T.D. 9393*], provide a means for employers to comply with the comparability requirements with respect to employees who do not establish an HSA by December 31, as well as with respect to employees who may have established an HSA but haven't notified the employer of that fact. These regs apply to employer contributions made for calendar years beginning on or after January 1, 2009. However, employers can rely on the guidance in the regulations beginning immediately.

Because the comparability rules are tested on a calendar-year basis, and because an employer that opts to contribute to employee HSAs is obligated to do so for *all* comparable participating employees, workers that failed to set up HSAs by December 31 (as well as those who did so but failed to notify their employer of the fact) create what Deloitte, in its April *Washington Bulletin* calls a compliance conundrum for such employers. They are required to make contributions to HSAs that do not exist, or at least that they do not know exist.

Comparability rules proposed by IRS in 2005 simply provided that employers were not required to make comparable contributions for employees who either didn't set up HSAs by the end of the calendar year or didn't notify the employer they had done so. The final regs, however, adopt the position taken in 2007 proposals and require employers to notify such employees in writing, by January 15 of the following calendar year, that each eligible employee who, by the last day of February, establishes an HSA and notifies the employer that he or she has done so, will receive a comparable contribution to their HSA by April 15.

The employer must contribute to the HSAs of these employees comparable amounts (taking into account each month that the employee was a comparable participating employee) plus reasonable interest.

The notice employers must give these employees may be delivered electronically. The proposed and final regulations provide sample language that employers may use as a basis in preparing their notices.

The final regulations provide the following example of these rules in operation:

Example. For the 2009 calendar year, Employer contributes to the HSAs of current full-time employees with family coverage under any HDHP. Employer has 500 current full time employees. As of the date for Employers first HSA contribution for the 2009 calendar year, 450 eligible employees have established HSAs. Employer provides timely written notice satisfying the content requirements of the final regulations only to those 50 eligible employees who have not established HSAs. Employer makes identical quarterly contributions to the 450 eligible employees who established HSAs. By April 15, 2010, Employer contributes comparable amounts to the other eligible employees who establish HSAs and provide the necessary information on or before the last day of February, 2010. Employer makes no contribution to the HSAs of eligible employees that do not establish an HSA or that do not provide the necessary information on or before the last day of February, 2010. Employer satisfies the comparability rules.

Acceleration of Contributions

The final regs also provide that, for any calendar year, an employer may accelerate part or all of its contributions for the entire year to the HSAs of employees who have incurred qualified medical expenses during the calendar year that exceed the employers cumulative HSA contributions at that time. If an employer accelerates contributions for this reason, these contributions must be available on an equal and uniform basis to all eligible employees throughout the year and employers must establish reasonable uniform methods and requirements for acceleration of contributions and the determination of medical expenses. An employer is not required to contribute reasonable interest on either accelerated or non-accelerated HSA contributions.

An employer that accelerates HSA contributions in this way will fail to satisfy the comparability rules because (1) employees who incur qualifying medical expenses that top the employers cumulative HSA contributions have received more contributions in a given period than comparable employees who do not incur such expenses, provided that all comparable employees receive the same amount or the same percentage for the calendar year, or (2) an employee who terminates employment before the end of the calendar year has received more contributions on a monthly basis than employees who work the entire year.

Practice Tip

What HSA Contribution Methods Are Available to Employers?

You can contribute to employee HSAs in a lump sum or in any amounts or at any frequency you wish; all contributions, both employer and employee, are aggregated to determine whether the amount of total contributions top the annual limits (discussed earlier in this article).

Earlier final IRS regulations governing employer comparable contributions to employee HSAs [*Reg. § 54.4980G-4*] give those employers that opt to contribute to such Accounts wide latitude with regard to contribution methods. Employers may contribute either on a Pre-funded basis, Pay-as-you-go basis, or Look-back basis (the method the employer selects must be applied to all HSA contributions).

Pre-funded. Under this method, at the beginning of the calendar year the employer makes contributions for the entire year to the HSAs of its employees who are eligible individuals, instead of contributing on a pay-as-you-go or on a lookback basis. While an employer that prefunds HSAs will fail to satisfy the comparability rules because an employee who terminates employment prior to the end of the calendar year may receive more contributions on a monthly basis than employees who work the entire calendar year, employers may want to avoid making a full-year contribution for a worker who leaves mid year (doing so would not be to their best interests since employers may not recoup HSA contributions). An employer that makes HSA contributions on a prefunded basis must use the same contribution method for all employees who are eligible individuals hired after the date of initial funding.

Pay-as-you-go. This method allows an employer to contribute amounts at one or more dates during the calendar year (e.g., monthly or quarterly) to the HSAs of employees who are eligible individuals as of the first day of the month, provided the contributions are the same amount or the same percentage of the HDHP deductible for employees who are eligible individuals as of the first day of the month with the same category of coverage and are made at the same time. Contributions made at the employers usual payroll interval for different groups of employees are considered to be made at the same time. For example, if salaried employees are paid monthly and hourly employees are paid bi-weekly, an employer may contribute to the HSAs of hourly employees on a biweekly basis and to the HSAs of salaried employees on a monthly basis. An employer may change the amount that it contributes to the HSAs of employees at any point. However, the changed contribution amounts must satisfy the comparability rules.

Pay-as-you-go will likely be the method employed by a majority of employers since workers customarily incur medical expenses throughout the course of the year.

Look-back. An employer may also determine comparable contributions for the calendar year at the end of the year, taking into account all employees who were eligible individuals for any month during the calendar year and contributing the same percentage of the HDHP deductible or the same dollar amount to the HSAs of all employees with the same category of coverage for that month.

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Fink on Taxation of Social Security and Tier 1 Railroad Retirement Benefits

2008 Emerging Issues 2393

Philip Fink on Taxation of Social Security and Tier 1 Railroad Retirement Benefits

By Philip R. Fink

June 23, 2008

SUMMARY: IRC Sections 86(a), (b) and (c) lay out the rules for determining how much of an individuals Social Security and tier 1 railroad retirement benefits, if any, are included in gross income.

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ARTICLE: *IRC Sections 86(a)*, (b) and (c) lay out the rules for determining how much of an individuals social security and tier 1 railroad retirement benefits (social security benefits), if any, are included in gross income.

A three tier system. Individuals who receive social security benefits may be required to report a certain portion of their benefits in their gross income depending on the amount of their modified adjusted gross income (MAGI). Those taxpayers who have a relatively low amount of income, do not have to report any of their benefits. Next, those taxpayers who fall into a middle-ground may have to report up to 50% of their benefits. Finally, those taxpayers who have a relatively high amount of income may have to report as much as 85% of their benefits in their gross income. MAGI is an individuals adjusted gross income (excluding social security benefits) plus the foreign earned income exclusion and any tax exempt interest income.

Low income taxpayers. Taxpayers in this category do not have to report any of their benefits if their MAGI plus one-half of their benefits do not exceed a certain base amount. For married taxpayers filing jointly, the base amount is \$32,000. For married couples who file separately, but live together, their base amount is \$0. For all other taxpayers it is \$25,000.

Example. Brad is 67 years-old and receives \$10,000 of social security benefits in the current year. He has a part-time job where he earns \$12,000. In addition, he receives \$3,000 of taxable interest and \$2,500 of tax-exempt interest. In this case, his MAGI is \$17,500 (\$12,000 + \$3,000 + \$2,500). Since his MAGI (\$17,500) plus one-half of his social security benefits of \$5,000 (\$10,000 x 50%) is less than \$25,000, Brad does not have to report any of his social security benefits.

Middle income taxpayers. Taxpayers in this category may have to include up to 50% of their social security

benefits in gross income. That is, those taxpayers who have MAGI plus one-half of their benefits that exceed the base amount must include their social security benefits to the extent of the lesser of these two amounts:

- . 50% of the social security benefits received, or
- . 50% of the excess of MAGI plus 50% of social security benefits over the base amount.

Example. Scott and Laura are both 68, and file jointly. They each receive \$15,000 of social security benefits. Scott has a part-time job where he earns \$16,000. In addition, they receive \$6,000 of taxable interest. In this case, they would report only \$2,500 of their benefits in gross income as follows:

- $\$30,000 \times 50\% = \$15,000$
- $(\$16,000 + \$6,000 + (\$30,000 \times 50\%)) - \$32,000 = \$5,000 \times 50\% = \$2,500$

High income taxpayers. Taxpayers in this category may have to include up to 85% of their social security benefits in gross income. That is, those taxpayers who have a MAGI plus one-half of social security benefits exceeding an elevated base amount must include their benefits to the extent of the lesser of these two amounts:

1. 85% of the benefits received, or
2. The sum of:
 - a. $85\% \times (\text{MAGI} + (50\% \times \text{social security benefits}))$ the elevated base amount, and
 - b. The lesser of:
 - i. the amount calculated by a middle income taxpayer, or
 - ii. \$4,500 (\$6,000 in the case of a joint return)

Elevated base amount. There are three different elevated base amounts, depending on filing status. First, married taxpayers filing jointly have an elevated base amount of \$44,000. Next, married couples who file separately but live together have the base amount of \$0. Last, all other taxpayers have an elevated base amount of \$34,000.

Example. Tony and Mary Beth file a joint tax return. They both have part-time jobs, earning a combined salary of \$50,000. In addition, they have \$8,000 of taxable interest and \$24,000 of social security benefits. The amount of the benefits that are required to be included in gross income is \$20,400, calculated by the formula in #1 ($85\% \times \$24,000$) since it is less than the amount calculated in #2:

- $85\% \times (\$58,000 + (50\% \times \$24,000)) - \$44,000 = \$26,000$, and

The lesser of the two amounts calculated for a middle income taxpayer or \$6,000:

- $50\% \times \$24,000 = \$12,000$
- $50\% \times (\$58,000 + (50\% \times \$24,000)) - \$32,000 = \$38,000$

Since \$6,000 is a lesser amount than either of the two calculations above, the second formula produces an amount of \$32,000 ($\$26,000 + \$6,000$). Since the result in #1 (\$20,400) is the lesser of the two amounts, it must be included in Tony and Mary Beths gross income.

Withholding and estimated tax payments. Many individuals collecting social security benefits do not have to include it in their gross income, so having amounts withheld from social security benefits, or making estimated tax

payments in regard to such payments is not an issue. However, for those individuals who do have to include social security benefits in their gross income, they should consider having withholding on their benefits or make estimated payments. For those individuals in the higher income tax brackets who receive substantial amounts of social security benefits, they may be in danger of underpayment penalties if they do not provide for withholding or estimated payments.

There are two distinct types of recipients of social security benefits for whom withholding or estimated payments should be made. First, many high-income people receiving social security have left the workforce; and therefore, do not have any income taxes withheld. Therefore, withholding on the benefits or making estimated tax payments is very important. Second, many recipients will work beyond the time that they are entitled to full benefits; and thus, not only are they in a relatively high tax bracket, they may be receiving substantial amounts of social security. Thus, individuals in this situation may face substantial underpayment penalties unless they have withholding on their benefits, increase their withholding on salary or wage income, or make estimated payments.

In order to have withholding on social security benefits, recipients must complete a Form W-4V.

State income taxes. Many states will allow taxpayers receiving social security benefits to either fully or partially exclude the amount of benefits in determining state taxable income. Other states will allow recipients of social security to claim a credit against these benefits.

Traditional or Roth IRA. With the exception of some high income taxpayers, most individuals can choose between having a traditional IRA or a Roth IRA. It is important to consider these two types of retirement plans in view of the impact that distributions from these accounts are going to have on the amount of social security benefits that have to be included in gross income. That is, distributions from a traditional IRA are included in gross income. Thus, the amount of MAGI is going to increase by the amount of the distribution, resulting in potentially a greater amount of social security benefits that have to be included in gross income.

In contrast to a traditional IRA, distributions from a Roth IRA are excluded from gross income. Thus, there is no affect to MAGI. As such, the amount of an individuals social security benefits that have to be included in gross income is not going to be adversely affected in situations where individuals are receiving distributions from a Roth IRA.

It is important to be aware of a secondary effect of receiving distributions from a traditional IRA in contrast to a Roth IRA. That is, a distribution from a traditional IRA increases a taxpayers MAGI, which increases the amount of social security benefits that must be reported. In turn, this increases a taxpayers AGI, which can reduce several tax benefits such as the amount of the medical expense deduction, casualty loss deduction, and the cutback adjustment on itemized deductions.

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Fink on Special Allowance for Certain Property Acquired After December 31, 2007

2008 Emerging Issues 2381

Philip Fink on Special Allowance for Certain Property Acquired After December 31, 2007, and Before January 1, 2009

By Philip R. Fink

June 16, 2008

SUMMARY: IRC Section 168(k) was added by the Economic Stimulus Act of 2008 to help strengthen the slumping economy by providing businesses with a tax incentive to purchase most types of tangible personal property. It is a temporary provision that is essentially in effect for qualifying property acquired and placed into service during 2008. In this commentary, Professor Fink provides a practical framework for applying Section 168(k).

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: *IRC Section 168(k)* was added by the Economic Stimulus Act of 2008 to help strengthen the slumping economy by providing businesses with a tax incentive to purchase most types of tangible personal property. It is a temporary provision that is essentially in effect for qualifying property acquired and placed into service during 2008.

Additional first year depreciation. Generally, taxpayers can deduct 50% of the cost of qualified property placed into service in 2008. If it is more advantageous not to deduct the additional first year depreciation, taxpayers can elect out of this provision.

Caveat. It is important to note that the election to not take the additional first year depreciation is an affirmative election and is made separately for each class of property that qualifies. If the election is not made properly, not only will the taxpayer lose the tax benefit of this deduction but also the adjusted basis of the property will be reduced by 50% of the cost of the asset.

Tax planning. In deciding whether to elect out of this provision, it is important to take into account two criteria. First, taxpayers have to compare the tax bracket that they are in for 2008 versus their estimated tax bracket in future years. Second, it is important to take into account the present value of money.

Example. General Corporation acquired \$300,000 of five-year class property during 2008. It is expected that General will be in the 15% tax bracket in 2008-2010, and the 34% bracket in 2011 and 2012. Assume an interest rate of 8% in determining a discount value for purposes of the present value of money. In such a situation, electing out of the additional first year depreciation results in a present value of tax benefits that are \$1,252 (\$44,170 -- \$42,918) greater

than taking the additional first year depreciation:

Election Out

2008:

2009:

2010:

2011:

2012:

$$\$300,000 \times .20 \times .15 \times .9259 =$$

$$300,000 \times .32 \times .15 \times .8573 =$$

$$300,000 \times .192 \times .15 \times .7936 =$$

$$300,000 \times .1152 \times .34 \times .7350 =$$

$$300,000 \times .1152 \times .34 \times .6806 =$$

\$ 8,333

12,345

6,859

8,636

7,997

\$44,170

First-year additional depreciation

2008:

2009:

2010:

2011:

2012:

$$\$150,000 + (\$150,000 \times .20) \times .15 \times .9259 =$$

$$150,000 \times .32 \times .15 \times .8573 =$$

$$150,000 \times .192 \times .15 \times .7938 =$$

$$150,000 \times .1152 \times .34 \times .7350 =$$

$$150,000 \times .1152 \times .34 \times .6806 =$$

\$ 24,999

6,173

3,429

4,318

3,999

\$ 42,918

Caveat. Even though electing out was the better strategy in this particular set of facts, in reality, it is very difficult to predict future tax rates. Therefore, in practice, the strategy that should normally be followed is to take advantage of the extra deduction in 2008, and let the chips fall where they may.

Qualifying property. In order to be eligible for the additional first-year depreciation, property must satisfy the following requirements:

- . generally, must have a specified class life of 20 years or less for which standard MACRS depreciation is allowed. Thus, most tangible personal property will qualify such as: machinery, equipment, furniture and computer equipment,
- . generally, must be acquired and placed into service during 2008, and
- . the original use of the property must begin with the taxpayer in 2008.

Example. On March 3, 2008, Huston, Inc. purchased five-year property from Uno Corp., for \$120,000. The Uno Corp. used this property for the last two years. Even though this property is new to Huston, Inc. it is *not* allowed to take the additional first year depreciation since the original use of the property began with Uno Corp.

Caveat. In contrast, if Huston, Inc. would have acquired the property new, and was the original user of the property, it would have been entitled to additional first-year depreciation of \$60,000 (\$120,000 x 50%).

Relationship to expensing election and standard MACRS depreciation. When taxpayers acquire tangible personal property they are allowed to take standard MACRS depreciation in addition to electing to take the expensing election under *IRC §179* (up to \$250,000 for 2008). If a taxpayer elects to use the expensing election, it must be calculated prior to taking the first-year additional depreciation. After that, the standard MACRS depreciation can be claimed.

Example. United Corp. acquires five-year property on January 19, 2008 at a cost of \$400,000. If it elects to take the expensing election, and does not elect out of the additional first-year depreciation, it can write off a total of \$340,000 in 2008 in connection with this purchase:

expensing election (under *IRC §179*)

addition first-year depreciation $(\$400,000 - \$250,000) \times 50\%$

standard MACRS depreciation $(\$400,000 - \$250,000 - \$75,000) \times 20\%$

\$250,000

75,000

15,000

\$340,000

Federal estimated tax payments. Taxpayers who have acquired qualifying property, or who plan to acquire qualifying property, should take into account the amount of this deduction in determining the proper amount of estimated tax payments that should be made. The reason for this provision is to make it more beneficial for taxpayers to purchase property by reducing their taxes; and therefore, the amount of their estimated tax payments. By reducing the amount of estimated taxes that are required to be paid, taxpayers will have the immediate enjoyment of the tax savings.

State income taxes. Although there is variation among the states with respect to this provision, many states require taxpayers to add back additional first-year depreciation to state taxable income. For those taxpayers who purchase substantial amounts of qualifying property during 2008, the add-back adjustment should be taken into account in determining the amount of quarterly estimated payments that should be made at the state level.

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Harl on Paying Wages in Kind to Agricultural Labor

2008 Emerging Issues 2376

Harl on Paying Wages in Kind to Agricultural Labor

By Neil E. Harl

June 12, 2008

SUMMARY: A task force was created by the IRS in the early 1990s to examine the outstanding issues relating to payment of wages to agricultural labor. Its recommendations were published in 1994--these have provided guidelines for handling wage payment to agricultural labor ever since.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: For almost 60 years, wages paid in kind to agricultural labor have not been subject to FICA tax. n1 That was accomplished by declaring wages paid in any medium other than cash for agricultural labor are exempt from the term wages. n2 For almost as long a period, wages paid in kind to agricultural labor have not been subject to FUTA tax, either. n3 More recently, agricultural labor has qualified for an exemption from income tax withholding n4 except as the payment is outside the scope of the agricultural labor exemption. n5 In addition, payments in kind to agricultural labor are not considered wages for purposes of determining the amount of earnings in retirement. n6

Those provisions encountered a stiff headwind from the Internal Revenue Service in the late 1980s and early 1990s which led to the creation of a task force to examine the issues and make recommendations to IRS. n7 Those recommendations, published in 1994, n8 have provided the guidelines for handling the payment of wages to agricultural labor. n9

Qualifying for the exemption

In order to qualify for the exemption from FICA, FUTA and income tax withholding, it is important that the requirements for the exemption be followed scrupulously. n10 Although the Internal Revenue Service resistance has been less visible in recent years, the authorities promulgated before the 1994 report was published remain and have not been nullified. n11 For example, in a 1994 technical advice memorandum payments in the form of grain to a husband and wife as employees of their farm corporation were treated as the equivalent of cash even though the grain was removed to the employees own storage facilities and held for period of five to 60 days. n12

Employer responsibility. The employer who is paying wages in kind to agricultural labor must report any gain on the in-kind payment into income and may claim an offsetting income tax deduction for the wages paid if income tax is withheld *as required by I.R.C. § 3402*. n13 Because wages paid in-kind to agricultural labor are not subject to withholding under *I.R.C. § 3402*, a compensation deduction is allowed.

The fair market value of the in-kind wage payment is reported by the employer on Form W-2 but with no payment of FICA, FUTA or income tax withholding required.

Employee responsibility. The value of the commodities received by the employee as an in-kind wage payment is taxed as wage income as of the date of the transfer to the employee. An in-kind wage payment is exempt from FICA, FUTA and income tax withholding but the in-kind wage is *not exempt from income tax*. That gives the commodity an income tax basis in the hands of the employee. Compensation paid in-kind is compensation for purposes of an IRA contribution. n14

If the employee exercises dominion and control over the commodity paid as a wage in-kind, gain or loss on subsequent disposition of the commodity is reported on Schedule D as a short-term capital asset. Unless the employee is engaged in the business of producing the commodity, any gain should not be subject to self-employment tax. n15

As noted more fully below, the procedure fails if the transfer of in-kind wages is equivalent to cash, such as with negotiable warehouse receipts. n16

Necessity of dominion and control

For in-kind wage payments to be exempt from FICA, FUTA and income tax withholding, the payment must not be in a form readily converted into cash and the employee must exercise dominion and control over the payment. Those factors were used as barriers to qualification for the exemption until late 1994.

As alluded to above, payment in the form of commodity storage receipts is treated as payment of cash. n17 In the facts of that ruling, the value of the storage receipts was equal to the amount that the employees would otherwise receive and the employer immediately redeemed the employees receipts for cash.

In a 1982 technical advice memorandum, n18 in what now appears to have been the peak of taxpayer success in the period leading up to 1994, wages paid in the form of milk and other commodities by a corporation carrying on a dairy operation met the requirements for avoiding payroll taxes. The situation involved employees who were compensated with a percentage of milk produced, a percentage of the calves and a percentage of grain production. n19 In a 1987 technical advice memorandum, n20 in-kind wages were in the form of employer-provided livestock production care as compensation to employees and the amounts were not subject to FICA tax. n21

The tide began to turn in 1991 with a technical advice memorandum in which a compensation arrangement whereby a spouse was paid \$200 in cash and 3,000 pounds of live hogs per month was held to be a payment in cash where the title to the hogs was not transferred to the spouse until delivery to the market. n22 That was followed by a 1993 TAM where payment to the husband in a family-owned farm corporation in the form of \$6,000 in cash wages and 20 percent of all market-weight butcher hogs produced payment of \$6,000 in cash and \$34,941 in hogs in one year and \$11,000 in cash and \$41,272 in hogs another year and was all considered to be equivalent to the payment of cash compensation. n23 The exemption from payroll taxes was denied.

In another 1993 ruling, payments of grain to a married couple who were employees of their wholly-owned farm corporation were treated as the equivalent to cash. n24 To be fair, the grain was not removed to separate storage facilities nor was the couple charged for storage although the couple bore the risk of loss after payment and sold their

own grain. n25 In a 1994 TAM, payment of grain to a husband and wife as employees of their farm corporation were treated as the equivalent of cash even though the grain was removed to the employees own bins and was held for periods ranging from five to 60 days. n26 It is difficult to fault the way the wage issue was handled in the facts of that TAM. It was this ruling that triggered action by a group of Senators and Members of the House of Representatives and resulted in the move by the Commissioner of Internal Revenue to appoint a task force to examine the issue and make recommendations to the Commissioner.

IRS guidelines

The 1994 report n27 contained guidelines specifying that the validity of a plan for paying wages in kind with no liability for FICA, FUTA and income tax withholding is dependent upon a facts and circumstances test. The major factors identified in the guidelines are as follows

- . Whether the commodity is readily identified;
- . Whether there is documentation of the transfer of the commodity used for the payment in-kind (the commodity should not have been acquired solely for the purpose of paying wages in kind, also);
- . Whether the in-kind payment is intended to be a substitute for cash (the use of negotiable commodity storage receipts, generic commodity certificates and deferred payment or installment contracts are likely to be treated as equivalent to cash);
- . Whether the employee negotiates the subsequent sale of the commodity (it is near fatal if the commodity is sold at the same time, to the same buyer and in the same transport vehicle as the same or similar commodity sold by the employer); n28
- . Whether the risk of gain or loss is shifted to the employee after the wage payment (no hold-harmless provisions);
- . The length of time between the employees receipt of the commodity and sale of the commodity by the employee (although the concept of a minimum stated time period was rejected by the task force);
- . Whether the employee bears the costs incident to ownership of the commodity, for example, storage, feeding, insurance and maintenance costs; n29 note that expenses associated with the commodity used to pay wages in kind appear to be subject to the two-percent floor for employee business expenses; n30
- . Whether the commodity used for in-kind wage payment was either produced in the trade or business or acquired for use in the business;
- . Whether the commodity was sold to someone other than the employer (sale back to the employer is a clear negative);
- . Whether any security interest held by a creditor of the employer on the commodity or commodities used to pay employees was released formally. n31

Downside of paying wages in kind to agricultural labor

The payment of wages in kind clearly has a downside. Receiving a wage payment in kind reduces or eliminates social security benefitsⁿ³² and can reduce disability benefits.ⁿ³³

Proposed legislation

In 1992, at the height of the IRS resistance to payment of wages in kind to agricultural labor, legislation was proposed to expand the definition of social security covered wages to include non-cash wages paid to agricultural labor.ⁿ³⁴ The proposed legislation was included in a bill that was vetoed by President George Bush following the 1992 election.

Under the proposal, exceptions would have been provided for meals and lodging furnished on the premises of the employer to the employee, the employees spouse or any of the employees dependents. For seasonal workers, temporary lodging in reasonable proximity to the premises which is furnished to the employee, the employees spouse or any of the employees dependents would be covered. Non-cash wages would be subject to the tax thresholds then applicable to agricultural cash wages that were the lesser of \$150 per worker or \$2500 for the employer.ⁿ³⁵

As noted, the legislation was not enacted into law and the proposal has not surfaced since the veto in 1992.

Return to Text

ⁿ¹ . *I.R.C. § 3121(a)(8)*. See generally 2 Harl, *Farm Income Tax Manual* § 8.02[1]b] (2007 ed.); 5 Harl, *Agricultural Law* § 36.02[3] (2008); Harl, *Agricultural Law Manual* § 4.06[2][a] (2008).

ⁿ²

[2]. *I.R.C. § 3121(a)(8)*.

ⁿ³

[3]. *I.R.C. § 3306(b)(1)*.

ⁿ⁴

[4]. *I.R.C. § 3401(a)(2)*.

n5

[5]. *I.R.C. § 3121(a)(8)*.

n6

[6]. *20 C.F.R. §§ 404.429(c)(3), 404.1055*.

n7

[7]. See Harl, *Farm Income Tax Manual* § 8.02[1][b][iii] (2007 ed.).

n8

[8]. IRS, Noncash Remuneration for Agricultural Labor, Market Segment Understanding Guidelines, December 20, 1994.

n9

[9]. The Market Segment Understanding Guidelines, December 20, 1994, have been published as Appendix A in 2 Harl, *Farm Income Tax Manual* (2007 ed.).

n10

[10]. See *Highway Farms, Inc. v. United States*, 02-1 U.S.T.C. . 50,281 (S.D. Iowa 2002) (payment of wages failed to qualify for exemption).

n11

[11]. E.g., *TAM 9428003*, April 5, 1994.

n12

[12]. *Id.*

n13

[13]. *Treas. Reg. § 1.83-6(a)(2)*.

n14

[14]. *Ltr. Rul. 9202003*, October 9, 1991.

n15

[15]. *I.R.C. § 1402(a)*.

n16

[16]. *Rev. Rul. 79-207*, 1979-2 *C.B.* 351.

n17

[17]. *Rev. Rul. 79-207*, 1979-2 *C.B.* 351.

n18

[18]. *TAM 8252018*, September 17, 1982.

n19

[19]. *Id.*

n20

[20]. *TAM 8738005*, June 5, 1987.

n21

[21]. *Id.*

n22

[22]. *TAM 9136001*, May 14, 1991.

n23

[23]. *TAM 9322003*, February 25, 1993.

n24

[24]. *TAM 9403001*, August 17, 1993.

n25

[25]. *Id.*

n26

[26]. *Id.*

n27

[27]. See note 7 *supra*.

n28

[28]. See *Highway Farms, Inc. v. United States*, 02-1 U.S.T.C. 50,281 (S.D. Iowa 2002) (wages-in-kind paid in form of hogs not successful in avoiding FICA tax; recipients did not market hogs separately, hogs transported

to market and sold to same buyer on same terms; court said disguised cash transfer with sole purpose of tax avoidance).

n29

[29]. *Ltr. Rul. 9428003*, April 5, 1994; *Ltr. Rul. 9403001*, August 17, 1993.

n30

[30]. *I.R.C.* § 67.

n31

[31]. IRS, Noncash Remuneration for Agricultural Labor, Market Segment Understanding Guidelines, December 20, 1994, included as Appendix A in 2 Harl, *Farm Income Tax Manual* (2007 ed.).

n32

[32]. See discussion in 2 Harl, *Farm Income Tax Manual* § 8.06[3] (2007 ed.).

n33

[33]. *Id.*, § 8.06[5].

n34

[34]. H.R. 11, § 7005, 102d Cong., 2d Sess. (1992). See 2 Harl, *Farm Income Tax Manual* § 8.02[1][b] (2007 ed.).

n35

[35]. *I.R.C.* § 3121(a)(8)(B). See 2 Harl, *Farm Income Tax Manual* § 8.02[1] (2007 ed.).

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Dr. Harl has published widely including 28 books; more than 400 professional articles and bulletins; and more than 850 articles in farm and financial publications. He is author of the 15-volume treatise, *Agricultural Law* and the single volume *Agricultural Law Manual and Farm Income Tax Manual*; senior author of two *Tax Management Portfolios--The Family-Owned Business Deduction and Reporting Farm Income* and co-author of *Taxation of Cooperatives* and co-author of *Principles of Agricultural Law*.

He has received more than 30 major awards including the USDA Superior Service Award in 1987; the Presidents Award from the Iowa State Bar Association in 1991; Charles A. Black Award from the Council for Agricultural Science and Technology in 1997, for effectiveness in communicating with the public; the Distinguished Service to Agriculture award from the Chicago Farmers Club in 1999, the Wallaces Farmer Iowa Master Farmer Award for Exceptional Service to Agriculture in 2000; the Speaker of the Year Award by the National Society of Accountants in 2000; the Presidential Service Award from Iowa State University in 2002; and the Service to American and World Agriculture Award from the National Association of County Agricultural Agents in 2006.

Dr. Harl has served on six federal advisory bodies a Farm Tax Reform Task Force for the U.S. Department of the Treasury in 1967; the Commissioner's Advisory Group (Commissioner of Internal Revenue) in 1979-80; the USDA Farm Structure Task Force in 1980; the Office of Technology Assessment, Technical Advisory Committee, by Congressional Appointment, 1987-1995 (chair in 1993-94); the USDA Advisory Committee on Agricultural Biotechnology, 2000-2002; and the Commission on Federal Payment Limitations in Agriculture, 2002-2003.

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Dialani on Tax Liability for Hardware/Software Maintenance Contracts with India

2008 Emerging Issues 2364

Jyoti Dialani on Tax Liability of U.S. Corporations That Have Hardware and Software Maintenance Contracts with Indian Companies

By Jyoti Dialani

June 10, 2008

SUMMARY: The Authority for Advance Rulings in India recently held that payment received by a US company for the repair of hardware is not liable to tax in India if the supply and installation of equipment and repairs under the hardware contract are done outside India, but payment made to the US company under the software maintenance contract is liable to tax in India where engineers are deputed on the site of the Indian company.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: In a February 28, 2008 ruling, the Authority for Advance Rulingsⁿ¹ (AAR) of India, a quasi-judicial body that gives rulings on applications made by any person on an issue pertaining to income-tax law, held that no tax is deductible at source by an Indian company from payments made by it to any foreign or non-resident company under a Hardware Repair Support Contract where the supply and installation of equipment and repairs and maintenance are carried out completely outside India. On the issue of deductibility of tax from payments to such a foreign company under a Software Maintenance Support Contract, the AAR has clarified that the amounts so paid in respect of installation and testing of software by an engineer deputed in India does in fact constitute fees for included services within the meaning of paragraph 4(a) of Article 12 of the India-USA Double Taxation Avoidance Agreementⁿ² (DTAA) and hence, being taxable in India, the Indian company is required to deduct tax at source from such payments. This ruling has provided the much needed comfort to those non-resident companies engaged in the supply, installation, repair and maintenance of hardware solutions systems to Indian companies where such supply and installation transactions take place outside the boundaries of India. However, rulings by the AAR, though not in the nature of binding judicial precedents in courts of law, certainly hold persuasive value before income tax assessing officers or judicial forums. Since each case is unique and tax liabilities are usually determined on the basis of the individual nature of every transaction and details such as the payment, activities involved, location of the transaction, the DTAA governing such transaction, domestic tax laws affecting the parties, contracts of services and supply, etc., it is important to analyze and penetrate the deeper issues in such cases before arriving at an assessment of probable tax liabilities. The ensuing paragraphs will delve into the facts of the case in discussion against the backdrop of relevant provisions of the income tax law in India, the specific clauses of the India-USA DTAA and the reasoning provided in the ruling for the decision so pronounced in the given case.

Background of the case

The AAR has pronounced the ruling ⁿ³ on an application filed by the Airport Authority of India ⁿ⁴ (AAI) on an issue arising out of contracts entered in the year 2006 with an American company, Raytheon Company, USA (Raytheon). These contracts were in continuation of certain earlier contracts entered into in 2003 on which a ruling was sought before the AAR but the issues in the current application, though similar to those raised in the earlier ruling, are borne out of a fresh transaction in the renewed contracts and the assessment authorities have taken a view different from that expressed in the ruling in the case of Raytheon. AAI had entered into a Hardware Repair Support Contract and a Software Maintenance Support Contract with Raytheon. Under the initial contracts, Raytheon had supplied certain hardware systems to AAI in its Delhi and Mumbai sites. AAI had been operating and maintaining the hardware systems independently. However, since the systems needed repairs from time to time, Raytheon had, under a contract, proposed and agreed to undertake repairs of the system outside India. Under the contract, AAI was responsible to send the components of the hardware needing repair to Raytheon outside India and also to take delivery of the repaired hardware from Raytheon outside India. Under the software contract, Raytheon was supposed to depute an engineer to the sites of AAI in India for the purpose of installing and testing software on the repaired systems. AAI had in an earlier application raised the following queries before the AAR:

In relation to the hardware repairs contract,

1. Whether the amount received by Raytheon is liable to tax in India in the hands of the recipient non-resident company.

2. If the amount received by Raytheon is held to be taxable, what is the rate at which tax will be attracted and what is the rate at which tax is deductible at source by AAI?

In relation to the software maintenance contract,

1. Whether deputation of an engineer by Raytheon to the sites of AAI in India will constitute Raytheons Permanent Establishment (PE) in India.

2. Whether the amount received by Raytheon under the contract is income liable to tax in the hands of Raytheon in India.

3. If the amount received by Raytheon is taxable in India, what is the rate of tax attracted on the amount and

what is the rate at which tax is required to be deducted at source by AAI?

The AAR, in its ruling n5 dated December 15, 2004, held that the payments made to Raytheon under the hardware contract were not taxable in the hands of the recipient non-resident company. The second question raised before the AAR, being consequential to the first, did not require any clarification in view of the ruling given on the first. On the questions raised in respect of the software contract, the AAR clarified that deputation of an engineer by Raytheon to AAIs site in India did not constitute Raytheons PE in India. However, the payments received by Raytheon in respect of such deputation were held as income taxable in India.

Facts of the present case

AAI and Raytheon had entered into the first batch of its contracts in the year 1993 for the supply and installation of equipment with provision of spares, training, documentation and software as also a service contract. In pursuance of these contracts, Raytheon delivered the equipment to AAI sites in India and the equipment was operated by AAI without any assistance from Raytheon. After some years, when some assemblies failed and the need for repairs arose from time to time, AAI entered into the two contracts for hardware repairs and software maintenance with Raytheon in 2003, which were the subject of analysis in the present case. With reference to these two contracts, AAI filed two applications before the AAR, which were consolidated as the issues involved were interdependent. In the applications, AAI framed the following questions before the AAR:

In respect of the hardware contract,

1. Whether the amount received by Raytheon is liable to tax in India in the hands of the recipient non-resident U.S. company.

2. Whether any tax is required to be deducted at source by AAI from payments made to Raytheon.

In respect of the software maintenance contract,

1. Whether deputation of an engineer by Raytheon to India for the purpose of installing and testing the repaired software will constitute Raytheons Permanent Establishment (PE) in India.

2. Whether any tax is required to be deducted at source by AAI from payments made to Raytheon. If yes, then what is the rate of withholding tax applicable?

The ruling was therefore primarily sought on the issue whether AAI was under an obligation under the law to deduct tax at source under section 195(1) of the Income-tax Act, 1961 (the Act) from payments made under two contracts: Hardware Repair Support Contract and Software Maintenance Support Contract to Raytheon, USA, a non-resident foreign company.

Contentions raised before AAR in previous application

AAI had contended before the AAR in the previous application that the payments made to Raytheon under the terms of the hardware contract did not give rise to income-tax liability in India as all the activities under the contract took place outside India and the property in the equipment was passed outside the Indian boundaries. It was further emphasized that the installation of the entire hardware equipment was also carried out by AAI itself without any assistance of Raytheon. Regarding the software maintenance support contract also, AAI contended that since a substantial part of the activities took place outside India, despite the deputation of engineers by Raytheon at site for running and testing software, the amounts paid to Raytheon were not taxable in India as it could not be said to have a PE in India. In support of its contention, AAI relied on Article 7, Clause 1 of the India-USA DTAA which is relevant to the argument and reads as follows:

Article 7 -- Business profits -- 1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in the other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in the other State of the same or similar kind as those effected through that permanent establishment.

Thus, regarding the hardware contract, the entire crux of AAI's contention was that the amounts paid by it to Raytheon were in the nature of business profits and the same will not be liable to tax in India in view of Article 7 of the India-USA DTAA as Raytheon had no PE in India.

Ruling of AAR in previous application

The AAR, in its previous ruling, ⁿ⁶ accepted AAI's contention that the payments received by Raytheon under the hardware repair contract were not liable to be taxed in India under the Act. The AAR held that the hardware and other equipment were the subject matter of a sale transaction in favor of AAI and that the repair of hardware by Raytheon outside the boundaries of India was not tantamount to furnishing services as defined in Article 12 of the India-USA DTAA. The payment was accordingly held to be in the nature of business profits within the meaning of Article 7. Having held a view on the classification of the payment as business profits coupled with the finding that Raytheon had no PE in India, it was ruled that the payments under the hardware repair contract were not taxable in India by virtue of Article 7.

On the software maintenance support contract, the AAR held that the payment received by Raytheon constitutes fees for included services within the meaning of Para 4(a) of Article 12 of the India-USA DTAA. This finding was reached and a distinction was drawn between the nature of income earned from the sale of hardware equipment and the maintenance of software. The AAR held that regarding the software contract, AAI merely acquired a right to use the software and documentation subject to certain conditions whereas in the case of the hardware contract, there was an outright sale of equipment.

Paragraph 4(a) of Article 12 of the India USA DTAA reads as follows:

4. For purposes of this Article, fees for included services means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services:

(a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3 is received; or

Paragraph 3 of Article 12 mentioned above defines Royalties as below:

3. The term royalties as used in this Article means:

(a) payments of any kind received as a consideration for the use of, or the right to use, any copyright or a literary, artistic, or scientific work, including cinematograph films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof; and

(b) payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial, or scientific equipment, other than payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping and Air Transport) from activities described in paragraph 2(c) or 3 of Article 8.

After analyzing the above clauses of the DTAA, the AAR, in its previous ruling, held that payments made to Raytheon under the software contract were taxable in India by virtue of Para 2 of Article 12 of the DTAA which reads as follows:

Article 12 -- Royalties and fees for included services -- 1. Royalties and fees for included services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties and fees for included services may also be taxed in the Contracting State in which they arise and according to the laws of that State; but if the beneficial owner of the royalties or fees for included services is a resident of the other Contracting State, the tax so charged shall not exceed:

Article 12, Para 2 of the India-USA DTAA clearly brings to tax fees for included services arising to any non-resident in the country where the income arises and, hence, the AAR held payments under the software contract to Raytheon as taxable in India.

Current ruling of AAR

With respect to the Software Maintenance Support Contract, the AAR held that the reasons given and the earlier ruling pronounced by it in the case of AAI itself were squarely applicable to the present application and therefore payments made to Raytheon under the software contract were held to be fees for included services liable to tax in India. AAI also did not oppose the taxability of the same and made it clear that the only clarification it needed from the AAR was about the rate of tax applicable for deduction at source. AAI did not press the question of taxability of the payments in the hands of Raytheon nor contested its obligation to deduct tax at source and pay to the Income-tax Department. The AAR held that since there was no dispute regarding the rate of withholding tax, the applicable rate of tax is ten percent as per section 195(1) of the Act read with Schedule I, Part II, 1(b), H(II).

On the issue of taxability of payments made under the Hardware Repair Support Contract, the Revenue raised the argument that the subsequent investigation in the context of assessment proceedings in the case of Raytheon revealed the existence of PE even in regard to the hardware repair contract. The AAR examined the assessment orders in the case of Raytheon and the related material and arrived at the conclusion that there was nothing in those orders to substantiate the Revenues version that there was a PE of Raytheon in India in connection with the hardware contract as well as the software contract. The fact that Raytheon admitted having a PE in India in the form of an installation PE, as seen from the assessment orders in its case, had no bearing on whether, in furtherance of the two contracts, any PE was set up by Raytheon in India. The PE referred to in one of the assessment orders was in connection with a major contract for the modernization of an air traffic system awarded to Raytheon in 1993 which was entirely different from the contracts in the present application. On the Revenues contention regarding the existence of a PE on the basis that Raytheon had a liaison office in India, the AAR held that there was nothing in the assessment order, the statement of the manager of Raytheons liaison office or from the salient features and terms of the present contracts which unerringly point to the existence of a PE. On the other hand, the probability was that as the entire activity of repair of equipment and rectification of anomalies took place outside India and AAI or its agent took delivery of the repaired equipment, there was very little part which the liaison office could have played in the implementation of the contracts in question. Going further, it observed that under Article 5(3) of the DTAA with the USA, a preparatory and auxiliary type of work

stands excluded from the purview of PE. Also, four or five technical personnel deputed by Raytheon made visits for very few days during a period of three years. Most of the visits were in connection with the software maintenance contract. The AAR held that from those sporadic visits of Raytheons personnel for a few days, it was difficult to draw any inference of the existence of a PE of Raytheon in India. The AAR went a step further and held that there was no definite finding supported by reasons which could throw any light on the existence of a PE in connection with the execution of the contracts. Also, the AAR chose to not go further about the assessment orders in view of the fact that the appeals filed by Raytheon were still pending. Hence, the argument of the Revenue on the existence of a PE in India was rejected by the AAR on all grounds.

The Revenue, finding it difficult to challenge the correctness of the earlier ruling of the AAR, raised the issue of maintainability of the application by contending that AAI could not invoke the jurisdiction of the AAR in view of the embargo laid down in clause (i) of the proviso to section 245R(2) of the Act. The Revenue argued that since the identical question regarding Raytheons liability to pay income-tax in India was pending before the Appellate Authority even before the present application was filed, the present application ought to be rejected and not heard on the merits. Therefore, the Revenue opposed the application to AAR on two grounds: the AAI could not seek a ruling from AAR on the tax liability of a non-resident, and since the same issue was pending in appellate proceedings of Raytheon, no reference could be made to AAR.

On the first objection raised by the Revenue, the AAR held that sub-clause (ii) of clause (a) of section 245N envisages a determination by the Authority in relation to the tax liability of a non-resident arising out of a transaction, undertaken or is proposed to be undertaken by a resident applicant with such non-resident. Sub-clause (ii) to clause (b) of section 245N confers the qualification of applicant on such resident. Thus, a resident who has entered into a transaction with a non-resident, as in the present case, is an applicant within the meaning of section 245N(b) and such applicant can approach the Authority to determine a question which has a bearing on the tax liability of its non-resident collaborator under sub-clause (ii) of clause (a). It further held that there is no bar, either express or implied, against a resident applicant falling within the scope of sub-clause (iii) invoking the jurisdiction of this Authority for a determination under sub-clause (ii) of clause (a) of the same section. The fact that such resident is a public sector undertaking (PSU) should not make any difference. A PSU, being a resident, can very well fall within the sweep of clause (b)(ii) of section 245N of the Act if it has undertaken a transaction with a non-resident and it can seek a ruling with respect to the tax liability of a non-resident as per clause (a)(ii) of section 245N.

To overcome the bar under clause (i) of the proviso to section 245R(2), AAI contended that in order to attract the said proviso, the issue should be firstly pending in the case of the applicant. Therefore, it was urged that an appeal filed by the non-resident, Raytheon, with whom AAI had entered into a contract does not affect the maintainability of the present application.

On the second objection raised by the Revenue, the AAR held that the question raised by AAI relating to TDS was not the question which was pending for consideration in appellate proceedings in the case of Raytheon, where the issue before the appellate authority was its tax liability under the Act read with the India-USA DTAA. In the present case, the question raised by AAI was about tax deduction at source. The AAR observed that although Raytheons liability to pay income-tax was crucial in the proceedings before it, the decision on the issue raised was incidental to the determination of the applicants obligation to deduct tax at source. Although the

issues were interrelated or allied, the question raised before the AAR could not be said to be identical nor could it be said to be the very same question pending determination by the appellate authority. This distinction, though it appears to be subtle, is real. The AAR noted that AAIs right to have recourse to an advance ruling on the point of tax deduction cannot be defeated by reason of an undecided appeal filed by Raytheon, though a related issue has to be decided in that appeal. The embargo under the proviso to section 245R(2) should be strictly construed so that an eligible applicant is not denied the remedy to have an early ruling in the matter. The AARs view was that AAI need not be called upon to go on deducting and paying income tax until and unless the appeal of Raytheon is decided. Assuming that an applicant has the alternative remedy of filing an application before the Income-tax Officer under section 195(2), it does not operate as a legal bar to the maintainability of the application before the AAR. The concept of tax deduction at source under the Income-tax Act has its own scheme and nuances. It stands as a separate issue, although aligned with the substantive tax liability of the recipient of income. The AAR further examined the meaning of the phrase in relation to in section 245N of the Act.

Section 245N, which provides definitions in the Chapter of Advance Rulings, opens as follows:

In this Chapter, unless otherwise requires, --

(a) advance ruling means --

(i) a determination by the Authority in relation to a transaction which has been undertaken or is proposed to be undertaken by a non-resident applicant; or

(ii) a determination by the Authority in respect of an issue relating to the tax liability of a non-resident arising out of a transaction which has been undertaken or is proposed to be undertaken by a resident applicant with such non-resident,

and such determination shall include the determination of any question of law or of fact specified in the application;

(iii)

The AAR observed that the phrase in relation to is of wide import and that the issue relating to TDS regarding which determination is sought by the applicant (AAI), being an issue in relation to the tax liability of the non-resident, namely, Raytheon, falls within the purview of sub-clause (ii) of clause (a) to section 245N of the Act.

Conclusion

The crux of the ruling given by the AAR in the case discussed herein is that payment received by a U.S. company for the sale, supply, installations and repair of hardware is not liable to tax in India if such activities are carried out outside the Indian shores, but payment received for software maintenance support where engineers are deputed to India, such payment, being qualified as fees for included services under the India-USA DTAA, is to be taxed in India. The rate of tax to be deducted at source from such payment by the Indian company is ten percent. This ruling has also cleared the air to a large extent on the controversy regarding who is entitled to approach the AAR for a determination on an issue concerning tax liability of a non-resident. There has been some amount of confusion on whether such an application before the AAR should be made by the non-resident himself or whether the person responsible for making payments to the non-resident is also entitled to make such an application. The view taken by the AAR in this ruling, apart from being fair and correct, is also crucial inasmuch as it is the sole responsibility of the Indian company under the Act to deduct the accurate amount of tax from payments made by it to the non-resident. The only pragmatic approach to avoid any pitfalls is to provide an option to the Indian company as well to be able to approach the AAR to determine the tax liabilities of the non-resident party and the obligations of the Indian party to deduct tax from such payments. Therefore, this ruling is a welcome decision to both Indian as well as foreign parties involved in any similar transactions as in the present case.

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n1 . An authority constituted by the Central Government under S.245-O of the Act for giving determinations called advanced rulings in relation to a transaction undertaken or proposed to be undertaken by a non-resident applicant on issues pertaining to tax liabilities on proposed transactions.

n2

[2]. The full text of the India-USA DTAA can be found at http://aar.gov.in/dtaa_USA.htm.

n3

[3]. *In re* Airport Authority of India, (2008) 215 CTR (AAR) 212.

n4

[4]. A statutory authority set up under the Airport Authority of India Act, 1994 and a public sector enterprise.

n5

[5]. *In re* Airport Authority of India, (2005) 273 ITR 437/ 143 Taxman 129 (AAR).

n6

[6]. *In re* Airport Authority of India, (2005) 273 ITR 437/ 143 Taxman 129 (AAR).

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Harl on Deferring Farm and Ranch Income

2008 Emerging Issues 2341

Neil E. Harl on Deferring Farm and Ranch Income: Constructive Receipt and Commodity Sales

By Neil E. Harl

June 4, 2008

SUMMARY: A high percentage of farmers and ranchers report income on the cash method. It is therefore not surprising that that farmers and their tax advisors focus attention on ways to defer income. However, due to various Congressional actions, the picture is far from clear and confusion is widespread. Professor Harl brings clarity to the issue in this Commentary.

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ARTICLE: For almost 60 years, wages paid in kind to agricultural labor have not been subject to FICA tax. n1 That was accomplished by declaring wages paid in any medium other than cash for agricultural labor are exempt from the term wages. n2 For almost as long a period, wages paid in kind to agricultural labor have not been subject to FUTA tax, either. n3 More recently, agricultural labor has qualified for an exemption from income tax withholding n4 except as the payment is outside the scope of the agricultural labor exemption. n5 In addition, payments in kind to agricultural labor are not considered wages for purposes of determining the amount of earnings in retirement. n6

Those provisions encountered a stiff headwind from the Internal Revenue Service in the late 1980s and early 1990s which led to the creation of a task force to examine the issues and make recommendations to IRS. n7 Those recommendations, published in 1994, n8 have provided the guidelines for handling the payment of wages to agricultural labor. n9

Qualifying for the exemption

In order to qualify for the exemption from FICA, FUTA and income tax withholding, it is important that the requirements for the exemption be followed scrupulously. n10 Although the Internal Revenue Service resistance has been less visible in recent years, the authorities promulgated before the 1994 report was published remain and have not been nullified. n11 For example, in a 1994 technical advice memorandum payments in the form of grain to a husband and wife as employees of their farm corporation were treated as the equivalent of cash even though the grain was removed to the employees own storage facilities and held for period of five to 60 days. n12

Employer responsibility. The employer who is paying wages in kind to agricultural labor must report any gain on

the in-kind payment into income and may claim an offsetting income tax deduction for the wages paid if income tax is withheld *as required by I.R.C. § 3402*. n13 Because wages paid in-kind to agricultural labor are not subject to withholding under *I.R.C. § 3402*, a compensation deduction is allowed.

The fair market value of the in-kind wage payment is reported by the employer on Form W-2 but with no payment of FICA, FUTA or income tax withholding required.

Employee responsibility. The value of the commodities received by the employee as an in-kind wage payment is taxed as wage income as of the date of the transfer to the employee. An in-kind wage payment is exempt from FICA, FUTA and income tax withholding but the in-kind wage is *not exempt from income tax*. That gives the commodity an income tax basis in the hands of the employee. Compensation paid in-kind is compensation for purposes of an IRA contribution. n14

If the employee exercises dominion and control over the commodity paid as a wage in-kind, gain or loss on subsequent disposition of the commodity is reported on Schedule D as a short-term capital asset. Unless the employee is engaged in the business of producing the commodity, any gain should not be subject to self-employment tax. n15

As noted more fully below, the procedure fails if the transfer of in-kind wages is equivalent to cash, such as with negotiable warehouse receipts. n16

Necessity of dominion and control

For in-kind wage payments to be exempt from FICA, FUTA and income tax withholding, the payment must not be in a form readily converted into cash and the employee must exercise dominion and control over the payment. Those factors were used as barriers to qualification for the exemption until late 1994.

As alluded to above, payment in the form of commodity storage receipts is treated as payment of cash. n17 In the facts of that ruling, the value of the storage receipts was equal to the amount that the employees would otherwise receive and the employer immediately redeemed the employees receipts for cash.

In a 1982 technical advice memorandum, n18 in what now appears to have been the peak of taxpayer success in the period leading up to 1994, wages paid in the form of milk and other commodities by a corporation carrying on a dairy operation met the requirements for avoiding payroll taxes. The situation involved employees who were compensated with a percentage of milk produced, a percentage of the calves and a percentage of grain production. n19 In a 1987 technical advice memorandum, n20 in-kind wages were in the form of employer-provided livestock production care as compensation to employees and the amounts were not subject to FICA tax. n21

The tide began to turn in 1991 with a technical advice memorandum in which a compensation arrangement whereby a spouse was paid \$200 in cash and 3,000 pounds of live hogs per month was held to be a payment in cash where the title to the hogs was not transferred to the spouse until delivery to the market. n22 That was followed by a 1993 TAM where payment to the husband in a family-owned farm corporation in the form of \$6,000 in cash wages and 20 percent of all market-weight butcher hogs produced payment of \$6,000 in cash and \$34,941 in hogs in one year and \$11,000 in cash and \$41,272 in hogs another year and was all considered to be equivalent to the payment of cash compensation. n23 The exemption from payroll taxes was denied.

In another 1993 ruling, payments of grain to a married couple who were employees of their wholly-owned farm corporation were treated as the equivalent to cash. n24 To be fair, the grain was not removed to separate storage facilities nor was the couple charged for storage although the couple bore the risk of loss after payment and sold their

own grain. n25 In a 1994 TAM, payment of grain to a husband and wife as employees of their farm corporation were treated as the equivalent of cash even though the grain was removed to the employees own bins and was held for periods ranging from five to 60 days. n26 It is difficult to fault the way the wage issue was handled in the facts of that TAM. It was this ruling that triggered action by a group of Senators and Members of the House of Representatives and resulted in the move by the Commissioner of Internal Revenue to appoint a task force to examine the issue and make recommendations to the Commissioner.

IRS guidelines

The 1994 report n27 contained guidelines specifying that the validity of a plan for paying wages in kind with no liability for FICA, FUTA and income tax withholding is dependent upon a facts and circumstances test. The major factors identified in the guidelines are as follows

- . Whether the commodity is readily identified;
- . Whether there is documentation of the transfer of the commodity used for the payment in-kind (the commodity should not have been acquired solely for the purpose of paying wages in kind, also);
- . Whether the in-kind payment is intended to be a substitute for cash (the use of negotiable commodity storage receipts, generic commodity certificates and deferred payment or installment contracts are likely to be treated as equivalent to cash);
- . Whether the employee negotiates the subsequent sale of the commodity (it is near fatal if the commodity is sold at the same time, to the same buyer and in the same transport vehicle as the same or similar commodity sold by the employer); n28
- . Whether the risk of gain or loss is shifted to the employee after the wage payment (no hold-harmless provisions);
- . The length of time between the employees receipt of the commodity and sale of the commodity by the employee (although the concept of a minimum stated time period was rejected by the task force);
- . Whether the employee bears the costs incident to ownership of the commodity, for example, storage, feeding, insurance and maintenance costs; n29 note that expenses associated with the commodity used to pay wages in kind appear to be subject to the two-percent floor for employee business expenses; n30
- . Whether the commodity used for in-kind wage payment was either produced in the trade or business or acquired for use in the business;
- . Whether the commodity was sold to someone other than the employer (sale back to the employer is a clear negative);
- . Whether any security interest held by a creditor of the employer on the commodity or commodities used to pay employees was released formally. n31

Downside of paying wages in kind to agricultural labor

The payment of wages in kind clearly has a downside. Receiving a wage payment in kind reduces or eliminates social security benefits n32 and can reduce disability benefits. n33

Proposed legislation

In 1992, at the height of the IRS resistance to payment of wages in kind to agricultural labor, legislation was proposed to expand the definition of social security covered wages to include non-cash wages paid to agricultural labor. n34 The proposed legislation was included in a bill that was vetoed by President George Bush following the 1992 election.

Under the proposal, exceptions would have been provided for meals and lodging furnished on the premises of the employer to the employee, the employees spouse or any of the employees dependents. For seasonal workers, temporary lodging in reasonable proximity to the premises which is furnished to the employee, the employees spouse or any of the employees dependents would be covered. Non-cash wages would be subject to the tax thresholds then applicable to agricultural cash wages that were the lesser of \$150 per worker or \$2500 for the employer. n35

As noted, the legislation was not enacted into law and the proposal has not surfaced since the veto in 1992.

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n1 . *I.R.C. § 3121(a)(8)*. See generally 2 Harl, *Farm Income Tax Manual* § 8.02[1]b] (2007 ed.); 5 Harl, *Agricultural Law* § 36.02[3] (2008); Harl, *Agricultural Law Manual* § 4.06[2][a] (2008).

n2

[2]. *I.R.C. § 3121(a)(8)*.

n3

[3]. *I.R.C. § 3306(b)(1)*.

n4

[4]. *I.R.C. § 3401(a)(2)*.

n5

[5]. *I.R.C. § 3121(a)(8)*.

n6

[6]. *20 C.F.R. §§ 404.429(c)(3), 404.1055*.

n7

[7]. See Harl, *Farm Income Tax Manual* § 8.02[1][b][iii] (2007 ed.).

n8

[8]. IRS, Noncash Remuneration for Agricultural Labor, Market Segment Understanding Guidelines, December 20, 1994.

n9

[9]. The Market Segment Understanding Guidelines, December 20, 1994, have been published as Appendix A in 2 Harl, *Farm Income Tax Manual* (2007 ed.).

n10

[10]. See *Highway Farms, Inc. v. United States*, 02-1 U.S.T.C. . 50,281 (S.D. Iowa 2002) (payment of wages failed to qualify for exemption).

n11

[11]. E.g., *TAM 9428003*, April 5, 1994.

n12

[12]. *Id.*

n13

[13]. *Treas. Reg. § 1.83-6(a)(2)*.

n14

[14]. *Ltr. Rul. 9202003*, October 9, 1991.

n15

[15]. *I.R.C. § 1402(a)*.

n16

[16]. *Rev. Rul. 79-207, 1979-2 C.B. 351*.

n17

[17]. *Rev. Rul. 79-207, 1979-2 C.B. 351*.

n18

[18]. *TAM 8252018*, September 17, 1982.

n19

[19]. *Id.*

n20

[20]. *TAM 8738005*, June 5, 1987.

n21

[21]. *Id.*

n22

[22]. *TAM 9136001*, May 14, 1991.

n23

[23]. *TAM 9322003*, February 25, 1993.

n24

[24]. *TAM 9403001*, August 17, 1993.

n25

[25]. *Id.*

n26

[26]. *Id.*

n27

[27]. See note 7 *supra*.

n28

[28]. See *Highway Farms, Inc. v. United States*, 02-1 U.S.T.C. 50,281 (S.D. Iowa 2002) (wages-in-kind paid in form of hogs not successful in avoiding FICA tax; recipients did not market hogs separately, hogs transported to market and sold to same buyer on same terms; court said disguised cash transfer with sole purpose of tax avoidance).

n29

[29]. *Ltr. Rul. 9428003*, April 5, 1994; *Ltr. Rul. 9403001*, August 17, 1993.

n30

[30]. *I.R.C.* § 67.

n31

[31]. IRS, Noncash Remuneration for Agricultural Labor, Market Segment Understanding Guidelines, December 20, 1994, included as Appendix A in 2 Harl, *Farm Income Tax Manual* (2007 ed.).

n32

[32]. See discussion in 2 Harl, *Farm Income Tax Manual* § 8.06[3] (2007 ed.).

n33

[33]. *Id.*, § 8.06[5].

n34

[34]. H.R. 11, § 7005, 102d Cong., 2d Sess. (1992). See 2 Harl, *Farm Income Tax Manual* § 8.02[1][b] (2007 ed.).

n35

[35]. *I.R.C.* § 3121(a)(8)(B). See 2 Harl, *Farm Income Tax Manual* § 8.02[1] (2007 ed.).

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Dr. Harl has published widely including 28 books; more than 400 professional articles and bulletins; and more than 850 articles in farm and financial publications. He is author of the 15-volume treatise, *Agricultural Law* and the single volume *Agricultural Law Manual and Farm Income Tax Manual*; senior author of two *Tax Management Portfolios*--*The Family-Owned Business Deduction and Reporting Farm Income* and co-author of *Taxation of Cooperatives* and co-author of *Principles of Agricultural Law*.

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Dr. Harl has served on six federal advisory bodies a Farm Tax Reform Task Force for the U.S. Department of the Treasury in 1967; the Commissioner's Advisory Group (Commissioner of Internal Revenue) in 1979-80; the USDA Farm Structure Task Force in 1980; the Office of Technology Assessment, Technical Advisory Committee, by Congressional Appointment, 1987-1995 (chair in 1993-94); the USDA Advisory Committee on Agricultural Biotechnology, 2000-2002; and the Commission on Federal Payment Limitations in Agriculture, 2002-2003.

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Fink on Limitation on Deductions for Certain Business or Rental Use of a Home

2008 Emerging Issues 2355

Philip Fink on Limitation on Deductions for Certain Business or Rental Use of a Home

By Philip R. Fink

June 4, 2008

SUMMARY: Section 280A(c) establishes the exceptions whereby taxpayers are allowed to deduct certain expenses in connection with the business use of a home.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: *IRC Section 280A* lays out the rules when taxpayers can depreciate their personal residences, as well as deduct other home related expenses in connection with the business use of their homes. It makes no distinction between taxpayers who use their home or those taxpayers who use an apartment to conduct their business activities. Thus, qualifying taxpayers who use their apartments to conduct their business can deduct a portion of the expenses of their apartments that are associated with their businesses.

Section 280A(c) establishes the exceptions whereby taxpayers are allowed to deduct certain expenses in connection with the business use of a home.

Requirements. The requirements to qualify for a home office deduction depend on whether an individual is self-employed or an employee. However, in either case, in order to deduct expenses in connection with the business use of a home, it must be used on an exclusive and regular basis for trade or business purposes.

Caveat. The exclusive test takes into account the use of a space during the entire day. For instance, even if an individual is using a designated part of their home for business purposes from 9-5 Monday through Friday, it is not being used on an exclusive basis if a child of the individual uses the area for doing homework in the evenings. Likewise, even if the taxpayer is using his or her office on an exclusive basis during the weekdays, but uses the office to pay personal bills during the weekend, the office is not considered to be used exclusively for business.

Self-employed. Self-employed individuals may take a home office deduction if they use a designated part of their homes as a principal place of carrying on their business.

Employee. Individuals who are employees may take a home office deduction if they use a designated part of their homes as a place of business that is used to meet or deal with patients, clients, or customers in the normal course of conducting business.

Caveat. In the case of a taxpayer who is an employee, there is a further requirement that the use of the employees home to conduct business must be for the convenience of the employer. For employees such as traveling sales people, it is not practical for an employer to provide an office. Thus, employees who maintain offices in their homes are deemed to do so for the convenience of their employers.

Special rule for a separate structure. Individuals can claim a home office deduction for trade or business use of a separate structure which is appurtenant to their home. For instance, if a self-employed individual kept supplies or inventory in a detached garage, he or she may deduct all of the expenses in connection with the garage including depreciation. Also, if a sales representative kept samples in a detached garage, the home office deduction would be allowable.

Investment use of home is not deductible. Many taxpayers have a home in their office that they use for their investments such as reading various books and journals on investments, tracking their investments, and filing transaction confirmations and quarterly reports. This use of an office does not constitute a trade or business; therefore, the expenses associated with this use of the office are not deductible.

Proportionate use of home for trade or business purposes. Generally, individuals are allowed to deduct home office expenses to the extent that the square footage of the area that is used for the office bears to the square footage of the entire house. Of course, those expenses that are direct expenses of the business such as office supplies or a cell phone dedicated to business use are fully deductible.

Example. Sarah has a qualifying use of a home office which has 200 square feet. Her entire home has 2,000 square feet. Accordingly, ten percent of her qualifying home expenses can be deducted. If Sarah's homeowners insurance is \$1,000, then \$100 ($\$1,000 \times 10\%$) can be deducted as a home office expense.

Home office expenses that are deductible. If a taxpayer qualifies to take the home office deduction, the following expenses can be deducted for that portion of a home that is used for trade or business purposes:

- . casualty losses
- . depreciation/rent
- . homeowners insurance
- . mortgage interest
- . real estate taxes
- . repairs
- . security systems
- . utilities

Telephone. Taxpayers that qualify to deduct various home expenses in connection with their trade or business cannot deduct the local portion of telephone charges related to the business. However, all long distance charges related to the business are deductible. If a taxpayer has a separate line for business use only, such an expense is deductible. Expenses of a cell phone that are used only for business purposes are deductible.

Lawn care. The cost of maintaining a lawn could be very expensive depending on the size of one's yard. However, the expenses of lawn care are deemed inherently personal, and cannot be considered part of the home office; and therefore, are not deductible.

Limitation of deduction. For purposes of claiming the home office deduction, expenses fall into three categories:

1. expenses directly related to the trade or business,
2. expenses that can be itemized such as mortgage interest and real estate taxes, and
3. depreciation related to the portion of the home used as the office.

The first category of expenses is deducted from the gross income of the trade or business. If the gross income is greater than the expenses in the first category, then the expenses in the second category are deducted to the extent of the excess. If the amount of the gross income from the business is greater than the expenses in the first two categories, then depreciation can be deducted to the extent of any excess.

Example. Natalie has a business that she operates out of her home. She qualifies for the home office deduction, and she uses 10% of her home for business purposes. The gross income from her business is \$10,000. Her direct expenses of the business amount to \$7,000. The portion of mortgage interest and real estate taxes related to her business amount to \$2,600. The depreciation on the business use of her home is \$1,000. Accordingly, she can only deduct \$400 (\$10,000 -- \$7,000 -- \$2,600) of depreciation.

Depreciation recapture of the sale of a residence. Those individuals who took depreciation deductions in connection with the business use of their homes cannot exclude the part of the gain on the sale of the residence attributable to depreciation. Gain has to be reported as unrecaptured depreciation on Form 4797 even if the home office deduction was *not* taken in the year of sale. A special rule taxes this gain at the lesser of two tax rates, either an individual's ordinary tax rate or 25%.

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Fink On Recomputation of Excess Front-Loading of Alimony Payments

2008 Emerging Issues 2327

Philip Fink On Recomputation of Excess Front-Loading of Alimony Payments

By Philip R. Fink

May 27, 2008

SUMMARY: In order to make sure that property settlements are not disguised as alimony, a special rule was put into law which is applicable for those divorces entered into after 1986 if payments within the first three years decline by more than \$15,000.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: *IRC Sections 71(c)* and (f) define alimony or separate maintenance payments and the tax treatment for both payors and payees. It is important to distinguish alimony or separate maintenance on the one hand from property settlements and child support payments on the other hand, since they are treated differently.

Alimony or separate maintenance. In order for payments to be considered alimony or separate maintenance, these payments must:

- . be made under a divorce or separation decree,
- . be paid in cash,
- . not continue after the death of the payee spouse.

Tax treatment. If payments qualify as alimony or separate maintenance, the payee must include them in gross income, and the payor is entitled to a deduction off-the-top. This is different than the tax treatment when there is a property settlement. If the parties incident to a divorce decide on a property settlement rather than alimony, the transfer is treated as if it was a gift. Thus, the transferor has no deduction and the transferee has no gross income. Another substantial difference is the fact that typically, a property settlement occurs immediately after the divorce is granted. In contrast, alimony or separate maintenance payments are typically made over a long period of time. Therefore, in deciding whether alimony or separate maintenance payments should be made or a property settlement entered into, both the tax implications and the time value of money should be considered.

Example. David is in the process of getting divorced from his wife, Janet. The parties can settle on one of two alternatives. The first alternative is a property settlement of \$200,000 that will occur immediately upon the divorce becoming finalized. The second alternative is alimony payments of \$25,000 a year for ten years, or until Janet dies or

remarries, whichever comes first. Assume that David is in the 35% tax bracket and that for purposes of calculating the present value of money, an interest rate of 6% will be used. Even though the total amount of the alimony payments (\$25,000 x 10 = \$250,000) exceed the amount of a property settlement by \$50,000 (\$250,000 -- \$200,000), the present value of the after tax payments of the alimony alternative are \$80,399 (\$200,000 -- \$119,601) less than a property settlement:

Property settlement

Alimony payments

annual alimony payments

after tax percentage (1 - 35%)

annual after-tax payment

present value factor for an annuity (ten years, 6%)

present value of after-tax payments

\$ 200,000

\$ 25,000

65 %

16,250

7.3601

\$ 119,601

How reported on Form 1040. A recipient of alimony payments must report them on Form 1040, line 11. Payors of alimony report their deductions (off-the-top) on line 31a. In order to properly complete the form, it is necessary for the payor of the alimony to provide the social security number of the payee.

Form over substance. If the terms of a divorce or separation instrument specify that payments are not alimony, then the payee will not be required to report alimony payments. In a consistent fashion, the payor will not be allowed to take a deduction for such payments.

Drafting tip. If the parties don't intend for certain payments to be considered alimony, they should explicitly indicate that in the decree of divorce or separate maintenance. By the same token, if the parties intend that payments be considered alimony, it should be explicitly mentioned in the decree.

State income taxes. In many states, the income tax is predicated on an individual's federal adjusted gross income with some adjustments. Accordingly, those payors who live in a high income tax state will get a double benefit: a deduction off-the-top for federal tax purposes, plus a deduction for state income tax purposes. Of course, the payees of alimony incur a double burden: these payments get taxed at both the federal level and the state level.

Legal fees associated with divorce. Legal fees associated with a divorce are generally not deductible. However, those legal fees associated with determining the tax effects of a divorce are deductible. Accordingly, if an attorney itemized the various charges associated with a divorce, then any fees connected with the tax determination of a divorce are deductible. Thus, an attorney who specifically charges for drafting the alimony provisions to maximize the after-tax benefits for their clients enables them to take a deduction for that part of the fees related to the tax determination.

Differentiated from child support payments. Child support payments are treated differently than alimony or separate maintenance payments. The payor of child support cannot take a deduction. In a consistent manner, a divorced parent who receives child support payments on the behalf of a child does not have to include it in his or her gross income.

Planning for estimated tax payments or withholding. When parties enter into an agreement where alimony is going to be paid, tax advisers should determine if their clients need to redetermine the amount of estimated payments they are making, and/or to adjust the amount of their withholding.

Example. Jeff and Carol have been married for six years, and they have two children. They get divorced, and Jeff is required to make alimony payments of \$3,000 a month and child support payments of \$2,000 a month. Prior to the divorce, Jeff was a supervisor for a manufacturing company earning \$120,000 a year, and Carol was a stay at home mom with no gross income. After the divorce, Carol will have gross income from alimony of \$36,000 ($\$3,000 \times 12$) a year that she will have to report and pay taxes on. Since she has had no withholding or has made no estimated tax payments in the past, it is important that she makes timely estimated tax payments in order to avoid incurring underpayment penalties. In addition, Jeff should reduce the amount withheld from his paycheck since the alimony payments that he is making will result in a substantial reduction of his tax liability.

Rule against front-loading. In order to make sure that property settlements are not disguised as alimony, a special rule was put into law which is applicable for those divorces entered into after 1986 if payments within the first three years decline by more than \$15,000. This three year period is called the post-separation years. The first post-separation year is the first calendar year in which alimony is paid under a decree of divorce or separate maintenance. The second and third post-separation years are the next two calendar years after the first post-separation year.

Recapture for the second-year payment is computed *first*. This is the excess, if any, of the second-year payment over the third-year payment, *minus* \$15,000. Recapture for the first-year payment is computed next. There is recapture if the first-year payment exceeds by more than \$15,000 the average payment made in the second and third years. In calculating the average payment, the second-year payment must be reduced by the amount recaptured for the second year.

If any amounts of alimony are required to be recaptured, it will be included on the line for reporting alimony income in the *third* year.

Example. In 2007, Herb obtains a divorce and makes his first alimony payment of \$100,000. In 2008, he pays \$40,000 and in 2009, he pays nothing. On his 2009 return, \$102,500 is recaptured as follows:

Recapture of 2008 payment

payment in 2008

less: payment in 2009

less: threshold

recapture for 2008

Recapture of 2007 payment

average calculation:

payment for 2008 and 2009

less: recapture in 2008

Payment in 2007

less: average payment for 08 & 09 after taking into account the recapture for 2008 (\$15,000/2)

less: threshold

Recapture for 2007

Total recaptured in 2009:

From 2008

from 2007

\$ 40,000

-- 25,000

15,000

7,500

15,000

\$ 40,000

-- 0

-- 15,000

\$ 25,000

\$100,000

22,500

\$ 77,500

\$25,000

77,500

\$ 102,500

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Campbell on Badaracco et al. v. Commissioner

2008 Emerging Issues 2317

Alan D. Campbell on Ernest Badaracco, Sr. et al. v. Commissioner

By Alan D. Campbell

May 20, 2008

SUMMARY: Alan Campbell comments on a non-fraudulent amended income tax return filing that follows a fraudulent return, the impact on the three-year statute of limitations, and related issues.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Facts of the Case. This commentary on the decision by the Supreme Court of the United States in *Ernest Badaracco, Sr., et al. v. Commissioner*, 464 US 386, 84-1 USTC 9150 (USSC, 1984) *affg* CA-3, 82-2 USTC 9697 (1983) addresses the issue of whether the filing of a non-fraudulent amended return after the filing of a fraudulent original return starts the running of the three-year statute of limitations on assessment under Section 6501(a).

Petitioners Ernest Badaracco, Sr. and Ernest Badaracco, Jr. operated an electrical contracting business as a partnership. They filed fraudulent partnership and individual income tax returns for calendar years 1965 through 1969. After federal grand juries subpoenaed the partnerships books and records, they filed non-fraudulent amended returns for the tax years at issue and paid the additional taxes due.

Ernest Badaracco, Sr. and Ernest Badaracco, Jr. were later indicted for filing false and fraudulent returns in violation of Section 7206(1). They each pled guilty to the charge with respect to the return for 1967 and the remaining counts were dismissed. The U.S. District Court for New Jersey entered judgments of conviction against them (*United States v. Badaracco*, Crim. No. 766-71 (DNJ)).

On November 21, 1977, the IRS mailed Ernest Badaracco, Sr. and Ernest Badaracco, Jr. notices of deficiency for each of the tax years at issue. They filed petitions in the U.S. Tax Court to contest the proposed deficiencies.

The Court heard *Badarocco* together with *Deleet Merchandising Corp. v. United States* (No. 82-1509). Petitioner Deleet Merchandising Corp. filed its corporate income tax returns for tax years 1967 and 1968 on time, but the returns failed to include some revenues from the corporations printing supply business. On August 9, 1973, the corporation filed amended returns for 1967 and 1968, which informed the IRS of the revenues it failed to report on the original returns. The government never charged Deleet Merchandising Corp. with any tax crimes, but it did pursue criminal and civil investigations on some former officers of the corporation. On December 14, 1979, the IRS issued a notice of deficiency to Deleet Merchandising Corp. for tax years 1967 and 1968.

Deleet Merchandising Corp. paid the assessments and then sued for a refund in the U.S. District Court for the District of New Jersey. Deleet Merchandising Corp. moved for summary judgment on the grounds that the three-year statute of limitations under Section 6501(a) barred the assessment because it was more than three years after the corporation filed the amended returns. The U.S. District Court granted the corporations motion for summary judgment based on *Klemp v. Commissioner*, 77 TC 201 (1981) appeal then pending but later *revd* and *remd* 84-1 USTC 9248 (CA-9, 1984) and on *Dowell v. Commissioner*, 80-1 USTC 9216 (CA-10, 1980).

The Arguments by the Petitioners. The petitioners argued that they were liable only for the addition to the tax for the 50-percent civil fraud penalty under Section 6653(b). (The civil fraud penalty is now 75 percent of the taxes not paid due to fraud under Section 6663.) They argued that the three-year statute of limitations on assessment of Section 6501(a) barred the IRS from assessing additional tax other than the civil fraud penalty. They argued that the provision of Section 6501(c)(1) that provides for no statute of limitations on a fraudulent return did not apply to them because they filed non-fraudulent amended returns. They claimed that the three-year statute of limitations on assessment began on the date that they filed the non-fraudulent amended returns. Deleet Merchandising Corp. argued that the filing of a fraudulent return should merely suspend the statute of limitations pending the taxpayers correction of the fraud.

The U. S. Tax Court ruled in favor of the petitioners Ernest Badaracco, Sr. and Ernest Badaracco, Jr. based on its decision in *Klemp v. Commissioner*, 77 TC 201 (1981). The Commissioner appealed the decisions of the U.S. Tax Court and the U.S. District Court for the District of New Jersey to the U.S. Court of Appeals for the Third Circuit, which reversed the decisions of the trial courts (*Badaracco v. Commissioner*, 82-2 USTC 9697 (1982)). The ruling by the Third Circuit was consistent with the ruling by the Fifth Circuit in *Nesmith v. Commissioner*, 83-1 USTC 9239 (1983), but it was contrary to the decision by the Second Circuit in *Britton v. United States*, 81-2 USTC 9739 (DC Vt., 1981) *affd* CA-2 in an unpublished opinion (1982). Because of this conflict, the Supreme Court of the United States granted certiorari.

The Courts Ruling. The Supreme Court of the United States affirmed the decision of the U.S. Court of Appeals for the Third Circuit. The court ruled that the filing of a non-fraudulent amended return after the filing of a fraudulent original return does not start the running of the statute of limitations on assessment.

The Court cited its decision in *E. I. DuPont de Nemours Co. v. Davis*, 264 US 456 (1924) in stating that statutes of limitations that litigants seek to impose against the government must receive a strict construction in favor of the government. The Court stated that the language of Section 6501 was clear on its face. The Court stated that Ernest Badaracco, Sr. and Ernest Badaracco, Jr. admitted to filing fraudulent returns and that Section 6501(c)(1) did not provide for any exception in the case the taxpayer filed a non-fraudulent amended return. In addition, the court stated that the Internal Revenue Code nowhere explicitly calls for the filing of an amended return nor the Commissioners acceptance of an amended return. The Court reasoned that because the Internal Revenue Code does not explicitly provide for the filing of an amended return that Section 6501(c)(1) means that the IRS may assess additional tax at any time in the case of a false or fraudulent original return. The Court noted that until the decision by the U. S. Court of Appeals for the Tenth Circuit in *Dowell v. Commissioner*, 80-1 USTC 9216 (1980) *revg* Tax Court, 68 TC 646 (1977) that courts had consistently ruled that Section 6501 applied to the taxpayers original return and not to an amended return.

The Court further stated that the fraud provisions of the Internal Revenue Code confirmed its conclusion that Section 6501(c)(1) allows assessment at any time notwithstanding the taxpayers repentance by filing a non-fraudulent amended return. The Court cited the cases of *United States v. Habig*, 68-1 USTC 9243, 390 US 222 (1968) and *Plunkett v. Commissioner*, 72-2 USTC 9541 (CA-7, 1972) in stating that once a taxpayer commits fraud, the taxpayer does not purge the fraud by a subsequent voluntary disclosure. Otherwise, the Court reasoned that a taxpayer could file a

fraudulent return and if the IRS ever began to investigate the fraudulent nature of the return, the taxpayer could avoid the fraud penalty by filing a non-fraudulent amended return.

The Court stated that if taxpayers who filed a fraudulent original return could start the running of the three-year statute of limitations on assessment, they would be in a better position than a taxpayer who filed a non-fraudulent original return but who omitted gross income on the return greater than 25 percent of the gross income shown on the return. Section 6501(e) provides for a statute of limitations on assessment of six-years from the later of the date the return was due or filed statute if a taxpayer omits gross income greater than 25 percent of the gross income shown on the return.

The Courts reasoning here appears to be incomplete because the Court simply stated that a taxpayer in such a case who filed an amended return could not start the running of the statute of limitations by filing an amended return. Nowhere does Section 6501(e) address the possibility of an amended return. If a taxpayer who filed a fraudulent original return or a taxpayer who filed a non-fraudulent original return that omitted gross income greater than 25 percent of the gross income shown on the return could each start the running of the three-year statute of limitations on assessment by filing an amended return, they would receive substantially equal treatment.

Section 6501. Section 6501(a) provides that the IRS may assess additional tax at any time within three years after the taxpayer files a return. Section 6501(b)(1) provides that if the taxpayer files a return before its due date, for purposes of Section 6501, the taxpayer will be deemed to have filed the return on its due date. Therefore, the IRS has three years from the later of the date the return is due or the date the taxpayer files the return to assess additional tax. Section 6501(c)(1) states that if the taxpayer files a false or fraudulent return with the intent to evade tax, the IRS may assess additional tax at any time. Likewise, Section 6501(c)(2) provides that in the case of any attempt to defeat or evade a tax, the IRS may assess additional tax at any time. Section 6501(c)(3) states that if the taxpayer does not file a return, the IRS may assess tax at any time. Section 6501(e) states that if a taxpayer omits gross income greater than 25 percent of the gross income shown on the return, the statute of limitations is six years from the later of the date the return was due or the date the taxpayer filed the return.

Caution for Practitioners. Practitioners must be careful not to file an amended tax return for a client who is under criminal investigation or indictment for tax crimes. The government could use the fact that the taxpayer filed an amended return in such circumstances as evidence against the taxpayer in a criminal trial. A taxpayer under criminal investigation or indictment for tax crimes should not file an amended return except on the advice of a competent attorney who is experienced in representing clients in criminal tax cases.

Practitioners should exercise care in filing an amended return that shows an additional tax liability within 60 days of the expiration of the statute of limitations on assessment even though the original return was not fraudulent. Section 6501(c)(7) provides that in such circumstances, the statute of limitations on assessment is extended for a period of 60 days after the IRS receives the amended return.

Best Practices. Best practice dictates that a practitioner should provide guidance to clients who are under investigation or indictment for tax crimes not to speak to the practitioner unless the practitioner is an attorney. Rather, practitioners who are not attorneys should urge the client to seek representation by a competent attorney who is experienced in representing clients in criminal tax cases.

Although Section 7525(a)(1) provides that a CPA, enrolled agent, or other federally authorized tax practitioner enjoys privileged communications regarding tax planning, Section 7525(a)(2) limits the privilege to non-criminal tax

matters. Therefore, a CPA, enrolled agent, or other federally authorized tax practitioner does not have privileged communication in criminal tax cases. A clients communications with an attorney regarding legal advice are subject to the attorney-client privilege. Neither attorneys nor other tax practitioners enjoy any privilege with respect to tax preparation work (*United States v. Richard Frederick et al.*, 99-1 USTC 50,465 (CA-7, 1999)). A CPA, enrolled agent, or other federally authorized tax practitioner may enjoy privileged communications if the tax practitioner works under the direction of the clients attorney using a properly drafted *Kovel* letter based on *United States v. Kovel*, 62-1 USTC 9111 (CA-2, 1961) in helping the attorney to provide legal advice. Work under a *Kovel* agreement has its limits so a tax practitioner must be very careful in working under the direction of an attorney pursuant to such an agreement.

Practitioners should also provide guidance that the taxpayer may not avoid the civil fraud penalty or a criminal penalty after being subjected to the other on the grounds of the Double Jeopardy Clause of the Fifth Amendment to the U. S. Constitution. The imposition of criminal penalties in addition to the civil fraud penalty would not violate the double jeopardy clause of the Fifth Amendment to the U. S. Constitution because a civil penalty is considered a remedial penalty rather than punitive (*Hudson v. United States*, 522 US 93 (1997)).

Conclusion. The main lesson to be learned from this case is that a taxpayer should never file a fraudulent return. The taxpayer should always file an honest original return. Filing a fraudulent return can subject the taxpayer to both civil and criminal penalties. The filing of a non-fraudulent amended return does not start the running of the statute of limitations on assessment.

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Dialani on Issues Regarding Taxation of Foreign Institutional Investors in India

2008 Emerging Issues 2282

Jyoti Dialani on Crucial Issues Regarding the Taxation of Foreign Institutional Investors in India

By Jyoti Dialani

May 12, 2008

SUMMARY: Jyoti Dialani, a Tax Counsel in India, throws some light on the crucial issues surrounding tax implications affecting Foreign Institutional Investors (FIIs) in India and elucidates the impact of various judicial opinions, amendments in the tax law and CBDT circulars on classification of income of FIIs from transfer of securities on tax liabilities of FIIs.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Tax Implications on the Transfer of Securities in Light of Recent Developments. Until recently, the tax environment concerning portfolio investments by Foreign Institutional Investors (FIIs), one of the major portfolio investors in Indian capital markets, was showing signs of being settled. However, the current scenario concerning tax laws impacting FIIs has been reflecting a great deal of uncertainty with some past political intention sailing towards pressing for modifying double taxation agreements with certain host countries of FIIs amidst deliveries of conflicting judicial opinions on the issue of character of income. However, a very recent announcement made by the government to not proceed with its earlier intention of amending the double taxation agreements has put an end to the controversy over tax incentives to FIIs registered in those countries. In the wake of the announcement, although some FIIs have a reason to breathe easy, certain crucial issues relating to the taxability of income from securities and on their transfer are still unsettled and would provide a relief if a clarification is issued by the government on the same. This commentary seeks to touch upon the present judicial opinion on the classification of income of FIIs from transfer of securities and legislative provisions relating thereto.

FII investments in India. A pressing need to provide an impetus to the Indian capital markets led to changes in policies announced by the government of India by liberalizing and opening up the economy to foreign countries. This led to the entry of Foreign Institutional Investors (FIIs) in India in the year 1992. To encourage foreign investments in India, the government also introduced a concessional tax regime for capital gains earned by FIIs as part of the overall regulatory framework in which they could operate. In current times, India is gaining a coveted place amongst the fastest growing economies in the world and needs foreign capital inflows in order to sustain growth of its capital markets. FII investments are critical to the growth and strength of the Indian capital markets. Keeping the importance of this need in mind, Indian laws permit offshore companies to invest in equity shares, which are traded on Indian stock markets if they are registered as FIIs or if they have a sub-account in India. Investment in Indian securities can be done by these FIIs through purchase of financial instruments such as Global Depository Receipts (GDR), American Depository Receipts

(ADR), Foreign Currency Convertible Bonds and Foreign Currency Bonds issued by Indian issuers. These securities are listed and traded overseas and are mainly denominated in U.S. dollars.

Tax incidence on transfer of securities. It is beyond doubt that for promoting any investment activity, a clear and stable tax and regulatory regime is a must. The Indian government also recognizes that to promote the growth of its capital markets and for the overall development of its financial system, portfolio investments, both domestic and foreign, need to be encouraged. In keeping with this imperative, a number of measures on the tax front have been introduced to encourage portfolio investments since the 1990s. Unfortunately, despite attempts to provide impetus to capital inflows, since implementation of measures has been inconsistent and one lacking concentrated efforts, in the midst of several rules, regulations and conflicting judgments, it has created an ambiguous and unstable tax environment for various investors. In the circumstances, it is only expected of offshore companies to decide the volumes of their investments on the basis of the tax climate existing within the country at any given point in time. The overall tax climate affecting FIIs in turn is impacted by several factors, such as classification of income earned by a FII, existence of tax treaties of India with the country where a FII is based, existence of a permanent establishment of a FII in India, etc.

Tax provisions governing FIIs. Any profits made by a FII on a sale of securities held by it would be taxable under the heading "Capital Gains." Section 115 AD of the Income tax Act, 1961ⁿ¹ (the Act) provides the scheme for taxation of FII income earned from securities or by way of long-term capital gain or short-term capital gain arising from a transfer of securities. Different rates of tax are prescribed by the Act depending on lengths of time for which such securities are held before transfer. If the transfer of any share, security or any unit of a mutual fund is affected within a period of twelve months of its purchase, the gains resulting from such transfer are in the nature of short term and a transfer after a period of twelve months attracts a long-term capital gains tax on the profits on such transaction.

Clause (ii) of subsection (1) of section 115AD of the Act provides that short-term capital gains would be taxed at 30% and without conversion of cost of acquisition by indexation and on full value of consideration in foreign currency. The proviso to clause (ii), however, prescribes a rate of ten percent tax on short-term capital gains on transfer of equity shares in a company or a unit of an equity oriented fund as specified in section 111A of the Act. Clause (iii) of subsection (1) of section 115AD of the Act provides a rate of 10% on any long-term capital gains to a FII on a transfer of securities other than units purchased in foreign currency. The rate of tax is calculated on the gains made without applying an indexation formula on the cost of acquisition. The benefit of indexation is specifically not provided to such transactions by virtue of section 115AD(3) of the Act which excludes the application of first and second provisos to section 48 on the computation of capital gains to FIIs.

The Union Budget of 2008ⁿ² has brought about an amendment to clause (ii) of subsection (1) of section 115AD increasing the rate of tax on short-term capital gains on transfer of securities to 15 percent by bringing about an amendment to section 111A and section 115AD with a view to encourage investors to stay invested for a longer term. Such gains will continue to be calculated without indexation of cost of acquisition. The said rates would be subject to applicable tax treaty relief and would be increased by applicable surcharge.

Options to FIIs: Income tax Act or Double Taxation Avoidance Agreement. A non-resident can opt to be governed by the provisions of the Act or by the Double Taxation Avoidance Agreement (DTAA), whichever is more beneficial. For example, India has a DTAA with countries such as Mauritius and Cyprus which provides that the capital gains arising in India from the sale of securities held by FIIs based in such countries would be taxed only in those countries and exempt in India. Since both these countries do not have any capital gains tax in force, such gains are practically tax exempt for such FIIs. This beneficial element gradually led to the misuse of the treaties. Many companies started resorting to "treaty shopping," which is a practice whereby residents of a third country take advantage of a beneficial tax treaty between two countries -- in this case India and Mauritius or India and Cyprus -- to lower their tax liability. Companies in third countries established their companies in tax havens such as Mauritius and Cyprus and routed investments into Indian stock markets through these countries thereby resulting in huge tax savings. According

to market analysts, about 30% of American funds come to India through Mauritius and the remaining portion invests directly into Indian equities. Active FIIs account for only about 11% of the total FII registrations. The flip side of this practice is that the Indian government suddenly sat up and took stock of the huge loss of tax revenues on these capital gains. Before the announcement of the Union Budget this year, the Income Tax Department was pressing for the inclusion of a "limitation of benefit" clause in the DTAA with Mauritius whereby the benefit of the treaty would only be limited to qualified residents in either of the states. The Indo-Mauritius DTAA does not contain provisions such as limitation of benefits and "no abuse" provisions which are incorporated in treaties with countries like the United States. This would mean that residents of a third country would not be able to take advantage of a treaty between India and Mauritius and route their investments through Mauritius to save on tax. The present government had, on assuming power in the year 2004, made a commitment in its Common Minimum Program (CMP) to implement measures to check misuse by way of this practice of treaty shopping. As a follow-up measure, the government was in talks with Mauritius to rework the tax treaty. The renegotiation of the double taxation regime with some of these countries has been under consideration for a long time. In fact, the situation had become more serious when India signed a protocol with Singapore containing anti-abuse provisions to check treaty shopping. India has also signed a recent protocol with UAE, whereby the capital gains on a transfer of Indian securities by a UAE-based FII has been made chargeable to tax in India. However, in the case of Mauritius, there was a lot at stake on the revenue front. The government was also aware of the fact that any such sudden change in policies could lead to a downswing in the stock markets owing to negative repercussions on the capital markets in India and investments of companies having subsidiaries in Mauritius. One option which was also being recommended was the introduction of a cut-off period or sunset clause, after which the benefits which flow from the present agreement would cease. This would ensure that the companies affected get prepared for a regime where capital gains are taxed. However, since this controversy arose, the net investment by FIIs had been on the downswing. FIIs here were unable to remit funds from India as chartered accountants refused to issue certificates due to uncertainty on the treatment of their tax liability. Anticipating a further slowdown in the markets, the Finance Minister, as a measure of damage control, sought to put an end to the controversy surrounding tax incentives to FIIs registered in Mauritius on April 5 this year. This announcement, made close on the heels after the Union Budget, states that the capital gains earned by an investor from Mauritius would be taxable only in Mauritius. The government also announced the cancellation of tax demands raised earlier on 24 FIIs which were denied the benefits of the Indo-Mauritius tax treaty. It further assured those companies who were served with tax demand notices that their cases would not be re-opened. This has provided the much needed breather to all those companies, domestic as well as offshore, registered or having subsidiaries established in Mauritius and with heavy investments in Indian stocks.

The big question: Business Income or Capital Gains? Any inclination of the government to reconsider the tax regime of FIIs will always invite a lot of criticism and debate. The characterization of income earned by FIIs from investing into capital markets is an important factor in determining the volumes and inflows of foreign investment in Indian stock markets. Such income from a transfer of securities could be characterized as "business income" or "capital gains." However, the tax authorities in India always rely on the characterization of income. From time to time, various courts and appellate authorities have enunciated various tests for determining the above question. Since FIIs realize gains or losses on investments made in the ordinary course of business, it has always been a debatable issue whether the gain or loss should be assessed as business income or as capital gains. However, in practice most FIIs have to date taken the position that the gains realized on sale of securities are in the nature of capital gains and subjected to tax at the concessional rates specified in the Act. This position has for the most part been accepted by the revenue authorities. However, depending on the facts of each case, such as securities being held as trading assets, the income could be characterized as business income. Since the treatment of such income as business income or capital gains lies in the hands of the assessing officer assessing such income, it could lead to further confusion and enormous litigation as there will be as many conflicting treatments as there are assessing officers. As a consequence of this, some FIIs would be put in a worse off situation than others as those FIIs registered in "unfavorable" treaty jurisdictions will certainly be liable to pay a heavier burden of tax as compared to those registered in "favorable" treaty jurisdictions as also certain domestic investors.

Judicial opinions. In the preexisting environment of the ongoing debate whether income earned by FIIs from transfer of securities should be treated as capital gains or business income, certain FIIs approached the Authority for Advance Rulings n3 (AAR) for a ruling seeking to characterize the gains from transfer of securities as business income, since foreign taxpayers established in a country with which India has entered into a tax treaty are not subject to tax on business profits earned in India in the absence of a permanent establishment. The subject matter of consideration before such authorities was the distinction between capital gains and business income. The AAR has initially delivered several rulings, where it has held that the investment income earned by FIIs is business income. However, in recent rulings, based on facts of the specific FIIs, the AAR held that gains earned should be regarded as capital gains.

The AAR Ruling in the case of *In re Fidelity Advisor Series VIII*. In one of the early rulings involving FIIs, in *In re Fidelity Advisor Series VIII*[4] (Fidelity VIII), the AAR examined the question as to whether the income from portfolio companies and the gains arising from the sale of portfolio investment in India would be treated as business income. The AAR examined various aspects relevant to the case such as the object of Fidelity VIII under the Declaration of Trust, its registration with SEBI, n5 and the enormity and frequency of purchases and sales of securities. The AAR concluded that Fidelity VIII held shares as business assets and the profits from the purchase and sale of shares were in the nature of business income. In the background of its classification, the AAR ruled that the income of the applicant FII would be business income based on the factual position that it held its investments as stock-in-trade and it was trading in shares with the motive of earning a profit. Subsequently, the AAR pronounced its ruling in *In re Morgan Stanley & Co. International Ltd.*, n6 in which the AAR addressed the same question as in Fidelity VIII's case except for the fact that securities were derivative contracts. The AAR held that the income from the sale of the derivatives should be characterized as business income. In a case where the income is characterized as business income, one would need to examine whether the concerned FII has a permanent establishment in India, and in a case where it does, then such FII would be liable to normal rates of taxes on such income in India.

The AAR Ruling in the case of *Fidelity Northstar Fund v. DIT*. Recently, in the case of *Fidelity Northstar Fund v. DIT*, n7 the AAR examined various regulatory aspects of foreign investments and, while referring to the decision of the Supreme Court in several cases, reiterated the principles enunciated in the case of Fidelity VIII.

It laid emphasis on the following principles:

"(i) Where a company purchases and sells shares, it must be shown that they were held as stock-in-trade and that existence of the power to purchase and sell shares in the memorandum of association is not decisive of the nature of transaction;

(ii) the substantial nature of transactions, the manner of maintaining books of accounts, the magnitude of purchases and sales and the ratio between purchases and sales and the holding would furnish a good guide to determine the nature of transactions;

(iii) ordinarily the purchase and sale of shares with the motive of earning a profit, would result in the transaction being in the nature of trade/adventure in the nature of trade; but where the object of the investment in shares of a company is to derive income by way of dividend etc. then the profits accruing by change in such investment (by sale of shares) will yield capital gain and not revenue receipt."

Dealing with the above three principles, the AAR has observed in the case of Fidelity group as follows:

We shall revert to the aforementioned principles. The first principle requires us to ascertain whether the purchase of

shares by a FII in exercise of the power in the memorandum of association/trust deed was as stock-in-trade as the mere existence of the power to purchase and sell shares will not by itself be decisive of the nature of transaction. We have to verify as to how the shares were valued/held in the books of account i.e. whether they were valued as stock-in-trade at the end of the financial year for the purpose of arriving at business income or held as investment in capital assets. The second principle furnishes a guide for determining the nature of transaction by verifying whether there are substantial transactions, their magnitude, etc., maintenance of books of account and finding the ratio between purchases and sales. It will not be out of place to mention that regulation 18 of the SEBI Regulations enjoins upon every FII to keep and maintain books of account containing true and fair accounts relating to remittance of initial corpus of buying and selling and realizing capital gains on investments and accounts of remittance to India for investment in India and realizing capital gains on investment from such remittances. The third principle suggests that ordinarily purchases and sales of shares with the motive of realizing profit would lead to inference of trade/adventure in the nature of trade; where the object of the investment in shares of companies is to derive income by way of dividends etc., the transactions of purchases and sales of shares would yield capital gains and not business profits.

The AAR, by its ruling, made it clear that the actual determination of the nature of transaction was a mixed question of law and fact. On a thorough examination of the facts of the applicants case, the AAR concluded that in view of the specific facts, the applicant, being a FII, the shares were held by it as capital assets and not as business assets. The AAR analyzed the circumstances and framework of FII regulations, the SEBI norms, the RBI regulations and the Income-tax law and concluded from a consolidated study that a FII is not registered for the purpose of carrying on trading activities in securities. It held that a FII could invest in securities in India only for the purpose of earning income through dividends and interest and resulting capital gains on their subsequent transfer, but could not carry on trading in securities. This ruling of the AAR has found favor with many FIIs and is a welcome decision being appreciated by most professionals who believe that the ruling holds merit in treating the income of the FIIs from transfer of securities as capital gains. However, the overall treatment of such gains would ultimately depend on the facts and circumstances of each case. Some experts have also criticized the ruling as it is felt that the basis of classification of such income, being the FII and SEBI regulations, is not totally in place with the overall scheme of things.

Role of the Central Board of Direct Taxes. n8 Since the growth of the Indian economy, the stock markets have witnessed high inflows of investments in capital markets through the FIIs over the last few years. With the numbers of FIIs registered with the SEBI growing rapidly and a corresponding rise in investments, the Central Board of Direct Taxes (CBDT), which is the apex tax administration authority in India, has shown inclinations towards maximizing its tax revenues from the FIIs. The CBDT issues circulars from time to time which are regarded as a guide for the interpretation of the Indian direct tax laws. By virtue of the provisions of section 119 of the Act, the CBDT is authorized to issue orders, instructions and directions and circulars which carry binding effect on income tax authorities employed in the execution of the Act. They carry a guidance value and are not binding on the assessee and the courts. It is an accepted law that the courts cannot be bound by circulars issued by the CBDT, as it would make their constitutional powers to decide and interpret the laws redundant. The Supreme Court has unequivocally held that the circulars issued by the CBDT cannot preempt a judicial interpretation of a provision of the Act as interpretation of the laws is and will be the exclusive domain of the courts. A circular cannot be interpreted in a way which adversely affects an assessee if such an interpretation seems to override any provision of the Act or enjoins upon an assessee a liability greater than what is prescribed under the Act. However, if any circular bestows upon the assessee the advantage of a beneficial interpretation despite not adhering to the strict parameters of the statutory provisions, the benefits cannot be denied to such assessee.

In the volatile scenario reflected by an ever-increasing debate and several conflicting decisions on the issue of characterization of gains from securities transactions, there was tremendous pressure on the CBDT to issue a clarification on the subject to put an end to the turmoil in the markets. Since the CBDT, through an earlier Instruction

No.1827 dated August 31, 1989, had come out with a clarification for the assessing officers on the distinction between shares held as investment (capital asset) and shares held as stock-in-trade (trading asset) and considering the subsequent contradictory judicial decisions, it proposed to update the earlier instructions for guidance of tax authorities and for the information of the assesseees. Keeping in mind the need to address this crucial issue of income characterization and taxation of FII on earnings through transfer of shares, the CBDT on June 15, 2007, issued Circular No 4/2007 n9 in line with its earlier Instruction of 1989.

CBDT Circular: Tests for distinction between shares held as stock-in-trade and shares held as investment.

The Circular No 4/2007 provides that the Act draws a basic distinction between a capital asset and a trading asset. The Act has classified assets into long-term and short-term and gains into long-term and short-term and has also defined capital assets and trading assets. n10

The CBDT mainly relied on the observations of the Supreme Court in the following two cases:

. *Commissioner of Income Tax (Central), Calcutta v. Associated Industrial Development Company (P) Ltd.*: n11

Whether a particular holding of shares is by way of investment or forms part of the stock-in-trade is a matter which is within the knowledge of the assessee who holds the shares and it should, in normal circumstances, be in a position to produce evidence from its records as to whether it has maintained any distinction between those shares which are its stock-in-trade and those which are held by way of investment.

. *Commissioner of Income Tax, Bombay v. H. Holck Larsen*: n12[12]

The High Court, in our opinion, made a mistake in observing whether transactions of sale and purchase of shares were trading transactions or whether these were in the nature of investment was a question of law. This was a mixed question of law and fact.

Before determining tax on any income, it is imperative to determine the nature of income earned by the taxpayer. Therefore, the circular chronicles a standard test to determine the nature of income derived from shares held by the taxpayer. The CBDT has merely emphasized the principles laid down by the AAR in *Fidelity Northstar Fund v. DIT* and the earlier pronouncements of the Supreme Court on the subject to ascertain the nature of income from shares held by assesseees.

The principles have been summarized as follows:

- (i) the manner of holding the shares, i.e., as stock-in-trade or investments;
- (ii) the manner of maintaining books of accounts by the assessee;
- (iii) the magnitude of transactions of purchases and sale of shares;
- (iv) the substantial nature of transactions;
- (v) objective of the assessee, i.e., profit motive or dividend income.

After laying down the above principles, which have been clearly set out in the ruling, the CBDT advises the tax authorities to examine them all and the total effect of the same as the determining consideration whether a FII is an investor or a trader in stocks, is a mixed question of law and fact.

Importantly, the CBDT emphasized the possibility for an assessee to have two portfolios, i.e., an investment portfolio and a trading portfolio. The investment portfolio may thus comprise securities which are to be treated as

capital assets, and the trading portfolio may comprise stock-in-trade to be treated as trading assets. Thus, an assessee may have income under both the headings of capital gains and business income.

Analysis. All that the circular actually delivers is the compilation or summary of the findings of the AAR and the principles laid down in several cases dealing with characterization of income. From the study of the judgments and ruling and the circular above, what surfaces is that it is only the actual nature of the transaction that can determine the classification of income and not merely a regulatory classification on the nature of income of a FII. Since the facts of each transaction are peculiar, the onus lies on the FII to prove that the transfer of shares is effected by it as a trader as opposed to an investor. If a FII is treated as a trader and if it has invested from a jurisdiction which has a tax treaty with India, its business income will be tax exempt in India in the absence of a permanent establishment in India. The flip side of treating gains as business profits is that those FIIs whose jurisdictions have no beneficial tax treaties with India will be adversely affected as the entire gains would then be taxed at general tax rates. However, if a FII is treated as an investor, the income will be regarded as capital gains and the same will be subject to tax in India in the absence of a beneficial tax treaty in this regard, between India and the jurisdiction of the FII.

Impact of the Circular. Although the circular helps clear the air for long-term foreign investors on the characterization of the gains from their investments and their subsequent taxability, it has still kept alive the debate on classification of securities as the line of distinction drawn between a trader and an investor is not definitive. For the purpose of FIIs, the circular can only be used to provide a certain amount of persuasive value before the tax authorities in making a case for the nature of the transaction as the circular clearly provides advisory value more than instructional value to the tax authorities, who have been provided leeway in making a decision after close examination of all principles. The circular will lead to more uncertainty among FIIs in the determination of tax liability due to the new announcement of the CBDT which declares the possibility of an assessee to assume both roles, that of an investor as well as the trader. This new possibility has laid a burden on the FIIs of proving its income as business income or capital gains. It has been advised to determine the character of income on an examination of the principles laid down in the AAR ruling in the case of *Fidelity Northstar Fund v. DIT*.

However, in one of the principles considered by the AAR, it was observed that Regulation 18 of the SEBI Regulations enjoins upon every FII to keep and maintain books of account containing true and fair accounts relating to remittance of initial corpus of buying and selling and realizing capital gains on investments and accounts of remittance to India for investment in India and realizing capital gains on investment from such remittances. The AAR concluded that the gains derived by it were in the nature of capital gains and it seems that it has relied on this regulation as the principle seems to have contributed to the decision. On an examination of the circular, it appears that the CBDT implies that gains derived by FIIs are in the nature of capital gains. Many experts opine that the government also seems to have the same intention at the time of introducing the concessional tax regime for FIIs as otherwise the provisions governing taxation of FIIs would be rendered redundant. The last determining principle laid down by the AAR, i.e., the motive of transaction, profit or dividend, which is reinforced by the CBDT, seems to deviate from the standards as it seeks to send out a signal that only those assesses who clearly intend to earn just dividend income from stocks will be provided the option of treating the resulting gains from their transfer as capital gains.

Conclusion. A common view shared by professionals and industry is that a uniform tax system should be introduced which seeks to tax all market participants on an equal footing. One possible alternative is to extinguish the controversy on the issue of categorization of gains as capital gains or business income by taxing such resulting gains under a different system as against the regular income tax provisions based on turnover levels in such transactions. This will eliminate all anomalies and lend clarity to such transactions. This will increase overall confidence levels amongst all stakeholders apart from avoiding litigation hassles.

The Securities Transaction Tax n13 (STT), which is an alternate means of tax on equity trades, introduced in 2004 with effect from assessment year 2005-06, had ushered a paradigm shift in the taxation of profits on financial securities. In the words of the Finance Minister, STT "*is a neat, efficient and easy-to-administer tax and it has the great advantage of virtually eliminating tax avoidance.*" The STT is applicable at different rates on the value of the taxable securities

transaction. After the introduction of this tax, it is felt that there is scope to just levy a minimum rate of tax on short-term capital gains and zero rate of tax on long-term capital gains, regardless of the motive behind the purchase and sale of shares. It is a shared sentiment that STT was a welcome approach and it only needs more uniformity in its implementation to iron out any creases. Such implementation will provide stability and strengthen the investors estimates of potential tax liabilities which is crucial to avoid volatilities in any capital market. Since Indian capital markets are extremely sensitive to any sudden changes in policies affecting tax liabilities, especially if such policies are retrospective in operation, it is imperative that a stable tax policy is announced concerning investments and transactions in stock markets which will ensure maturity in the capital markets movements and a gradual growth. If the tax laws are clear, it will be an added incentive for attracting capital inflows. A stable and mature market in turn is a boon to not only foreign portfolio investors but also domestic investors.

The road ahead: 2008 Union Budget; Amendments to Income tax Act, 1961. In the 2008 Union Budget, the Finance Minister announced an increase in the tax rate from 10% to 15% on short-term capital gains arising to FIIs with effect from April 1, 2009, by amending Section 111A of the Act. One important measure introduced is in relation to the treatment of STT in the computation of tax liability under the Act. Earlier, STT paid was allowed as a rebate under section 88E of the Act against tax liability. Any sum paid on account of STT was not an admissible deduction by virtue of section 40(a)(ib). The budget has done away with the system of rebate for STT paid with effect from April 1, 2008, and has announced a deduction of the STT paid in computation of taxable income under section 36(1) of the Act by incorporating clause (xv). However, this deduction is allowable only if income arising from such securities transaction is included in the income from business, not in capital gains. This deduction will be made allowable from April 1, 2009, applicable only from assessment year 2009-2010 onwards. Further, STT on options was levied on the aggregate of the strike price and the option premium and was borne by the seller. Now, the levy of STT, in the case of options, will be only on the option premium where the option is not exercised, and the liability will be on the seller. In a case where the option is exercised, the levy will be on the settlement price and the liability will be on the buyer. No changes have been made in the present rates. STT, being a tax introduced in lieu of exemption in respect of long-term capital gains and concession in tax on short-term capital gains was treated like advance tax by giving credit to the extent of the tax paid in computing tax liability. However, the increase in rate of tax in short-term capital gains and the rebate being withdrawn, the budget does not do much in terms of providing incentives for foreign investors.

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n1 Full text of the Act can be found at the official website of the Indian Income Tax Department, Ministry of Finance at <http://law.incometaxindia.gov.in/TaxmannDit/DisplayPage/dpage1.aspx>.

n2 The details of the Union Budget are available at <http://indiabudget.nic.in/ub2008-09/ubmain.htm>.

n3 An authority constituted by the Central Government under S.245-O of the Act for giving determinations called advanced rulings in relation to a transaction undertaken or proposed to be undertaken by a non-resident applicant on issues pertaining to tax liabilities on proposed transactions.

n4

[4] *In re Fidelity Advisor Series VIII*, (2004) 192 CTR (AAR) 201, (2004) 271 ITR 1 (AAR).

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[5] The SEBI is a regulatory body established under The Securities and Exchange Board of India Act, 1992 with a view to regulate Indias securities markets, at www.sebi.gov.in.

n6 *In re Morgan Stanley & Co. International Ltd.*, (2005) 193 CTR (AAR) 161, (2005) 272 ITR 416 (AAR).

n7

[7] *Fidelity Northstar Fund v. DIT*, (2007) 288 ITR 641 (AAR).

n8

[8] CBDT or Board as defined in S.2 (12) of the Act is an income tax authority constituted under the Central Boards of Revenue Act, 1963 (54 of 1963).

n9 Circular No 4/2007 is at http://law.incometaxindia.gov.in/dittaxmann/circular/cir4_2007.htm.

n10

[10] Sections 2(29A), 2(42A), 2(29B), 2(42B), 2(14) and 28 of the Income tax Act, 1961.

n11

[11] *Commissioner of Income Tax (Central), Calcutta v. Associated Industrial Development Company (P) Ltd.*, (1971) 82 ITR 586 (SC).

n12

[12] Commissioner of Income Tax, Bombay v. H. Holck Larsen, (1986) 160 ITR 67 (SC).

n13

[13] Securities Transaction Tax is at <http://indiabudget.nic.in/ub2004-05/bill.htm>.

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Campbell on Commissioner v. Kowalski

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Alan D. Campbell on Commissioner v. Robert J. Kowalski et ux.

By Alan D. Campbell

May 5, 2008

SUMMARY: Alan Campbell comments on the tax treatment of employer cash meal allowances to employees. Can employees exclude such payments from gross income for tax purposes? Find answers in this commentary on Commissioner v. Robert J. Kowalski.

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ARTICLE: Facts of the Case. This commentary on the decision by the Supreme Court of the United States in *Commissioner v. Robert J. Kowalski et ux.*, 434 US 77, 77-2 USTC 9748 (USSC, 1977) revg CA-3, 76-2 USTC 9769 addresses the issue of whether cash payments to employees for meal allowances during working hours are excluded from gross income under Section 119.

Robert J. Kowalski was a state trooper in New Jersey. The state of New Jersey provided a cash meal allowance for its state troopers biweekly in advance with the troopers salary. The state of New Jersey separately stated the meal allowance from the troopers salary. The amount of the allowance varied with the troopers rank. The state of New Jersey included this meal allowance in calculating a troopers pension benefits. The troopers did not have to spend the meal allowance on their mid-shift meals or account for the meal allowance in any way. The troopers received a cash meal allowance even while they are away from active duty, such as on leave or on vacation.

During 1970, Robert J. Kowalski received a base salary of \$8,739.38 and a meal allowance of \$1,697.54. He reported wages of \$9,066 shown on his Form W-2 on his income tax return for 1970. This amount was his base salary plus \$326.45 of his meal allowance because on October 1, 1970, the state of New Jersey began to withhold income tax on the cash meal allowance. The fact that the state of New Jersey began to withhold income tax on cash meal allowances did not affect the decision in this case. Robert J. Kowalski did not include the remaining meal allowance of \$1,371.09 in his gross income. The IRS audited his return and determined that he should have included all of his meal allowance in his gross income and issued him a notice of deficiency.

Robert J. Kowalski filed a petition with the U. S. Tax Court to contest the proposed deficiency. In a reviewed decision, the U. S. Tax Court ruled (65 TC 44 (1975)) that the cash meal allowance was income within the meaning of Section 61 and that Robert J. Kowalski could not exclude the cash meal allowance from his gross income under Section 119. He appealed to the U. S. Court of Appeals for the Third Circuit. It held that the meal allowance was for the

convenience of the employer and reversed the decision of the U. S. Tax Court. The Supreme Court of the United States granted certiorari to resolve a conflict among the U. S. Courts of Appeals.

The Argument by Robert J. Kowalski . Robert J. Kowalski argued that the meal allowance was not income within the meaning of Section 61. He argued that the meal allowance was for the convenience of his employer and not intended to be compensation. Therefore, he argued that the meal allowance should be excluded from his gross income under Section 119.

The Courts Ruling. The Supreme Court of the United States ruled that the cash allowance for meals was income within the meaning of Section 61. The court cited *Helvering v. Clifford*, 40-1 USTC 9265, 309 US 331 (1940) and a number of other cases in stating that Congress created the income tax to use the full measure of its taxing power. The court cited its decision in *Commissioner v. Glenshaw Glass Co.*, 55-1 USTC 9308, 348 US 426 (1955) in stating that the cash meal allowance was an accession to wealth, clearly realized, and over which the recipient had complete control. Therefore, the court ruled that the cash meal allowance was income within the meaning of Section 61.

The court further ruled that the meal allowance was not excluded from gross income under Section 119. Section 119 excludes the fair market value of meals provided to employees on the employers premises for the employers convenience. Section 119 does not provide for any exclusion from gross income for a cash allowance for meals.

The court cited the Senate Finance Committee report that accompanied the enactment of Section 119. This report stated that Section 119 applied only to meals furnished in kind (S. Rep. No. 1622, 83rd Cong., 2nd Sess., 190 (1954)). The court analyzed the legislative history of Section 119. The court stated that in enacting Section 119 Congress intended to replace prior law and end any confusion about the taxation of meals provided by the taxpayers employer. The court stated that Congress did not create a class of non-compensatory cash meal allowances to be excluded from gross income. Therefore, the court ruled that Robert J. Kowalski could not exclude the cash meal allowance from his gross income under Section 119.

Section 119. Section 119(a) provides that the value of free meals provided by an employer to an employee, the employees spouse, and the employees dependents is excluded from the employees gross income if the employer provides the meals on the employers business premises for the employers convenience. In addition, Reg. §1.119-1(a)(2) requires that the meals furnished free of charge by the employer to the employee must be for a substantial non-compensatory reason. Section 119 does not exclude any cash meal allowances from gross income.

Section 119(b) provides that the terms of an employment contract or state statute are not determinative of whether the meals or lodging are for the convenience of the employer. Whether an employee may exclude the value of meals or lodging from gross income must be determined by an objective analysis of all relevant facts and circumstances as required by Reg. §§1.119-1(a)(1) and 1.119-1(b).

Accountable Plans. Although Section 119 does not exclude cash payments for meals from gross income, Reg. §1.62-2(c)(4) excludes payments for business meals from gross income if an employer makes the payments to reimburse the employee for business meals under an accountable plan. Business meals include meals that an employee consumes while away from home overnight on business (*United States v. Homer O. Correll*, 68-1 USTC 9101, 389 US 299 (1967) revg 66-2 USTC 9778). The taxpayer must require sufficient rest or sleep to cause the taxpayer to obtain lodging. Merely working long hours on the road and stopping on the road for a nap does not meet this requirement (*Frederick J. Barry et ux v. Commissioner*, 71-1 USTC 9126 (CA-1, 1970) affg Tax Court, 54 TC 1210).

Business meals also include meals that are for a valid business reason even when not away from home overnight on business. Such business meals would include business lunches or dinners with a customer or other person with whom the taxpayer has a business relationship. Section 274(a) requires the taxpayer to engage in an actual business discussion before, during, or after the meal.

For cash payments for meals to be excluded from gross income under an accountable plan, the employee must provide receipts to the employer or accept the allowed per diem reimbursement. If a cash payment for business meals meets the requirements of an accountable plan, the employee excludes the payment from gross income.

The employer may deduct the cost of the meals reimbursed to the employee as an ordinary and necessary business expense under Section 162(a). However, Section 274(n) limits the deduction to 50 percent of the cost of the business meals.

The employee may not claim a deduction for the meals unless the amount spent for qualified meals exceeds the reimbursement. The employee may deduct 50 percent of the excess of the cost of the business meals over the amount of the reimbursement as a miscellaneous itemized deduction. If an employer provides a cash meal allowance to cover the cost of business meals and does not require substantiation of the business meal expenses, the employer must include the meal allowance in the taxpayers wages. The employee may deduct the cost of business meals as an ordinary and necessary business expense under Section 162(a). However, the deduction is a miscellaneous itemized deduction and Section 274(n) generally limits the deduction to 50 percent of the cost of the business meals.

What Practitioners Should Do. Practitioners should clearly inform their clients that employees may not exclude a cash meal allowance from gross income under Section 119. Practitioners should explain to their clients the requirements for the exclusion for meals provided free of charge or at a price below fair market value by employers. Understanding the requirements is especially important for employees of restaurants because the value of meals consumed free of charge by restaurant employees on days that they do not work is not excluded from their gross income under Reg. §1.119-1(a)(2)(d).

Practitioners should carefully document the facts and circumstances that support the exclusion from gross income under Section 119 of the value meals or lodging provided by an employer. While an employment contract is not determinative that meals or lodging are for the employers convenience, having a copy of the taxpayers employment contract in the file that shows that the employer requires the taxpayer to accept lodging as a condition of employment would provide some evidence for the exclusion.

Practitioners should explain to clients the benefits of having an accountable plan in place for employee business expenses, including meals while away from home overnight on business or while entertaining people with whom the employee has a business relationship.

Caution for Practitioners. Practitioners must be careful to provide guidance to clients on the requirements for exclusion from gross income of the value of meals and lodging provided by an employer under Section 119. Practitioners must remember that Section 119(b) provides that an employment contract or state statute is not conclusive of whether the meals and/or lodging qualify for the exclusion. Rather, an objective analysis of all relevant facts and circumstances is necessary to determine whether free meals and/or lodging qualify for the exclusion under Section 119.

Best Practice. Best practice dictates that a practitioner should provide guidance to clients about the conditions they must meet to exclude the value of meals and lodging provided by their employer from their gross income. The issue of

free or discounted meals often arises in the case of employees of restaurants. Reg. §1.119-1(a)(2)(d) provides that meals furnished to an employee of a restaurant immediately before working hours, during working hours, or immediately after working hours are excluded from the employees gross income.

Best practice is also providing guidance to clients who are employers not only what they cannot provide to employees on a tax-free basis but also what they can provide as tax-free fringe benefits to employees. The Internal Revenue Code provides for a number of tax-free fringe benefits, including group term life insurance up to \$50,000 under Section 79, cafeteria plans under Section 125, and qualified parking under Section 132(f). Employers can use such provisions to provide tax-free fringe benefits to employees.

Conclusion. The main lesson to be learned from this case is that an individual may not exclude a cash meal allowance from gross income under Section 119. Rather, an individual must include a cash meal allowance in gross income under Section 61. An employee may exclude the value of meals furnished in kind by an employer for the employers convenience on the employers premises from gross income under Section 119.

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Alan D. Campbell on Bob Jones University v. United States

2008 Emerging Issues 2251

Alan D. Campbell on Bob Jones University v. United States

By Alan D. Campbell

May 1, 2008

SUMMARY: Know the requirements for exclusion from gross income of the value of meals and lodging provided by an employer to its employees free of charge. Understand if employer intent or an employment contract has any bearing on this issue.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Facts of the Case. This commentary on the decision by the U. S. Court of Claims in *Bob Jones University v. United States*, 82-1 USTC 9168 (670 F.2d 167; 1982 U.S. Ct. Cl. LEXIS 23 1982) addresses the issue of whether the value of meals and lodging provided free of charge by a religious university to many of its faculty and staff members is excluded from their gross incomes under Section 119. A panel of three judges of the U. S. Court of Claims reviewed the case after Bob Jones University took exception to the findings of fact and conclusions of law of the trial judge. The panel of three judges adopted the opinion of the trial judge with a few changes.

Bob Jones University is a Christian university located in South Carolina. The university seeks to reduce its students contacts with the secular world and instill in them Christian values. To further this objective, the university expects its faculty and staff members to serve as role models of Christian behavior for its students.

Bob Jones University provided meals free of charge to 551 of its 636 faculty and staff members who were not graduate students. Many faculty and staff members had the option of eating their evening meal away from the university dining room. Bob Jones University paid such faculty and staff members a \$25 per month salary supplement. Other faculty members ate some of their meals away from the university dining room without additional compensation.

Of the 636 total faculty and staff members, 439 lived in housing provided free of charge by Bob Jones University. Of the 439 faculty and staff members who received the free housing, 188 of them lived on campus and 251 lived off campus. Bob Jones University generally required its faculty and staff members to live in the housing it provided free of charge, but it allowed for some exceptions. Faculty members who did not live in housing provided by the university received a salary supplement of \$110 per month if single and \$310 per month if married.

On August 29, 1977, the IRS informed Bob Jones University that it was revoking a previous ruling that allowed the value of meals and lodging Bob Jones University provided to its employees to be excluded from their gross incomes

under Section 119. Bob Jones University deposited \$514.91 for the withholding taxes on the value of the meals and lodging it provided to six of its employees during January and February 1978.

Bob Jones University then filed a claim for refund of that amount on June 15, 1978. After the IRS denied its claim, the university filed suit for refund in the U. S. Court of Claims on December 20, 1978. The United States filed a counterclaim on April 30, 1979, for \$42,213.51 for additional withholding taxes for all of the faculty and staff members for the first quarter of 1978. The parties later stipulated that the amount should be reduced to \$28,100.01.

Bob Jones University did not include the fair market value of the meals and lodging it provided to faculty and staff members on their Forms W-2. The university believed that the fair market value of the meals and lodging was excluded from the gross incomes of the affected faculty and staff members because the university provided the meals and lodging to them for its own convenience in furtherance of its values.

Faculty and staff members ate in a different dining room from the one where the students ate. The only interaction between faculty and staff members and students during meal time was limited communications while they went to and from their respective dining rooms.

The Argument by Bob Jones University. Bob Jones University argued that the meals and lodging it provided to many of its faculty and staff members were for the university's convenience. The university wanted to promote a Christian community protected from the influence of the outside world and to foster informal contacts between the faculty and staff members and the students. Therefore, the university argued that the meals and lodging should be excluded from the gross incomes of the faculty and staff members under Section 119.

The Courts Ruling. The U.S. Court of Claims held that the meals and lodging provided free of charge to many of the faculty and staff members were not provided primarily for the employer's convenience. Therefore, the court ruled that the value of such meals and lodging was not excluded from the gross incomes of the faculty and staff members under Section 119. The court said that its ruling did not encroach on the right to free exercise of religion guaranteed by the First Amendment to the U. S. Constitution. The court ruled that the United States could recover on its counterclaim except with respect to dorm counselors.

The court found that the employer's subjective goal is not conclusive. Rather, the court cited *Dole v. Commissioner*, 351 F.2d 308, 43 TC 697, *aff'd* 65-2 USTC ¶9688 (CA-1, 1965) in stating that it must use an objective test to determine whether an employer provides meals and lodging to employees for the employer's convenience.

The court found that based on this objective standard, the students had little opportunity to interact with faculty and staff members during meals because they ate in different dining rooms. The court found that breakfast and the evening meal were clearly not eligible for the exclusion because the employees did not eat such meals during their working hours as required by Reg. §1.119-1(a)(2)(i).

Neither did students have much interaction with faculty and staff members in their homes because Bob Jones University did not allow students access to the homes of faculty and staff members after 6:00 p.m. without permission. The court also noted that faculty and staff members seldom invited students into their homes.

The court also cited testimony by faculty and staff members who lived in their own homes or who did not eat in the university dining room. These faculty and staff members testified that their ability to do their jobs was not affected by the fact that they lived off campus or that they did not eat all their meals in the university dining room. The court found that such testimony rebutted the argument of Bob Jones University about the necessity of the free meals in the university dining room and the free use of university housing to promote its Christian values. The court found that

faculty and staff members were not required to accept the lodging provided by the university as a condition of their employment.

The court found one exception. It ruled that dormitory counselors met the requirements for the exclusion under Section 119.

Section 119. Section 119(a) provides that the value of free meals provided by an employer to an employee, the employees spouse, and the employees dependents is excluded from the employees gross income if the employer provides the meals on the employers business premises for the employers convenience. The meals furnished free of charge by the employer to the employee must be for a substantial noncompensatory reason as required by Reg. §1.119-1(a)(2) to be excluded from the gross incomes of the employees. The Supreme Court of the United States ruled in *Commissioner v. Robert J. Kowalski et ux.*, 434 US 77, 77-2 USTC 9748 (1977) revg CA-3, 76-2 USTC 9769 that the exclusion for meals provided by the employer for the employers convenience does not apply to a cash allowance received for meals.

Section 119(a) also provides that the value of lodging provided to an employee by an employer is excluded from the employees gross income if the employer provides the free lodging on the employers premises. In addition, the employer must require the employee to accept the lodging as a condition of employment. Reg. §1.119-1(b) provides that for the value of the lodging to be excluded from the employees gross income under Section 119, the employee must need to live in the lodging to be able to perform the duties of the employment.

Section 119(b) provides that the terms of an employment contract or state statute are not determinative of whether the meals or lodging are for the convenience of the employer. Whether an employee may exclude the value of meals or lodging from gross income must be determined by an objective analysis of all relevant facts and circumstances as required by Reg. §§1.119-1(a)(1) and 1.119-1(b).

Section 119(d) specifically addresses housing provided by certain educational institutions to their employees. It provides that the value of qualified campus lodging is excluded from the employees gross income. The exclusion under Section 119(d) is limited because it applies only if the employee pays an adequate rent. The exclusion does not apply to the extent of the lesser of the following exceeds the actual rent paid by the employee for the year: (1) five percent of the appraised value of the property at the end of the year or at the beginning of the rental if the rental period is less than one year or (2) the average rent paid by individuals other than employees or students of the educational institution for comparable lodging the educational institution provides to such other individuals.

Section 119(b)(3) states that qualified campus lodging must be located on or in the proximity of the campus and provided by the educational institution as a residence to its employee, the employees spouse, and any of the employees dependents. In this case, the court found that the housing provided by Bob Jones University was not in close proximity to the campus. The court noted that many faculty and staff members could not see the campus from where they lived.

What Practitioners Should Do. Practitioners should explain to their clients the requirements for the exclusion for meals and lodging provided free of charge or at a price below fair market value by their employers. Understanding the requirements is especially important for employees of restaurants because the value of meals consumed free of charge by restaurant employees on days that they do not work is not excluded from their gross income under Reg. §1.119-1(a)(2)(d).

Practitioners should carefully document the facts and circumstances that support the exclusion for meals or lodging provided by the employer. While an employment contract is not determinative that meals or lodging are for the employers convenience, having a copy of the taxpayers employment contract in the file that shows that the employer

requires the taxpayer to accept lodging as a condition of employment would provide some evidence for the exclusion.

Caution for Practitioners. Practitioners must be careful to provide guidance to clients on the requirements for exclusion. Practitioners must remember that Section 119(b) provides that an employment contract or state statute is not conclusive of whether the meals and/or lodging qualify for the exclusion. Rather, an objective analysis of all relevant facts and circumstances is necessary to determine whether free meals and/or lodging qualify for the exclusion under Section 119.

Best Practice. Best practice dictates that a practitioner should provide guidance to clients about the conditions they must meet to exclude the value of meals and lodging provided by their employer from their gross income. The issue of free or discounted meals often arises in the case of employees of restaurants. Reg. §1.119-1(a)(2)(d) provides that meals furnished to an employee of a restaurant immediately before working hours, during working hours, or immediately after working hours are excluded from the employees gross income.

Conclusion. The main lesson to be learned from this case is that an employers subjective intent is not conclusive of whether the value of meals or lodging furnished to employees free of charge is excluded from the employees gross income under Section 119. Neither is an employment contract or state statute controlling. Whether an employee may exclude the value of meals or lodging from gross income must be determined by an objective analysis of all relevant facts and circumstances. Another lesson to be learned is that if a taxpayer advances a free exercise of religion argument under the First Amendment of the U. S. Constitution, then the taxpayers own policies and actions should be congruent with the taxpayers argument.

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FSAs, HRAs and HSAs all provide for health care expense reimbursement..

2008 Emerging Issues 2245

Dorinda D. DeScherer on How to Avoid Problems With FSA- or HRA-to HSA Switches

By Dorinda D. DeScherer

April 30, 2008

SUMMARY: HSAs are the newest addition to the panoply of health reimbursement arrangements. HSAs are available only to taxpayers covered by a high-deductible health plan (\$1,100 for self-only coverage and \$2,200 for family coverage for 2008) and are subject to annual contribution limits. HSAs can be included in an employers cafeteria plan and can accept both employee and employer contributions.

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ARTICLE: This title may look like alphabet soup. However, each of the three-letter acronyms stands for a specific type of tax-favored reimbursement arrangement for health care expenses: health flexible spending accounts (FSAs), health reimbursement arrangements (HRAs) and health savings accounts (HSAs).

While the arrangements have some things in common--they each provide for contributions that are excludable from income and tax-free distributions for health care expenses--they differ significantly in operation. FSAs, for example, are accounts within an employer-sponsored cafeteria plan, that are typically funded on a year-by-year basis with employee salary reductions (although employers may make contributions as well) and do not provide for carryover of unused funds [*Prop. Treas. Reg. §1.125-5(a)(1)*]. HRAs, on the other hand, are funded solely with employer contributions, but do provide for a carryover of unused contributions from year to year. [*Rev. Rul. 2002-41, 2002-28 I.R.B. 75; Notice 2002-45 (June 27, 2002); Rev. Rul. 2005-24, 2005-16 I.R.B. 892 (Apr. 5, 2005)*] Finally, HSAs, which also provide for carryovers, are available only to taxpayers covered by a high-deductible health plan (HDHP) (\$1,100 for self-only coverage and \$2,200 for family coverage for 2008) and are subject to annual contribution limits (\$2,900 for self-only coverage and \$5,800 for family coverage for 2008) [*IRC § 223*]. HSAs can be included in an employers cafeteria plan and can accept both employee and employer contributions.

HSAs are the newest addition to the panoply of health reimbursement arrangements. Therefore, employees who opt for an HSA may have had previous coverage under an FSA or HRA. And, if thats the case, special care must be taken to avoid unfavorable tax consequences.

Reason: As a general rule, an employee is ineligible for an HSA if he or she is covered by an employer-sponsored health FSA or HRA that pays or reimburses medical expenses incurred before the minimum annual HDHP deductible has been satisfied. [*Rev. Rul. 2004-45, 2004-22 I.R.B. 971*] Such overlapping coverage will disqualify the HSA.

Consequently, any contributions to the HSA will be taxable to the employee.

Because of the carryover feature of HRAs, overlapping is inevitable even if no further contributions are made to the HRA. While an employee cannot carry over unused FSA funds from year to year, there can be an overlap if the FSA has a grace period. An FSA can provide that expenses incurred during a grace period of up to 2 1/2 months immediately following the end of the year may be paid or reimbursed from funds remaining in the employee's FSA at the end of the prior plan year. [IRS Notice 2005-42, 2005-23 I.R.B. 1; Prop. Reg. § 1.125-1(e)]

There are several ways to handle an overlap in FSA or HRA and HSA coverage to ensure favorable tax treatment to an HSA.

Limit or suspend HRA or FSA reimbursements. One approach is to convert the HRA or FSA into an HSA-compatible account by placing limits on reimbursements.

The IRS has specifically ruled that coverage under the following types of HRAs or FSAs will not disqualify an employee from HSA participation: [Rev. Rul. 2004-45; Prop. Treas. Reg. § 1.125-2(m)]

Limited purpose HRA or FSA. A limited-purpose health FSA that pays or reimburses only benefits for permitted coverage (e.g., dental and vision, but not long-term care) or a limited-purpose HRA that pays or reimburses benefits for permitted insurance (for a specific disease or illness or that provides a fixed amount per day or other period of hospitalization) or permitted coverage, can be offered in tandem with an HSA. A limited-purpose health FSA or HRA may pay or reimburse preventive care benefits.

Post-deductible FSA or HRA. An employee covered by a post-deductible FSA or HRA is an eligible individual for making contributions to an HSA. A post-deductible health FSA or HRA is one that does not pay or reimburse any medical expense incurred before the minimum annual HSA deductible is satisfied. The deductible for the HRA or health FSA need not be the same as the deductible for the HDHP, but in no event may any benefits be provided before the minimum annual HSA deductible has been met.

Practice Tip. A combination of the above two options is also permitted. For example, before the HDHP deductible is satisfied, a combination limited-purpose and post-deductible health HRA or FSA may reimburse only preventive, vision or dental expenses. A combination limited-purpose and post-deductible health FSA may also reimburse any medical expense that may otherwise be paid by an FSA that is incurred after the HDHP deductible is satisfied.

Suspended HRA. An employee covered by an HRA is eligible for an HSA if an election is made before the beginning of the coverage period to suspend all reimbursements for medical expenses other than permitted insurance and permitted coverage (if otherwise allowed to be paid or reimbursed by the HRA). Eligibility for HSA contributions is limited to the period during which the HRA reimbursements are suspended. Moreover, if the HSA is funded through salary reduction under a cafeteria plan during the suspension period, the terms of the salary reduction election must indicate that the salary reduction is used only to pay for the HSA offered in conjunction with the HRA and not to pay for the HRA itself.

Retirement HRA. A retirement HRA that pays or reimburses only those medical expenses incurred after retirement (and no expenses incurred before retirement) will not cause an employee to lose HSA eligibility. However, HSA contributions are limited to the period before retirement. After retirement, when payment or reimbursements can be made from the retirement HRA, no additional HSA contributions may be made.

Practice Tip. In order for any of these options to work, the employer will have to amend its plan to allow for them.

For example, the IRS has suggested that in the case of an FSA grace period overlap, an employer can amend its cafeteria plan document to provide for mandatory conversion of the general purpose FSA to a limited-purpose or post-deductible FSA during the grace period. *[Rev. Rul. 2005-86, 2005-49 I.R.B. 1075]*.

HRA and FSA rollovers. Another option for an employee whose existing FSA or HRA is incompatible with the establishment of an HSA is to roll over the FSA or HRA funds to the HSA by means of a qualified HSA distribution *[IRC § 106(e)]*. A qualified HSA distribution is treated as a contribution by the employer to an employee's HSA that is excludable from gross income and is exempt from employment taxes. A qualified HSA distribution is permitted in addition to any regular HSA contributions for the year. However, only one qualified HSA distribution is allowed with respect to any health FSA or HRA. Moreover, a qualified HSA distribution cannot exceed the lesser of (a) the balance of the FSA or HRA on September 21, 2006, or (b) the balance on the date of the distribution. Qualified HSA distributions are permitted only through 2011.

Planning Tip. Because of the restriction of qualified HSA distributions to the balance in the account on September 21, 2006, this option won't work for all employees. For example, an employee who began participation in an HRA or FSA after that date is effectively barred from making a rollover. Moreover, if funds in the account at the time of the rollover exceed the account balance on that date, additional steps will need to be taken to insure the employee's HSA eligibility. For example, any remaining funds in the HRA or FSA can be converted to a limited purpose or post-deductible account.

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DeScherer on the Rights and Obligations of Returning Service Members

2008 Emerging Issues 2215

Dorinda D. DeScherer, Esq. On The Rights and Obligations of Returning Service Members

By Dorinda D. DeScherer

April 25, 2008

SUMMARY: Federal law guarantees reemployment as well as the restoration of certain tax-favored benefits, such as health care coverage and retirement plan contributions to returning service members.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: When Johnny comes marching home again from military service, he may be marching straight to his former employers door asking for his old job back. And in most cases, the employer will have to accommodate that request—even if it means firing another employee. Federal law guarantees reemployment as well as the restoration of certain tax-favored benefits, such as health care coverage and retirement plan contributions to returning service members. Significantly, the law protects both employees who were called up and those who enlisted voluntarily. Moreover, unlike many other federal laws protecting employee rights, there are no exceptions for small employers: the law applies to *all* employers from the mega company to the one-employee shop owner.

Johnnys second stop in his march home may be right to your door for tax advice. He may have tax obligations to fulfill that were put on hold during his period of service as well as questions about upcoming tax transactions.

In this commentary, we will take a detailed look at the employment and tax rights and obligations of returning service members.

Employment Rights and Obligations

Both federal employment law and the federal tax law grant special rights and impose some obligations on individuals who return from a period of military service.

The employment rights and responsibilities of returning service members stem from the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) (38 U.S.C. §§ 4301-4333). USERRA prohibits employers from discriminating or taking acts of reprisal against persons who serve in the uniformed services. Among other things, an individual cannot be denied initial employment, reemployment, retention in employment, promotion, or any benefit of employment because of membership in the uniformed services, performance or application for service, or

an obligation to perform service in the uniformed services (38 U.S.C. § 4311).

In the case of employees who are returning from a tour of duty in the uniformed services, protected rights upon return from service fall into three broad categories:

1. Reemployment
2. Retention in employment, and
3. Restoration of benefits

Covered Service Members. Reemployment and other rights under USERRA apply to all persons who are absent from employment because of service in the uniformed services.

Service in the uniformed services generally includes active duty in:

§ The Army, Navy, Marine Corps, Air Force, or Coast Guard;

§ The Army, Navy, Marine Corps, Air Force, or Coast Guard Reserves;

§ The Army or Air Force National Guard; and

§ The Commissioned Corps of the Public Health Service.

USERRA rights also apply to any other category of persons designated by the President during a time of war or national emergency. In addition, the Public Health Security and Bioterrorism Preparedness and Response Act of 2002 provides that service as an intermittent disaster-response appointee on activation of the National Disaster Medical System (NDMS) is service in the uniformed services (42 U.S.C. 300hh-11(e)(3)).

USERRA applies to service members who volunteer for active duty, as well as those who are called up.

The law does not apply when a state calls up members of the National Guard for relief during disasters, riots, or other emergencies. However, state laws generally provide comparable reemployment rights in those cases.

USERRA regulations provide that service in the uniformed services includes active duty, training duty, federal National Guard duty, absence from employment for an examination to determine fitness for duty, and absence to perform funeral honors. (DOL Reg. §§1002.5))

Covered Employers. USERRA applies to any employer that pays a salary or wages or has control over employment opportunities. There is no minimum number of employees required for the law to apply, and it covers both public and private employers (38 U.S.C. § 4303(4)). For example, an employer with only one employee is covered by the law.

In addition, DOL regulations make it clear that the USERRA applies to foreign employers operating in the United States as well as to U.S. employers operating overseas, unless compliance would violate the law of the foreign country in which the U.S. employer's workplace is located (DOL Reg. § 1002.34).

An employer also includes a successor in interest to a service member's former employer (DOL Reg. §1002.35). Consequently, a successor in interest can be liable to provide reemployment rights and benefits to a returning service member, even if the successor in interest was unaware of the employee's potential claim at the time of a merger, acquisition, or other succession (DOL Reg. § 1002.36).

Practice Tip. To plan for USERRA responsibilities, acquiring companies should make it a practice to ascertain

whether the company to be acquired has any employees who are absent on military duty.

Reemployment Rights. An employee is entitled to be absent from a particular position of employment because of service in the uniformed services for up to a cumulative period of five years and still retain reemployment rights with that employer. [38 U.S.C. § 4312; DOL Reg. § 1002.101]

The five-year limit will be extended for time required to complete an initial period of required service or if the employee is unable to obtain release within the five-year period. Under DOL regulations, certain other periods of service, including service to fulfill periodic National Guard and Reserve training requirements, do not count against the cumulative five-year limit (DOL Reg. § 1002.103).

The five-year limit also does not apply to service under an order to active duty or to remain on active duty during a war or national emergency declared by the President or Congress.

Practice Tip. Given the duration of the war in Iraq, some returning service members may have exceeded the five-period of cumulative military service. And employers may assume that these service members are no longer entitled to reemployment rights. However, they may do so at their peril. On May 22, 2003, President Bush declared a national emergency to deal with the unusual and extraordinary threats to the national security and foreign policy of the United States constituted by the action and policies of the Government of Iraq (Executive Order No. 13303). Therefore, although there has apparently been no official pronouncement on this issue, periods of service under a call to active duty to serve in Iraq after that date would appear to be exempt from the five-year rule.

In addition, DOL regulations make it clear that the five-year period includes only the time the employee spends actually performing military service. For example, after an employee completes a period of service, he or she is given a certain amount of time to report back to work and submit an application for reemployment, and that time is not counted against the five-year limit (DOL Reg. § 1110.100).

Return to work. To be eligible for full reemployment rights, an employee is required to return to work within a specified time. The exact time period depends on the employees length of service:

§ For periods of service of up to 30 days, the employee must report back to work on the first regularly scheduled workday following the completion of service and safe transportation home, plus an eight-hour period of rest.

§ For periods of 31 to 180 days, the employee must submit a written or verbal application for reemployment no later than 14 days after completion of service.

§ For periods of 181 days or longer, the employee must submit an application for reemployment not later than 90 days after completion of service (DOL Reg § 1002.117).

If the deadline for applying for reemployment falls on a day when the employer's offices are not open, or when no one is available to accept the application, the deadline is extended to the next business day. In addition, the deadlines for reporting to work or applying for reemployment can be extended for up to two years if the employee is hospitalized for, or convalescing from, an injury or illness that occurred or was aggravated during the period of military service.

When an employee is returning from a period of service of 31 days or more, the employer may ask the employee to provide documentation that will allow the employer to check the length of the employee's service and whether the employee made a timely application for reemployment (DOL Reg. § 1002.121)] However, if the employee cannot provide documentation because it is not readily available, the employer cannot delay the employee's return to work. If it later turns out the employee was not eligible for reemployment, he or she may be terminated (DOL Reg. § 1002.122).

Observation. This hire-first-fire-later approach sounds fine in theory. However, it may prove troublesome in application. In order to immediately rehire the returning service member it may be necessary to relocate or even fire

another employee. Moreover, the DOL regulations do not explain how the employer is to obtain the required documentation nor do they set a time limit for the employee to submit the documents.

Job requirements. As a general rule, an employee must be reinstated to the job he or she held before leaving for service. In some cases, however, an employee may be entitled to a better job.

In the case of service of less than 90 days, the employee is entitled to the job he or she would have attained without the break for service, as long as he or she is qualified for the job or can become qualified with reasonable efforts. If service lasted more than 90 days, the employee must be reemployed in (1) the position he or she would have attained without the break for service, or (2) a position of equivalent seniority, status, and pay (DOL Reg. §1002.196-197).

Practice Tip. In other words, the employee must continue to climb the corporate ladder while he or she is absent for service. If the employee is not initially qualified for the position he or she would have attained, the employer must make reasonable efforts to update the employee's skills or provide training the employee would have received on the job.

As noted above, when a returning service member cannot be reemployed in the position he or she would have attained but for the break for service, the employer must provide a position that is equivalent in seniority, status, and pay. Whether a job is equivalent in seniority and pay is relatively easy to determine. But what makes a job equivalent in status? According to USERRA regulations, job status generally refers to the incidents or attributes attached to, and inherent in, a particular job. Examples include the exclusive right to a sales territory, the opportunity to advance in a position, greater availability of work where piece rates apply, the opportunity to work additional hours and to advance in a job, or the opportunity to work a particular shift (DOL Reg. §§1002.193-194).

Like other returning service members, a disabled veteran is entitled to the position he or she would have attained but for military service. If the disability limits the service member's ability to perform the job, the employer is required to make reasonable efforts to accommodate the disability (38 U.S.C. § 4313(a)(3)). However, when a returning disabled service member cannot become qualified for that position despite reasonable accommodations, he or she is entitled to be reemployed in any other position that is equivalent in seniority, status, and pay that he or she is qualified to perform or can become qualified to perform with reasonable efforts by the employer (38 U.S.C. § 4313(a)(3)(A)). If no equivalent position exists, the returning service member must be reemployed in an appropriate job that is the nearest approximation in terms of seniority, status, and pay (38 U.S.C. § 4313(a)(3)(B)).

In the case of a non-permanent disability, a returning service member may be entitled to interim reemployment in an alternate position that he or she is qualified for and can perform despite the disability. If no such alternate position exists, the disabled service member would be entitled to reinstatement on sick leave or light duty status until he or she completely recovers.

Prompt reemployment. An employee returning from military service is entitled to prompt reemployment (DOL Reg. § 1002.180). But what is prompt enough will depend on the circumstances. For example, when an employee returns from a weekend of National Guard duty, prompt reemployment will generally mean the next regularly scheduled workday. On the other hand, prompt reemployment after several years of active duty may require some time because the employer may have to reassign or give notice to another employee who is filling the returning employee's former position. DOL regulations provide that, absent unusual circumstances, reemployment must occur within two weeks of the application for reemployment (DOL Reg. § 1002.181).

Practice Tip. The DOL regulations make it clear that an employee leaving for a period of service is not required to decide whether he or she intends to return to work for the employer. The employee may defer that decision until after the period of service, and an employer may not press the employee about his or her plans (DOL Reg. § 1002.88). Moreover, even if the employee indicates that he or she does not plan to return, the employee does not forfeit the right

to reemployment. An employee cannot waive his or her right to reemployment.

Reemployment exceptions. There are some situations in which a returning service member forfeits his or her reemployment rights or an employer is not obligated to reemploy a returning service member.

As noted above, a returning service member will not be eligible for reemployment if he or she does not return to work or apply for reemployment within the appropriate time limit.

In addition, separation from service with a dishonorable or bad conduct discharge or under other than honorable conditions will terminate an employee's right to reemployment. Similarly, an individual who is dropped from the military rolls because he or she is absent without leave for more than three months or has been imprisoned by a civilian court is not entitled to reemployment. A commissioned officer who is dismissed under circumstances involving a court martial or by order of the President in time of war is not required to be reemployed (DOL Reg. § 1002.135).

Here again, the employer may ask for documentation showing that the employee's separation from service was not under circumstances that would disqualify the employee for reemployment (DOL Reg. § 1002.121). If the employee cannot provide documentation because it is not readily available, the employer cannot delay the employee's return to work. However, if it later turns out the employee was not eligible for reemployment, he or she may be terminated (DOL Reg. § 1002.122).

Reemployment of a returning service member is not required if the employer's circumstances have changed so that reemployment is impossible or unreasonable. A reduction-in-force that would have included the returning service member is an example of such a change in circumstance.

In addition, reemployment is not required if it would cause undue hardship for an employer. For this purpose, undue hardship means employer actions requiring significant difficulty or expense when considered in light of factors such as the overall financial resources of the employer, the size (in terms of employees) of the employer, and the operations of the employer (38 U.S.C. § 4303(15)).

Finally, reemployment is not required if the employee was employed for only a brief, nonrecurrent period before his or her service, and there was no reasonable expectation that the employment would continue indefinitely or for a significant period (38 U.S.C. § 4311(d)(1)).

Retention in Employment. An employee who is reemployed after a period of service of more than 180 days cannot be discharged, except for cause, within one year after the date of reemployment.

An employee whose service lasted more than 30 days but less than 181 days, cannot be discharged for 180 days.

Employees who served 30 or fewer days are not protected from discharge. However, they are protected from discrimination because of their military service. (DOL Reg. § 1002.247).

Restoration of Employee Benefits. As a general rule, employee benefits must be reinstated when an employee returns from service as if the employee had been on the job all along.

Retirement plan benefits. A period of service is not treated as a break in service for purposes of participation, vesting, or accrual of benefits under an employer's qualified retirement plan. In addition, the time allowed for the employee to report back to work or apply for reemployment as well as any time (up to two years) required to recover from an illness or injury must be counted for participation, vesting and benefit accrual purposes. (DOL Reg. § 1002.259).

Therefore, once the employee is reemployed, the employer is required to contribute make-up contributions to the plan to cover those periods (DOL Reg. § 1002.261; IRC § 414(u)(8)).

In the case of a plan to which the employee is not required or permitted to contribute (e.g., a pension plan or a noncontributory defined benefit plan), the employer must make the contribution for the employee's period of service no later than ninety days after the date of reemployment, or when plan contributions are normally due for the year in which the service was performed, whichever is later. If it is impossible or unreasonable for the employer to make the contribution within this time period, the employer must make the contribution as soon as practicable (DOL Reg. § 1002.262(a)).

In the case of a contributory plan (e.g., a 401(k) plan), the returning service member is allowed (but not required) to make up his or her own missed contributions. These makeup contributions must be made during the period starting with the date of reemployment and continuing for up to three times the length of the immediate past period of service, but not more than five years (DOL Reg. § 1002.262(b)). So, for example, if a returning service member's period of service lasted one year, he or she has three years to make up missed contributions; but if it lasted two years, he or she has a five-year window.

If a returning service member does not make up missed contributions to a contributory plan, the employer is not required to make up any employer matching contributions that are contingent on the employee's contributions (DOL Reg. § 1002.262(c)).

In addition to making up missed contribution, a returning service member who is a participant in a 401(k) or other defined benefit plan must be allowed to repay (with interest) any amounts withdrawn from plan in connection with his or her service. The repayment period is the same as for missed contributions (DOL Reg. § 1002.264).

A new rule added by the Heroes Earnings Assistance and Relief Tax Act of 2008 (PL 110-245, 6/17/2008) provides that, for benefit accrual purposes, an employer sponsoring a retirement plan *may*--but is not required to--treat an employee who cannot be reemployed because of a service-connected disability as if he or she was rehired on the day before the disability occurred and then terminated on the date of the disability. (This option also applies in the case of an employee who dies during military service.) If an employer includes this option in a retirement plan, the plan can either provide for the same make-up contributions that would have been required if the employee had actually been reemployed or may make only partial make-up contributions. (Code Sec. 414(u)(9)(A) as amended by 2008 Heroes Act §104(b)) The new rule applies for deaths and disabilities occurring on or after Jan. 1, 2007, provided the plan is timely amended to reflect the new rule.

Health benefits. USERRA imposes COBRA-like continuation of coverage requirements for employer-provided health benefits. The continuation coverage period is up to 24 months from the date the employee leaves for service. The service member can be required to pay 102 percent of the full premium during a period of continuation coverage unless the period of service is for fewer than 31 days, in which case the service member can be required to pay only the employee share of the premium. However, unlike COBRA, USERRA does not have a minimum employer size requirement. The continuation coverage requirement applies to all employers.

Despite USERRA's continuation coverage requirements, service members with lengthy periods of service may lose coverage under their former employer's plan. In addition, other service members may choose to drop coverage. If health plan coverage for the service member or a dependent was terminated because of a period of service, the coverage must be reinstated upon reemployment (DOL Reg. § 1002.168). The reason for the termination of coverage is irrelevant. Thus, an employee who does not elect continuation coverage is entitled to reinstatement on the same basis as an employee who elects continuation coverage but whose period of service lasts beyond the 24-month continuation coverage period. Similarly, an employee who elects continuation coverage but whose coverage is terminated for nonpayment is also entitled to reinstatement of coverage.

No exclusion or waiting period for coverage can be imposed if the exclusion or waiting period would not have been imposed if coverage had not been terminated by reason of the period of service. However, USERRA does permit a health plan to impose an exclusion or waiting period with respect to illnesses or injuries that were incurred in or aggravated during the period of service. A determination that the illness or injury is service-connected must be made by the Secretary of Veterans Affairs (DOL Reg. § 1002.168).

Health plan coverage must generally be reinstated at the time of reemployment. However, an employer is permitted, but not required, to allow an employee to delay reinstatement of health coverage until a later date (DOL Reg. § 1002.168). An employee may prefer a delay, for example, if he or she has been covered by a spouse's health plan and wants to wait until the next open enrollment period to drop that coverage.

Seniority rights and benefits. A returning service member who qualifies for reemployment is entitled to the same seniority rights and benefits at the beginning of his or her period of military service *and* any additional seniority rights and he or she would have attained if he or she had been continuously employed (38 U.S.C. § 4316).

Example. Barker Company provides two weeks' paid vacation to employees with up to nine years of service and three weeks' paid vacation to employees with ten or more years of service. Joe, an eight-year employee of Barker Company, leaves the company for three years for a period of uniformed service. Joe properly applies for reemployment at the end of his period of service and returns to work at Barker Company. Barker Company must treat Joe as if he had completed 11 years of employment for purposes of its vacation policy, giving Joe three weeks of paid vacation following his reemployment.

Example. Barker Company's long-term disability plan requires ten years of service as a condition of eligibility. When Joe returns from his three-year period of service, his three years of military service must be credited toward eligibility under the long-term disability plan. Therefore, with 11 years of employment under his belt, Joe must be covered by the long-term disability plan.

DOL regulations make it clear that USERRA does not require employers to implement seniority systems. Rather, the law requires only that those employers who do provide benefits based on seniority restore a returning service member to his or her proper place on the seniority ladder (DOL Reg. § 1002.211).

Family and medical leave. The Family and Medical Leave Act (FMLA) generally allows employees of a covered employer to take up to 12 weeks of unpaid, job-protected leave during a 12-month period for certain family and medical reasons, such as the birth or adoption of a child, or the illness of the employee or a family member (P.L. 103-3). To be eligible for leave, an employee must have worked for the employer for at least (1) 12 months (whether or not consecutive) and (2) 1,250 hours during the 12-month period immediately preceding the start of the leave.

In this case, USERRA does not extend the FMLA to employers not normally covered by the law. The FMLA generally applies only to employers with 50 or more employees. However, USERRA does impact the eligibility of service members for FMLA leave if they return to work for a covered employer.

The DOL says that the 12-month employment requirement must be calculated by including an employee's period of uniformed service. So, for example, if an employee works for an employer for 9 months followed by a period of service of 4 months, he or she will have met the 12-month employment requirement upon return to work.

In addition, the DOL says that the 1,250-hour requirement must be calculated using the employee's pre-service work schedule. Thus, the hours the employee would normally have worked for the employer but for the period of service are added to the hours actually worked in determining whether the employee worked 1,250 hours in the 12-month period immediately preceding the leave. [USERRA-FMLA Questions and Answers, 7/25/02]

While an employer will generally have no special obligation to provide family or medical leave to a returning service member, *family members* of returning service members may have special leave rights thanks to a new law

enacted in 2008. The new law, dubbed the Wounded Warrior Act (Sec. 585 of PL 110-181) amends the FMLA to allow an otherwise eligible employee who is the spouse, son, daughter, parent, or next of kin (i.e., closest blood relative) of a covered servicemember with a serious illness or injury incurred in the line of duty up to *26 weeks of leave* in a 12-month period to care for the service member [FMLA § 102(a)(3); 29 U.S.C. 2612(a)(3)]. The new law applies only to employers that are otherwise covered by the FMLA.

A covered servicemember is a member of the Armed Forces, including a member of the National Guard or Reserves, who is undergoing medical treatment, recuperation, or therapy for a serious injury or illness; receiving care as an outpatient; or is on the temporary disability retired list for a serious injury or illness. Serious injury or illness means an injury or illness incurred in the line of duty that may render the service member medically unfit to perform his or her duties. [FMLA § 101(16); 29 U.S.C. 2611(16)]

The FMLA expansion relating to the 26 weeks of unpaid leave to care for service members injured in combat took effect as of the date the President signed the new law on January 28, 2008.

Observation. The DOL has not yet issued specific guidance on the new provision allowing 26 weeks of FMLA leave to care for a covered service member. And while many of the general principles governing the 12 weeks of FMLA leave allowed in other qualifying situations should apply, there may be some differences when that guidance is issued. For example, under current FMLA rules son or daughter is defined as an individual under 18, or 18 or older and incapable of self-care. However, the DOL has suggested that Congress intended son or daughter to be defined more broadly to include adult children for purposes of the family military leave rules.

Note. The expansion of the FMLA also includes a provision allowing an otherwise eligible employee up to 12 weeks of leave in a 12-month period because of any qualifying exigency arising out of the fact that the spouse, son, daughter, or parent of the employee is on active duty (or has been notified of an impending call or order to active duty) in the Armed Forces. [FMLA § 102(a)(1)(E)]; 29 U.S.C. 2612(a)(1)(E)] However, that provision will not officially take effect until the DOL defines what's meant by a qualifying exigency.

Tax Rights and Obligations of Returning Service Members

A returning service member may have some catching-up to do when it comes to taxes, but may also be eligible for some special tax breaks.

Filing extended returns. Many service members may routinely file their returns by the regular April 15 due date (June 15 for service members stationed outside the United States and Puerto Rico), especially if they are due refunds. Or they may take advantage of the six-month extension that applies to all individual taxpayers.

However, returning service members who were deployed in qualifying combat zone service may have taken advantage of a far more generous extension provision that will necessitate the filing of prior years returns now that they have returned home.

Extension rules. This special extension applies to U.S. Armed Forces personnel serving in a combat zone or performing other qualifying combat zone service.

For qualifying service members, the deadline for filing tax returns, paying taxes, and taking certain other tax actions is extended for at least 180 days after:

§ The last day of qualifying combat zone service, or

§ The last day of any continuous qualified hospitalization for injuries from service in combat service (*IRC §7508(a)*).

Qualifying combat zone service includes service in a combat zone, service in a qualified hazardous duty area, service outside the qualified hazardous duty area in support of the area, and service in a contingency operation. Time in missing status counts as time in a combat zone or contingency operation.

Qualified hospitalization includes any hospitalization outside the United States and up to five years of hospitalization in the United States.

In addition to the 180 days, a deadline is extended by the number of days that were left to take the action with the IRS when the service member entered combat zone service.

Planning Tip. Bear in mind, however, that the clock may have started ticking before the service member returned home if a service member left qualifying combat zone service before the end of his or her period of service.

Example. Captain Alvin Potter entered a combat zone on December 1, 2005. He remained there through March 31, 2007, when he was shipped back to the United States. He served at a base in the United States until December 1, 2007, when he left the military and returned to his home in Kansas. On December 15, 2007, he visited a tax return professional to discuss filing his 2005, 2006 and 2007 returns. Captain Potter discovered that his 2005 and 2006 returns were due in short order--on January 10, 2008--and that his 2007 return is due by the regular return due date. Here's why:

2005 return. The deadline fell 285 (180 plus 105) days after Captain Potters last day in the combat zone on March 31, 2007. The 105 additional days are the number of days in the 2005 filing period (January 1-April 15, 2006) that were left when he entered the combat zone.

2006 return. Here again, the deadline fell 285 days (180 plus 105) after Captain Potter's last day in the combat zone (March 31, 2007) because there were 105 days left in the 2006 filing period (January 1-April 15, 2006) when he entered the combat zone.

2007 tax return. On the other hand, Potters 2007 return is due on the normal April 15 2008 due date. That's because the 180-day extension period after March 31, 2007, plus the number of days left in the 2008 filing period when he entered the combat zone (106) ended on January 11, 2008, before the regular due date.

Planning Tip. Even if a returning service members 2007 return is eligible for extension, he or she may want to file it sooner rather than later. By filing a timely return, the returning service member will receive an economic stimulus rebate sooner rather than later. Moreover, that's true even if the returning service member owes no tax for 2007 because his or her entire income for 2007 consists of nontaxable combat pay (see below). An IRS news release on the stimulus rebate makes it clear that nontaxable combat pay is qualifying income for purposes of the rebates (IR-2008-48). Therefore, a returning service member who would not normally file because his or her income is nontaxable combat pay should file a Form 1040A, *U.S. Individual Income Tax Return*, to receive a rebate. Nontaxable combat pay should be entered on Line 40b of Form 1040A in order to show at least \$3,000 of qualifying income for rebate purposes. Nontaxable combat pay is reported in box 12 of Form W-2 with Code Q.

Other tax actions extended. The extension for qualifying combat zone service also applies to other tax actions such as filing gift and estate tax returns and filing refund claims (*IRC § 7508(a)(1)*). Most significantly, it also applies to making IRA contributions for tax years on extension. So a returning service member may be able to make up several years of missed IRA contributions.

Spousal extensions. A combat zone extension also applies to the spouses of service members. However, some special rules apply. The extension does not apply to a spouse for any tax year beginning more than two years after the date that the area in which the member served, ceases to be a combat zone or the operation ceases to be a contingency operation. The extension also does not apply to a spouse for any period the service member is hospitalized in the United

States for injuries incurred in a combat zone or contingency operation (*IRC* §§ 7508(c), (g)).

Planning Tip. Because of the special rules, a service member and spouse who plan to file a joint return may have to file earlier than the extended return deadline. This is particularly true in the case of hospitalized veterans.

Paying deferred taxes. Some returning service members may have to ante up taxes that came due before or during their military service but were deferred under a special tax rule.

If a service member on active duty receives a collection notice for back taxes, the IRS will grant a deferment if the service members ability to pay has been materially affected by his or her military service.

If a deferment is granted, the service member will have up to 180 days after termination or release from military service to pay the tax. If the tax is paid in full by the end of the deferral period, no interest or penalty is charged for the 180 day period. Interest is charged during the period of military service. However, a maximum 6% interest rate applies.

Moving expenses. To deduct moving expenses, taxpayers generally must meet certain time and distance tests (*IRC* § 217). However, those tests do not apply to members of the Armed Forces on active duty who move because of a permanent change of station (*IRC* § 217(g)). Moreover, a move because of a permanent change of station includes a move from the members last post of duty to his or her home or to a *nearer* point in the United States (Reg. §1.217(g)(3)). To qualify for a waiver of the time and distance tests, the move must generally occur within one year of the end of active duty.

The value of moving and storage services or a moving allowance provided by the government are not included in income (*IRC* § 217(g); Reg. § 217(g)(2)). However, those amounts cannot be included in calculating deductible moving expenses.

Sale of home. Many service members will return to the family homestead following their period of service. But others may seize the opportunity to sell the home and move to a new location.

Individual taxpayers can generally exclude up to \$250,000 of gain on the sale of a home, while married taxpayer filing jointly can generally exclude up to \$500,000 (*IRC* § 121). However, to qualify for the exclusion, the home must have been owned and used as a principal residence for at least two of the five years preceding the sale. Joint filers will qualify if ownership was in the name of only one spouse, but both spouses must meet the two-year use requirement.

Consequently, if a single filers period of service is lengthy, he or she might not meet the two-year use test. And the same holds true for a married service member if his or her spouse relocated in connection with a tour of duty. However, in this situation the tax law provides a--

Special election. A taxpayer can elect to have the 5-year test period for ownership and use suspended for any period the taxpayer or spouse served on qualified official extended duty as a member of the uniformed service (*IRC* §121(d)(9)). Therefore, the taxpayer may be able to meet the two-year use test even if the taxpayer (or spouse) did not use the home as a residence for the required two years preceding the sale.

Example. Kevin Olsen bought and moved into his home in 2000. He used it as his main home for 2 years. However, for the next 6 years, he did not live in it because he was on qualified official extended duty with the Army. He sold the home at a gain in 2008. In order to meet the use test, Kevin elected to suspend the 5-year test period for the 6 years he was on qualifying official extended duty. Therefore, Kevins 5-year test period consisted of the 5 years before he went on qualifying official extended duty. He met the ownership and use tests because he owned and lived in the home for 2 years during that test period.

A service member is on qualified official extended duty if he or she is serving on extended duty either at a duty station at least 50 miles from his or her main home or is living in government quarters under government orders (*IRC § 121(d)(9)(C)(i)*). Extended duty means a call up to active duty for more than 90 days or for an indefinite period.

There is a 10-year limit on the period of extended duty that can be discounted under the special rules (*IRC § 121(d)(9)(B)*).

Planning Tip. If a returning service member plans to move directly to a new home, the waiver of the time and distance tests for the moving expense deduction (see above) will apply only if the new home is *nearer* to his or her last post of duty than the old home.

Nontaxable combat pay. A returning service member who leaves the military in 2008, may have received nontaxable combat pay for some part of the year. However, service members who returned in earlier years may also be eligible for the combat pay exclusion (*IRC § 112*).

In the case of an enlisted service member, warrant officer or commissioned warrant officer, all pay for any months service in a combat zone or in a qualified hazardous duty area is excludable from income.

These service members can also exclude military pay earned while hospitalized as a result of wounds, disease, or injury incurred in the combat zone. However, the exclusion does not apply to any military pay received for any month of service that begins more than 2 years after the end of combat activities in the combat zone. The hospitalization does not have to be in the combat zone (*IRC §§ 112(a), (c)(1)*).

Commissioned officers are eligible for the combat pay exclusion under the same circumstances. However, the amount of the exclusion for commissioned officers (other than commissioned warrant officers) is limited to the highest rate of enlisted pay (plus any imminent danger/hostile fire pay received) for each month (or part of a month) served in a combat zone or hospitalized as a result of service in a combat zone (*IRC §§ 112(b), (c)(5)*).

Practice Tip. The wages shown in box 1 of a service member's Form W-2 should not include military pay excluded from income under the combat zone exclusion provisions. Nontaxable combat pay is reported in box 12 of Form W-2 with Code Q. If nontaxable combat pay is reported in box 1, the service member should request a corrected Form W-2.

Military retirement benefits. Military retirement benefits based on length of service are taxable. [*Treas Reg. § 1.61-2(a)*] On the other hand, veterans' benefits based on a service-connected disability are excluded from income. [*IRC § 104(a)(4)*] If a retired service member receives taxable retirement benefits but is later retroactively determined to be eligible for service-connected disability benefits, the portion of the retirement benefits attributable to the disability is retroactively excluded from income. The retired service member can claim a refund of the tax paid on the retroactively excluded benefits. However, there's a catch: There's a time limit on filing a refund claim.

In the past, refund claims for the tax paid on retroactively excluded benefits were subject to the general statute of limitations for refunds. In other words, the claim had to be filed within three years of the filing of the tax return on which the retirement benefits were reported, or within two years of the payment of the tax, whichever was later. The Heroes Earnings Assistance and Relief Tax Act of 2008 (PL 110-245, 6/17/2008) extends the time period for filing a refund claim until one year after the date of the disability determination (if that's later than the time allowed under the general limitations period). However, the extended time period does not apply to a tax year beginning more than five years before the date of the disability determination. [*IRC § 6511(d)(8)*, as amended by Heroes Act § 106(a)]

The extended refund period generally applies to refund claims filed after June 17, 2008. Under a special transition rule, in the case of a disability determination made after 2000 and on or before June 17, 2008, the refund period is extended until June 17, 2009 (if later than the time period allowed under prior law). However, the transition rule does not apply to any tax year that began before January 1, 2001. [Heroes Act § 106(c)]

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Zanglein on Recent Changes to Roth IRAs and Annuities

2008 Emerging Issues 2227

Jayne Zanglein on IRS Notice 2008-30 on Pension Protection Act Changes Relating to IRA Rollovers and Qualified Optional Survivor Annuities

By Jayne Zanglein

April 25, 2008

SUMMARY: In March 2008, the IRS issued *Notice 2008-30* on miscellaneous Pension Protection Act (PPA) provisions relating to rollovers from qualified retirement plans to Roth IRAs and distributions from Qualified Optional Survivor Annuities.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: In March 2008, the IRS issued *Notice 2008-30* on miscellaneous Pension Protection Act (PPA) provisions relating to rollovers from qualified retirement plans to Roth IRAs and distributions from Qualified Optional Survivor Annuities. This commentary will summarize those changes. n1

Rollover Contributions to Roth IRAs. According to *IRC § 408A(c)(6)(A)*, a Roth IRA can accept only qualified rollover contributions. Before the PPA, *IRC § 408A(e)* defined a qualified rollover contribution as a contribution from a designated Roth account, another Roth IRA, or a non-Roth IRA (traditional or SIMPLE IRA). The PPA expanded the list of plans from which distributions are permitted to include an individual account plan as defined by *IRC § 408(a)*; § 403(a) and (b) annuity plans; and § 457(b) governmental plans (called eligible retirement plans under *IRC § 402(c)(8)(B)*). Under this amendment, beginning in 2008, a Roth IRA can accept rollover distributions from any eligible retirement plan, if the distributions meet certain requirements.

Distributions from an individual account plan can either be rolled over to a Roth IRA or distributed from the qualified plan and then contributed to a Roth IRA within 60 days. *Notice 2008-30 A-1*. The amount rolled over must be an eligible distribution (under *IRC § 402(c)(4)*) and under *IRC § 408A(d)(3)(A)*, the participant must include in his or her gross income the amount that would have been includible in gross income if it had not been part of the qualified rollover contribution. *Notice 2008-30 A-1*. For taxable years beginning before January 1, 2010, a participant may not roll a contribution over from an eligible retirement plan other than a Roth IRA if, in the year in which the distribution is made, the participants modified adjusted gross income (MAGI) exceeds \$100,000 or the participant is married and files a separate tax return. § 408A(c)(3)(B); *Notice 2008-30 A-1*. These limitations (\$100,000 MAGI and married/separate return) also apply to rollovers made in taxable years beginning before 2010 from § 403(a) and (b) annuity plans and § 457(b) governmental plans. *Notice 2008-30 A-2*.

Although *IRC* § 72(t) imposes a 10% tax for a premature distribution, this tax will not apply to rollovers from individual account, 403(a) or (b), or 457(b) plans. § 408A(d)(3)(A)(ii). *Notice 2008-30 A-3*. If, however, a taxable amount is rolled over into a Roth IRA from one of these eligible retirement plans and then is distributed within 5 years, the 10% additional tax will apply to the distribution as if it were includible in gross income. § 408A(d)(3)(F). *Notice 2008-30 A-3*.

IRC § 401(a)(31) requires a plan to abide by a distributees election to directly roll over distributions to an eligible retirement account. *Notice 2008-30 A-4*. The *IRC* regulations governing direct rollovers provide exceptions for small amounts and multiple distributions. See Section 1.401(a)(31)-1. The plan administrator is not responsible for assuring that the distributee is eligible to make a plan rollover to a Roth IRA. *Notice 2008-30 A-5*.

IRC § 3405(c), which remains unchanged by the PPA, requires that the plan withhold 20% of the eligible rollover distribution paid to an employee or employees spouse. When a distributee elects to roll over an eligible retirement distribution directly to an eligible plan, the mandatory withholding is not required; however, a voluntary withholding agreement is permitted between the payor and distributee. *Notice 2008-30 A-6*.

Beneficiaries can make qualified rollover contributions from an eligible retirement plan other than a Roth IRA; however, the MAGI and filing status of the beneficiary are used to determine eligibility to make the rollover contribution to the Roth IRA. *Notice 2008-30 A-7*. The PPA added *IRC* § 402(c)(11) which permits, but does not require, rollovers by a person who inherits an eligible retirement plan (i.e. a nonspouse). A rollover by an inherited individual must be made via a trustee to trustee transfer. *IRC* § 402(c)(11)(A); *Notice 2008-30 A-7*. If the inherited individual is ineligible to make the rollover contribution, she may instead recharacterize the contribution under *IRC* § 408A(d)(6). When making the rollover to the Roth IRA, the surviving spouse may treat the Roth IRA as her own, or may create the Roth IRA in the name of the deceased spouse, naming herself as the beneficiary. In contrast, an inherited individual does not have the option to treat the IRA as his own. *Notice 2008-30 A-7*.

Qualified Optional Survivor Annuity. The PPA amended *IRC* § 417(a)(1)(A)(i) to require defined benefit plans (and certain defined contribution plans that are subject to *IRC* § 412s funding rules) subject to *IRC* § 401(a)(11), to offer plan participants a new form of survivor annuity in addition to the qualified joint and survivor annuity (QJSA). This new optional benefit is called a qualified optional survivor annuity (QOSA). *IRC* § 417(a)(1)(A)(i).

If a participant waives the QJSA, then the plan must offer the participant the opportunity to elect a QOSA. *IRC* § 417(a)(1)(A)(i). *IRC* § 417(g)(1), which was added by the PPA, defines a QOSA. The percentage of benefit required by the QOSA depends on the percentage of spousal annuity offered by the QJSA. *IRC* § 417(g)(2). For example, if the QJSA provides a survivor benefit of less than 75% of the amount paid over the joint lives, then the QOSA must provide a benefit of 75%. *Notice 2008-30 A-8*. If the QJSA offers more than 75%, then the QOSA must provide a benefit of 50%. *Notice 2008-30 A-8*.

If the plan offered, before and after the effective date of the PPA amendment to *IRC* § 417(a)(1)(A)(i), a QJSA that already provides the additional benefits that would be required by a QOSA, then the plan does not have to offer a QOSA. *Notice 2008-30 A-9*. For example, if a plan already offers a 50% QJSA as well as a 75% QJSA, then the plan does not have to offer a formal QOSA. *Notice 2008-30 A-10*. If the plan offers a more generous QJSA than the plans single life annuity, the QOSA does not have to be as generous. *Notice 2008-30 A-10*. Spousal consent is required only if the participant elects a QOSA that is not equivalent to the plans QJSA. *Notice 2008-30 A-11*.

The plan must provide an applicable election period in which the participant who waives the QJSA can elect a QOSA. *IRC* § 417(a)(6). In addition, the plan must provide the participant with a written explanation of the terms and conditions of the QOSA. *IRC* § 417(a)(2). The plan can satisfy this requirement by meeting the conditions of *IRC* § 1-417(a)(3)-1, plus the plan must treat the QOSA as an optional form of benefit presently available to participants under

the plan. *Notice 2008-30 A-12*. The plan is not required to offer a qualified preretirement survivor annuity based on a QOSA. *Notice 2008-30 A-13*.

If a plan is amended to implement a QOSA, and the plan is operated as if the amendment were in effect from the effective date of the changes until the date of amendment, then the plan will be treated as being operated in accordance with its terms during this time and the amendment will be considered to be adopted on the date of the changes made. *Notice 2008-30 A-14*.

These changes apply to plan distributions with annuity starting dates in plan years that begin after December 31, 2007. For collectively bargained plans, the changes apply to distributions with annuity starting dates beginning on or after the earlier of January 1, 2008 or the date on which the last collective bargaining agreement related to the plan expires. If a participant elects a retroactive annuity starting date that is before PPA amendment becomes effective, the date of the first actual payment of benefits based on the elected date will be substituted for the purpose of applying the above distribution rules. *Notice 2008-30 A-15*.

Determination of Present Value of the Benefits. The PPA amended *IRC § 417(e)(3)*. As a general rule, under this section, the present value of a benefit cannot be less than the present value calculated by using the applicable mortality tables and the applicable interest rate. *IRC § 417(e)(3)(A)*. Before 2008, the applicable interest rate was defined as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other date as the Secretary may by regulations prescribe. *Notice 2008-30 at 7*. For plan years beginning in 2008, *IRC § 417(e)(3)(C)* defines the applicable interest rate as the adjusted first, second, and third segment rates for the month before the date of the distribution or such other time as the Secretary may by regulations prescribe. These segment rates are determined without regard to the 24-month averaging and are phased in over five years. *Notice 2008-30 at 7*.

A QJSA will not fail to meet the requirement that it must be as valuable as any other form of benefit payable simply because the amount payable under an optional form of benefit that is subject to *IRC § 417(e)(3)* is calculated using the applicable interest rate and mortality rates under *IRC § 417(e)(3)*. *Notice 2008-30 A-16*. See also A-17, A-18, and *Rev. Rul. 2007-67* for additional guidance.

Gap-Period Earnings. The Notice also provides guidance on the mandatory inclusion of gap-period earnings with the distribution of excess deferrals (i.e. elective deferrals that exceed the *IRC § 402(g)* limits). A corrective distribution must be made by the April 15th following the year of the excess deferral and the distribution must be corrected for gains and losses. For tax years beginning on or after January 1, 2007, this adjustment must include the gains and losses that occur during the gap-period. *Notice 2008-30* provides that a restated plan submitted to the IRS in Cycle B or Cycle C must contain gap-period language. *Notice 2008-30 A-19*. As of March 24, 2008, in order to receive an IRS determination letter, a restated plan must provide for the distribution of gap-period earnings. *Notice 2008-30 A-19*. An interim plan amendment is not required until the last day of the first plan year beginning on or after January 1, 2009. *Notice 2008-30 A-20*. Plans are required to include gap-period earnings in the distribution of excess deferrals, effective for deferrals attributable to taxable years beginning on or after January 1, 2007. *Notice 2008-30 A-21*.

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Fink on Boulware v. U.S.

2008 Emerging Issues 2140

Philip Fink on Boulware v. U.S.: Are Returns of Capital Included in a Shareholder's Gross Income?

By Philip R. Fink

April 16, 2008

SUMMARY: The distributions were a return of capital, and not required to be reported by Boulware in his gross income. Moreover, if there is no gross income, there is no tax deficiency on Boulwares return. The court indicated that there cant be any criminal tax evasion unless there is a deficiency. Thus, Boulware was not guilty of criminal tax evasion.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: There has been a controversy among the circuit courts as to whether intent is a necessary element in determining if a distribution (or, a deemed distribution) is to be considered a return of capital treated as a nontaxable distribution.

Background. In general, the tax laws require individuals to report all income from whatever source, except for those items specifically excluded by the Internal Revenue Code. One of the exceptions is the manner in which dividends are treated. The IRC states that any distribution of property or money from a corporation to its shareholders is included in their gross income if one of the following conditions exist:

- . The corporation has accumulated earnings and profits (E&P), or
- . The corporation has current E&P in the year the distribution is made.

E&P. In general, accumulated E&P is the same as beginning retained earnings. Current E&P is generally equal to the current years increase to retained earnings

Example. United Corp. has accumulated E&P of \$40,000 and no current E&P. It pays a dividend of \$75,000. Hence, \$40,000 is considered gross income to the shareholders and \$35,000 is considered to be a return of capital.

Example. United Corporation has no accumulated E&P, but has current E&P of \$10,000. If it makes a distribution of \$12,000 to its shareholders, only \$10,000 is required to be included in their gross incomes.

The logic of the law in this situation is that if a return of capital was included in gross income of a shareholder, it would be an income tax on something that the shareholder already owns, and has already been taxed.

Facts. Michael Boulware was charged with several counts of tax evasion and filing a false income tax return, stemming from his diversion of funds from Hawaiian Isles Enterprises (HIE), a closely held corporation of which he was the president, founder, and controlling (though not sole) shareholder. At trial, the United States sought to establish that Boulware had received taxable income by systematically diverting funds from HIE in order to support a lavish lifestyle. At the time of the distributions, HIE had neither accumulated E&P, nor current E&P.

The issue. The issue was whether Boulware could treat the distributions as a return of capital without showing evidence that either he or HIE *intended* a capital return when the distributions occurred.

Lower courts decisions. The lower courts ruled that since Boulware or HIE did not show that there was an intent to treat such distributions as a return of capital, that it should have been included in Boulwares gross income. Since there were millions of dollars of distributions not included on his tax return, he was guilty of tax evasion.

Supreme Court decision. The Supreme Court ruled that whether or not Boulware or the corporation intended the distributions to be a return of capital is immaterial. The test is a mechanical one. That is, any distribution to the extent of E&P is included in a shareholders gross income. Further, the court noted that the E&P test is applied as of the end of the year. Thus, the tax status of a distribution at the end of the first quarter is dependent on the amount of E&P at the end of the year. Thus, when a board of directors declares a dividend at the end of the first quarter it is impossible for them to have an intention on the status of such a distribution since it is dependent on the amount of E&P as of the end of the year. Such amount cannot be known at the end of the first quarter.

Since HIE had no accumulated or current E&P, the distributions were a return of capital, and not required to be reported by Boulware in his gross income. Moreover, if there is no gross income, there is no tax deficiency on Boulwares tax return. The court indicated that there cant be any criminal tax evasion unless there is a deficiency. Thus, Boulware was found not guilty of the charge of criminal tax evasion. (*Boulware v. U.S.*, 2008 U.S. LEXIS 2356).

Embezzlement issue. The issue of whether the corporate funds were acquired by embezzlement was never raised at the trial court, so the Supreme Court did not entertain that issue. Since Boulware diverted the funds without some sort of corporate approval, an argument could have been made that the funds were in fact embezzled and not a dividend. In this case, the IRS could have made an argument that such embezzled funds should be included in Boulwares gross income under *IRC Section 61* (gross income is any income from whatever source, unless otherwise excluded.) Since there is no exception for embezzlement (as there is for dividend distributions with respect to E&P), it would have had to be included in his gross income. Had the government made this argument, there would have been a tax deficiency resulting in criminal tax evasion.

Declaration. In this case, there was no declaration of a dividend by the board of directors. The Court emphasized that a declaration is not a necessary ingredient to having a dividend since in many other situations the tax laws create constructed dividends.

Example. Bob is the controlling shareholder of a corporation that owns a corporate jet. He and his family use the jet to go on a family vacation. The fair rental value of using the jet to go to and from his vacation is \$2,500. Thus, Bob would have a constructive dividend of \$2,500, even though there was no formal declaration by the board of directors of the corporation.

Disproportionate. The Court was not concerned that the constructive dividend in this case was disproportionate. It is typical that when there is a constructive dividend, it is disproportionate. For instance, in the prior example, only Bob

got to obtain the benefit of the corporate jet. Hence, he is the only one deemed to have received a constructive dividend.

Tax planning implications. A corporation may want to declare a dividend in a year in which there is no E&P. Such a distribution would be considered a return of capital.

Example. The American Corp. began business a few years ago. In those years it incurred minor losses. It is projected that beginning next year, it will have substantial E&P. In order to reward the shareholders for sticking with the corporation through the tough times, it declares a dividend to its shareholders this year. By declaring the dividend this year, rather than next year, it is deemed to be a return of capital. Hence, the shareholders do not have to include such a dividend in their gross incomes.

Caveat breach of fiduciary duty. The board of directors in the prior case may be breaching its fiduciary duty by making a distribution at a time following a period when the corporation has had losses, resulting in a depletion of its resources to a point where it may be hard for them to conduct business, or they have to obtain a loan to keep the corporation afloat.

No free lunch reduction of basis for stock. When a dividend is considered to be a return of capital, shareholders must reduce their adjusted bases in their stock by the amount of the dividend considered to be a return of capital. A dividend that exceeds the adjusted basis of stock is considered to be a capital gain.

Example. On May 7, 2007, Bill purchased 100 shares in the United Corp. for \$15,000. In 2008, United paid a dividend in the amount of \$10,000. Since United had no E&P, the entire amount of the dividend was deemed to be a return of capital. Thus, his basis in the stock is reduced to \$5,000 (\$15,000 -- \$10,000). In 2009, United made a distribution to Bill in the amount of \$12,000. For 2009, United had no E&P. Thus, Bill must report a long-term capital gain of \$7,000 (\$12,000 -- \$5,000).

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Dialani on Long-Term Capital Gains Tax on Sale of Listed Securities

2008 Emerging Issues 2163

Jyoti Dialani on Long-Term Capital Gains Tax on Sale of Listed Securities by a Non-Resident Indian

By Jyoti Dialani

April 16, 2008

SUMMARY: In a landmark ruling, the Authority for Advanced Rulings in India has held that non-resident or foreign companies in India are entitled to a lower tax rate of 10 percent of the long-term capital gains made on the sale of any listed securities bought in India in foreign currency. This decision is a boon to non-resident investors in the share market in India who can pay the beneficial tax rate on all gains made on sales of securities.

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ARTICLE: Birth of a controversy

A recent ruling in India passed by the Authority of Advance Rulings n1 (AAR) under the Income-tax Act, 1961 (the Act) in the case of Timken France SAS, a non-resident French company engaged in the manufacture of ball and roller bearings, has come as a boon to non-resident investors in the share market, but it has also sparked off a major controversy in the tax arena. The ruling by the AAR contradicts a decision of the Mumbai Income Tax Appellate Tribunal n2 (ITAT) in the case of BASF Aktiengesellschaft, a non-resident German company engaged in the manufacture of chemicals. The controversy concerns the appropriate tax rate which will be applicable to long-term capital gains n3 (LTCG) to a non-resident Indian in the Indian stock market on a sale of listed securities.

Background of tax on capital gains on a sale of listed securities

For years, the Income Tax Department has taken a stand and has also implemented in practice that the concessional rate of tax at 10 percent of capital gains, arising from the sale of securities on which no securities transaction tax has been paid, is only restricted to residents and this concession is not applicable to non-residents. The reason for providing a concession to residents is that they also have an option under the law to pay a higher rate of tax on capital gains computed by taking the cost of acquisition as on the date of purchase after applying the cost inflation index n4. However, non-residents are excluded from the beneficial option of indexation as is evident from a reading of the second proviso to Section 48 of the Act which provides the method of computation of capital gains.

Current scenario

Relevant provisions affecting taxability of long-term capital gains on listed securities

Section 112 of the Act provides that long-term capital gains tax on the sale of securities or shares should be computed at the rate of 10 percent. Subsection (1) of Section 112 n5 of the Act provides for a tax rate of 20 percent on long-term capital gains. However, in the case of a non-resident, the first proviso to Section 48 n6 provides that such gains shall be computed in terms of the foreign currency in which the shares or debentures were acquired, and the gains so computed in terms of foreign currency shall then be reconverted into Indian rupees. Therefore, when the shares are purchased in foreign currency, the sale consideration must be converted in the same foreign currency in which the shares are purchased and then the gain or loss is to be determined in the foreign currency, which again is to be reconverted into Indian currency. The second proviso to Section 48 provides that where long-term capital gain arises from the transfer of a long-term capital asset, other than capital gain arising to a non-resident from the transfer of shares in, or debentures of, an Indian company referred to in the first proviso, the provisions relating to cost of acquisition and cost of improvement shall have effect as if for the words "cost of acquisition" and "cost of any improvement," the words "indexed cost of acquisition" and "indexed cost of any improvement" had, respectively, been substituted. Simply put, the second proviso to Section 48 provides that for the purpose of computing capital gains, the indexed cost is to be taken in place of cost. Therefore, Section 48 also provides for indexation benefits. This proviso does not apply to gains to a non-resident from a transfer of shares or securities in a company. Also, Section 112 provides for a tax rate of 20 percent when the benefit of indexation is utilized by an assessee. The proviso to Section 112(1) provides that where the long-term capital gains tax on a transfer of listed securities or units exceeds 10 percent of the amount of capital gains before giving effect to the second proviso to Section 48, the excess tax shall be ignored for the purpose of computing the tax payable by the assessee. In other words, the long-term capital gains tax on a transfer of listed securities or units is the lower of 20 percent of the capital gains computed with indexation of cost or 10 percent of the capital gains computed without indexation of cost. Listed shares are sold on a recognized stock exchange and such sale is normally subjected to Securities Transaction Tax. Long-term capital gain, if any, arising from the sale of such listed shares is exempt under Section 10(38) of the Act with effect from assessment year n7 (A.Y.) 2005-2006. However, the proviso to Section 112(1) is applicable to transactions of sale of listed shares otherwise than on a recognized stock exchange, which may be by negotiated sale or direct open offer, buy-back of shares, reorganization, redemption, or reduction of share capital, etc.

Issues in controversy

The current hot issue which has arisen before the Tax Tribunals and the Authority for Advance Rulings in India is whether a non-resident having sold listed shares of a company in India is entitled to the beneficial tax rate of 10 percent on the long-term capital gains on such sale transaction computed without indexation of cost, since a non-resident is not entitled to indexation of cost on the sale of shares as discussed in the analysis of provisions immediately above. In the present scenario, there are conflicting decisions of the Mumbai Bench of the ITAT on the issue, with one Bench taking a view that the concessional tax rate of 10 percent is applicable even to a non-resident, and another holding an opposite view that the tax on the long-term capital gains should be computed at the rate of 20 percent. The AAR has held that the concessional rate of 10 percent is available even to a non-resident on a sale of listed shares.

In its recent decision, the Mumbai ITAT has held that non-residents protected from inflation through currency appreciation are not accorded the benefit of claiming a concessional rate of tax on capital gains. This view of the ITAT has been contradicted by the AAR in its ruling. However, the view of some experts is that fluctuations in local currency, being inconsequential and having little to no impact on a non-resident investor, should not be the basis of denying such

non-resident assessee any benefit, which in the normal course is available to all assessees. The fact that non-residents get protection from rupee value fluctuations in terms of foreign currency should not disentitle them from the benefit of a reduced rate of tax available to residents under the law. Although a controversy has been stirred in the wake of the ruling of the AAR, it will be applicable only to the assessee in that case. However, in the present times, post this ruling, the persuasive value emerging out of the ruling also cannot be ignored, which can influence future judicial opinions on the aspect of capital gains tax liability arising from the sale of securities to non-residents.

Current judicial opinions

In *In re Timken France SAS*,⁸ the AAR has ruled that non-residents are liable to pay long-term capital gains tax at the beneficial rate of 10 percent on the sale of securities listed on the stock exchange. By this ruling, the AAR has held that the concessional tax rate of 10 percent on long-term capital gains is available to non-residents as well. This ruling is path breaking in as much as it holds that on the long-term capital gain arising from the sale of original and bonus shares of the Indian company, the applicant, which is a foreign company, is entitled to the benefit of the second proviso to Section 112(1).⁹ This, if translated, means that the quantum of tax payable shall not exceed 10 percent of the amount of capital gain. This ruling is in complete contrast to and challenges the view endorsed by the Mumbai ITAT in its order, which holds that non-residents are liable to LTCG tax at the rate of 20 percent. Both the judicial pronouncements, the AAR ruling and the ITAT judgment are analyzed in detail in the forthcoming paragraphs. This will shed some light on the legal position presently in force on the debatable issue.

The *Timken France SAS* case before the Authority for Advance Rulings

Facts of the case

In *In re Timken France SAS*, the Applicant, a non-resident French company engaged in the business of manufacturing anti-friction bearings and allied products and providing related services, acquired shares in an Indian company, NRB Bearings. The payment towards the purchase of such shares was made in French francs. The shares of the Indian company were listed on the Bombay Stock Exchange and the National Stock Exchange. Over a period of time, the Applicant also received bonus shares from the Indian company. The Applicant held both the original shares and bonus shares for more than 12 months. During the previous year relevant to A.Y 2006-2007, the Applicant sold its entire shareholding consisting of the original and the bonus shares to the promoters of the Indian company. On these facts, the Applicant sought an advance ruling of the AAR as to the manner of computation of capital gains and the rate of tax to be applied.

Questions of law raised in the application

In its application, the Applicant sought the ruling of the Authority on the following questions of law:

- (a) Whether the rate of tax payable on the capital gains on the sale of the original shares would be 10 percent under the proviso to Section 112(1) of the Income-tax Act, 1961, and
- (b) Whether the rate of tax payable on the capital gains on the sale of the bonus shares would be 10 percent under the proviso to Section 112(1).

Issue before the AAR

The short issue for consideration before the AAR can be summarized as whether the concessional rate of 10 percent on long-term capital gains arising on the sale of original and bonus shares is available to a non-resident investor who has purchased the same in foreign currency.

Contentions of the Applicant

The argument raised on behalf of the Applicant was that since all the conditions requisite to attract the proviso to Section 112(1) were satisfied, the tax on long-term capital gains arising on sale of the shares should be computed at the concessional rate of 10 percent. It was claimed that the phrase "*before giving effect to the second proviso to Section 48*" in the proviso to Section 112(1) meant, before giving effect to the proviso wherever it was applicable. Accordingly, it was further argued that the proviso to Section 112(1) applied to all clauses of Section 112(1) including clause (c) which talks about a non-resident or a foreign company. Therefore, it was contended that tax on long-term capital gains arising on the sale of original shares should be computed at 10 percent. Similarly, it was also argued that the sale of bonus shares would also be taxable at 10 percent. The main ground for claiming the benefit of the reduced rate of 10 percent was that the same is applicable to non-resident companies as well and was not to be confined to residents only. A non-resident company was not disentitled to use the rate of 10 percent on the ground that it was not eligible to get the benefit of indexation, as provided in the second proviso to Section 48. In other words, the applicability of indexation benefit was not a condition precedent for availing the benefit of the lesser rate of 10 percent. The Applicant further contended that Section 112(1) did not intend to maintain the distinction between resident and non-resident taxpayers. Due to the fact that a level playing field between the non-resident and resident investors in share market was intended to be carved out, a different treatment of non-resident companies was not called for in the matter of the application of a lesser rate of tax. Reliance was placed on the Explanatory Memorandum to the Finance Bill 1992, which stated that the provision for deduction from fluctuation of rupee value against foreign currency regarding capital assets that are shares or debentures of Indian companies, so far available to non-resident Indians, will now be extended to all non-residents. However, in such case no indexation benefit would be available.

Contentions of the Income-tax Department

The tax authorities contended that the Applicant could not avail the benefit of the lower rate of 10 percent as indexation benefit was not applicable to the Applicant as the Applicant was a non-resident and the second proviso to Section 48 did not apply to non-residents. It was argued on behalf of the tax authorities that the intent of the legislature in inserting the proviso to Section 112 was to give an option to resident investors towards rate of taxation, i.e., 10 percent without indexation benefit or 20 percent with indexation benefit. This would not mean that the non-resident investors to whom benefit of indexation was not available (as they have the benefit of rupee value appreciation arising out of currency fluctuation) could also compute their tax on capital gains at the rate of 10 percent. The non-resident company could not claim to have the double benefit of protection against rupee value fluctuation as well as the reduced tax rate of 10 percent. Reliance was placed on CBDT n10 (Central Board of Direct Taxes) Circular of August 31, 1992, containing explanatory notes on the provisions of the Finance Act, 1992. The principle of cost inflation index was introduced by the Finance Act, 1992. The circular, Circular No. 6363, stated that as protection from fluctuation in rupee value in terms of foreign currency ensured protection from inflation, further relief in terms of indexation would not be available to non-residents who would enjoy the concession available in the first proviso to Section 48. The tax authorities further argued that non-residents were excluded from the purview of the second proviso to Section 48 (providing for cost inflation index). The CBDT had ruled that relief in terms of indexation will not be available to non-residents enjoying the concession of 10 percent. The rate of 10 percent is available only when cost indexation is not resorted to. Reliance was also placed on the decision of the Mumbai Bench of the ITAT in the case of *BASF Aktiengesellschaft v. Deputy DIT (International Taxation)*, n11 which is discussed below.

Ruling of AAR

The AAR analyzed the provisions of Section 48 and Section 112 of the Act, and noted that since the first proviso to Section 48 applied to the Applicant's case, the second proviso would be inapplicable to it. Having examined the reasons behind the introduction of the two provisos to Section 48 and the proviso to Section 112(1), it noted that the proviso to Section 112(1) applied to all clauses of Section 112(1), including clause (c). It narrowed down the controversy to being whether, having regard to the language employed in the proviso, the proviso to Section 112(1) ought to be applied to category (c) assessee (non-residents) as well. The Authority observed that there did not seem to be any clear intention to exclude non-residents. It interpreted the proviso to Section 112(1) as meaning that the quantum of capital gains should be arrived at without taking into account the formula provided in the second proviso to Section 48 based on the indexed cost of acquisition. Therefore, it was of the view that the words employed in the proviso to Section 112(1) were not words of exclusion of a category of assessee, but words stating the manner of computation in order to obtain the benefit of the lower rate of tax. The Authority also pointed out its disagreement with the interpretation of the ITAT in BASF Aktiengesellschaft's case. The AAR observed that the ITAT failed to note that there were no words for the exclusion of assessee governed by the first proviso to Section 48. The Authority felt that the assumption of the ITAT that it was giving effect to literal construction as well as legislative intent was incorrect.

Highlights of the AAR Ruling

Benefit of proviso to Section 112(1) cannot be denied to foreign companies

The benefit of the proviso to Section 112(1) could not be denied to non-resident/foreign companies who were also entitled to a relief in terms of the first proviso to Section 48. The proviso to Section 112(1) was a special provision in relation to a transfer of certain long-term capital assets, such as listed securities, units and zero coupon bonds. There was no warrant to limit the 10 percent effective rate provided therein, as against the normal rate of 20 percent, only to the three categories of resident assessee specified in clauses (a), (b) and (d). If the legislature so intended, clear words would have been deployed in the proviso if one particular category, i.e., non-residents, were to be excluded. The eligibility to avail the benefit of indexed cost of acquisition was not a *sine qua non* for applying the reduced rate of 10 percent. It was only a mode of computation of capital gains.

First proviso to Section 48 applicable to the Applicant

In the case of the Applicant, the first proviso to Section 48 was applicable for the computation of the capital gains arising from the transfer of shares because the original shares were purchased by utilizing foreign currency.

If tax authorities contention were accepted, even Zero coupon bonds (ZCBs) and debentures would go out of the purview of Section 112, which was not intended

As per the third proviso to Section 48, the benefit of indexation would not apply to long-term capital gains arising from the transfer of bonds or debentures other than capital indexed bonds issued by the Government. The authorities had contended that the proviso to Section 112(1) could not be applied where indexation benefit was not available to non-residents. Thus, if this contention were accepted, then ZCBs and debentures would also go out of the purview of the proviso to Section 112(1), which was not intended. The resident taxpayers would have to pay tax at the normal rate of 20 percent. The proviso to Section 112(1) could not be read in one way insofar as the listed securities/shares were concerned and be read in a different way in relation to ZCBs and debentures.

Explanatory Memorandum and CBDT Circular do not suggest either way

With regard to the Explanatory Memoranda and CBDT Circular relied on by the taxpayer and tax authorities, respectively, the AAR held that they did not clearly throw light on the rationale of extending or not extending the benefit of reduced rate of tax to foreign companies. The words employed in a Circular intended for administrative guidance could not be interpreted as those in a statute. There was nothing in the circulars or explanatory memoranda to indicate that the non-residents were either excluded or included from using the reduced rate of 10 percent.

Rationale of introducing the provisos to Section 48 and non-application of the second proviso to foreign companies

As per CBDT Circular No. 5544, the first proviso to Section 48 was introduced to compensate non-resident Indian investors for the lower earning in foreign currency on account of the decline of rupee value. As per CBDT Circular No. 636, the second proviso to Section 48 was introduced as a measure to offset the effect of inflation. Further, non-residents were excluded from the purview of the second proviso. As protection from a fluctuation in rupee value in terms of foreign currency ensured protection from inflation, further relief in terms of indexation would not be available to non-residents who would enjoy the concession available in the first proviso to Section 48.

Dissenting view

The Mumbai ITAT in BASF Aktiengesellschafts case held that the option to pay capital gains tax at the rate of 10 percent or 20 percent under Section 112(1) did not apply to non-resident taxpayers who were covered under the first proviso to Section 48. In the present case, the AAR's view was that the Tribunal purported to reach this conclusion merely on a literal construction of the proviso. The Tribunal's views were based on the premise that the legislature did not intend to provide double relief to a non-resident taxpayer -- one under the proviso to Section 48 and another under the proviso to Section 112(1). Having observed the rationale of the Tribunal's decision, the AAR held that no such legislative intention could be imputed to the legislature except by way of some guess work or *a priori* reasoning. The Tribunal's assumption that it was giving effect to literal construction as well as legislative intent was incorrect. Therefore, on the central issue regarding the entitlement of non-residents to exercise the optional rate of capital gains tax, the AAR held a view in contrast with the Tribunal's decision.

Bonus shares also taxable at 10 percent

Bonus shares and original shares were listed securities. The proviso to Section 112(1) did not make any distinction between original and bonus shares. Under the proviso to Section 112(1), the benefit of the lower rate of tax could not be denied to non-residents in respect of long-term capital gains arising from the transfer of the original shares. By the same reasoning, the benefit of a lower tax rate was available also in respect of the bonus shares as once it was held that the benefit of a lower tax rate was available to non-residents in respect of original shares, that would also be the case for bonus shares.

Cost of acquisition of bonus shares to be taken at nil

The cost of acquisition of the bonus shares had to be taken as nil. The proviso to Section 112(1) limits the rate of tax on long-term capital gains from the transfer of listed securities to 10 percent, but with an important rider that the quantum of capital gains should be arrived at without taking into account the formula provided in the second proviso to Section 48 based on the indexed cost of acquisition. Thus, long-term capital gains arising on the transfer of bonus shares

would be equal to the amount of sale consideration as the cost would be taken at nil and such gains were liable to be taxed at the rate of 10 percent as per the proviso to Section 112(1).

Section 48 merely provides mode of computing capital gains

The second proviso to Section 48 merely provides a mode of computing capital gains. It cannot be construed as words of exclusion of a category of assessee, i.e., non-residents who cannot avail of the indexation benefit.

Double benefit is not a taboo under the law

The Income-tax authorities contended that the Applicant could not claim double benefit. However, the AAR held that double benefit or additional relief was not a taboo under the law. Merely because the non-residents got protection from rupee value fluctuation in terms of foreign currency, it did not follow that the non-residents should not get the benefit of a reduced rate of tax which the residents were getting. The protection in terms of the first proviso to Section 48, made available to a non-resident, might be a justification to deny the benefit of the cost of indexation as stated in CBDT Circular No. 636, but the same cannot be said of the application of a lesser rate.

When intention is not clearly ascertainable, go by the plain language

The AAR's view was that it was not safe to interpret the proviso to Section 112(1) with reference to the supposed intention of the legislature when such intention was not clearly ascertainable. The best course would be to go by the plain language. The objective was to be inferred from the language itself.

Conclusion of the AAR

The AAR held that the long-term capital gains to the Applicant on the sale of shares in the Indian share market should be taxed at the rate of 10 percent as per the proviso to Section 112(1) of the Income-tax Act, 1961. The same rate was also held to be applicable to the gains arising out of the sale of bonus shares, subject to the condition that the cost of such shares is taken as nil and the gain equals the amount of sale consideration.

The *BASF Aktiengesellschaft* case

Facts of the case

In *BASF Aktiengesellschaft v. Deputy DIT (International Taxation)*, above, the assessee, a foreign company, sold shares during the previous year relevant to A.Y. 2001-2002, in a listed Indian company, which had been acquired by it in foreign currency. The assessee computed the long-term capital gains in terms of the foreign currency in which it had acquired the shares and converted such gains into Rupees as required by the first proviso to Section 48. It claimed that such gains were liable to tax at the rate of 10 percent under the proviso to Section 112(1) of the Act. The Assessing Officer (AO) had the view that the proviso to Section 112(1) applied only to those cases which were covered by the

second proviso to Section 48, and could not be applied to the assessee's case. According to the AO, for the application of the proviso to Section 112(1), the applicability of the second proviso to Section 48 was a *sine qua non*. According to the AO, a situation of "before giving effect to" could only arise if the act of "giving effect" was a possibility -- otherwise the phrase "before giving effect" would be rendered meaningless. The AO relied on CBDT Circular No. 779, which clarified that the proviso to Section 112(1) was being inserted on account of the demand raised by resident investors in the share market to create a level playing field between them and non-resident Foreign Institutional Investors (FIIs), who paid tax only at the rate of 10 percent. The AO therefore was of the opinion that the proviso to Section 112(1) was inserted to give an option to resident investors, and not to non-residents. The AO therefore applied the rate of 20 percent to the long-term capital gains of the assessee. On first appeal, relying on the words "before giving effect to the second proviso to Section 48" in the proviso to Section 112(1), the Commissioner of Income-tax (Appeals) held that the benefit of the proviso to Section 112(1) could be taken only by assessee who had the option of the benefit of indexation under the second proviso to Section 48. He opined that where the assessee opted for the benefit under the first proviso to Section 48, it was not entitled to further benefit under the second proviso to Section 48, and therefore the proviso to Section 112(1) would become inapplicable. He therefore upheld the order of the AO.

Contentions raised by the assessee before the ITAT

Before the ITAT, the assessee raised the following contentions:

1. For the proviso to S. 112 to apply, the second proviso to Section 48 should not be taken advantage of. It is irrelevant whether the second proviso to Section 48 is inapplicable or whether it is not availed of by choice.
2. The case of the AO that the second proviso to Section 48 did not apply to non-residents was erroneous. It applied to non-residents (other than FIIs) who had invested in Indian companies in Indian currency.
3. The proviso to Section 112(1) was placed after clauses (a) to (d) of Section 112(1). It therefore applied to all the clauses.
4. Circular No. 779 made it clear that it applied to all assessee.
5. The AO's case that the phrase "all assessee" referred to FIIs, only, was erroneous, as FIIs were governed by Section 115AD and not by Section 112.
6. Section 112(1) was not rendered otiose if the assessee's interpretation were accepted. The 20 percent rate would apply to non-residents and foreign companies who chose to take advantage of the second proviso to Section 48.
7. If the Legislature intended that the lower rate ought not to apply to non-residents investing in Indian companies in a foreign exchange, a reference to the first proviso to Section 48 would have found a place in the proviso to Section 112.

Contentions raised by the Income-tax Department before the ITAT

On behalf of the Income-tax Department, it was argued that the first and second provisos to Section 48 were mutually exclusive, and that neither the assessee nor the AO had any option in computing the long-term capital gains. It was contended that since the assessee's case fell under the first proviso to Section 48, it could not get the benefit of the proviso to Section 112(1), which applied only to those cases where long-term capital gains had been computed under the second proviso to Section 48.

Decision of the ITAT

The ITAT considered the provisions of Section 48 and Section 112. It agreed with the assessee that the proviso to

Section 112 applied to all clauses of Section 112(1), including clause (c) which applied to non-residents. According to the ITAT, clause (c) of Section 112 applied to all non-residents, other than FIIs and non-residents referred to in Section 115AB and Section 115AD. It further agreed with the Department's contention that both provisos to Section 48 were mutually exclusive, and that no option lay either with the assessee or the AO in application of either of the provisos. The ITAT followed the rule of literal interpretation, since the language of the proviso to Section 112(1) was unambiguous, to hold that the proviso to Section 112(1) could not be applied to a case where the capital gain was computed under the first proviso to Section 48. According to the Tribunal, the expression "*before giving effect to the provisions of the second proviso to Section 48*" presupposed the existence of a case where the computation was to be made in accordance with the formula contained in the second proviso to Section 48. The ITAT also relied on the provisions of Section 115AB(2) and Section 115AD(3) which expressly provided that the second proviso to Section 48 would not apply in computing the long-term capital gains under those sections. It expressed the view that it was in that context that the Legislature had thought that the assessee falling under the second proviso to Section 48 should not be put in a more disadvantageous position as compared to the assessee falling under Section 115AB and under Section 115AD.

Conclusion of the ITAT

The ITAT held that the rate of long-term capital gains tax on gains applicable to non-residents/foreign investors in the stock markets in India as computed under the first proviso to Section 48 was 20 percent.

Analysis

The Authority for Advance Rulings is correct in holding that the proviso to Section 112(1) did not exclude any category of assessee, as it applied to non-residents falling under clause (c) as well. It granted the benefit without indexation of cost, and therefore merely stated the manner of computing the capital gains in order to compute the concessional rate of tax.

An earlier decision of the Mumbai Bench of the Tribunal in the case of *Alcan Inc. v. Deputy Director of Income-tax (International Taxation)* n12 has been rendered on the issue of the rate of long-term capital gains tax applicable to non-residents/foreign investors where it has been held that non-resident assessee is also eligible to avail the beneficial rate of tax of 10 percent on long-term capital gains arising on a sale of securities in Indian share markets. However, the order was a brief one without detailed reasoning.

The language used in Section 115AB(2) and Section 115AD(3) is very clear in providing that capital gains for the purpose of those sections shall be computed without considering the provisions of the first and second provisos to Section 48, though the second proviso would not be applicable in most of those cases. This clearly indicates that Section 48 only provides the manner of computing the capital gains provided for and does not specify the category of assessee to whom it is applicable.

Conclusion

The AAR ruling has come as a boon to non-resident investors in the Indian share market. Though the ruling is not binding on any jurisdiction but is binding only on the applicant who has sought for it, it does have persuasive value. The

ruling, a fairly reasoned one with in-depth analysis of the relevant provisions, could certainly have a guiding effect. However, in view of conflicting decisions, the issue has not achieved finality and the matter will be litigated further in the courts. Regardless of the existing debate in courtrooms on the issue, the better view seems to be that non-resident assesseees who have invested in Indian shares and securities would be entitled to the benefit of the 10 percent tax rate provided under the proviso to Section 112(1) of the Act. This benefit will be available to non-residents/foreign companies regardless of the fact that they may not be entitled to the benefit of indexation of cost under the second proviso to Section 48.

Return to Text

n1 . An authority constituted by the Central Government under S.245-O of the Act for giving determinations called advanced rulings in relation to a transaction undertaken or proposed to be undertaken by a non-resident applicant on issues pertaining to tax liabilities on proposed transactions.

n2

[2]. Income Tax Appellate Tribunal ITAT is the Appellate Tribunal as defined in S.2(4) of the Act as constituted under S.252 of the Act, which is a judicial authority and also the final fact finding authority whose decisions are final on facts. Appeals from such decisions can be made before the High Court only on substantial questions of law.

n3

[3]. Section 2 (29B) of the Act defines long-term capital gain as, long-term capital gain means capital gain arising from the transfer of a long-term capital asset. The official link to the Government of India, Ministry of Finance website hosting the updated bare Income-tax Act, 1961 can be found at <http://law.incometaxindia.gov.in/TaxmannDit/DisplayPage/dpage1.aspx>.

n4

[4]. Indexation means a method of computation of cost of acquisition after applying the Cost Inflation Index as specified by the Central Government in relation to a particular year. Section 48 of the Act provides the mode of computation of capital gains and defines Indexed Cost of Acquisition.

n5

[5]. S. 112. Tax on long-term capital gains.

(1) Where the total income of an assessee includes any income, arising from the transfer of a long-term capital asset, which is chargeable under the head Capital gains, the tax payable by the assessee on the total income shall be the aggregate of, ----

4. (a) .

(b) .

[(c) in the case of a non-resident (not being a company) or a foreign company,

(i) the amount of income-tax payable on the total income as reduced by the amount of such long-term capital gains, had the total income as so reduced been its total income; and

(ii) the amount of income-tax calculated on such long-term capital gains at the rate of twenty per cent;]

[(d)] in any other case [of a resident],

(i) the amount of income-tax payable on the total income as reduced by the amount of long-term capital gains, had the total income as so reduced been its total income; and

(ii) the amount of income-tax calculated on such long-term capital gains at the rate of [twenty] per cent.

Explanation. [***]

[**Provided** that where the tax payable in respect of any income arising from the transfer of a long-term capital asset, being listed securities [or unit] [or zero coupon bond], exceeds ten per cent of the amount of capital gains before giving effect to the provisions of the second proviso to section 48, then, such excess shall be ignored for the purpose of computing the tax payable by the assessee.]

n6 . Section 48

Mode of computation.

48. The income chargeable under the head Capital Gains shall be computed, by deducting from the full value of the consideration received or accruing as a result of the transfer of the capital asset the following amounts, namely:

(i) expenditure incurred wholly and exclusively in connection with such transfer;

(ii) the cost of acquisition of the asset and the cost of any improvement thereto:

Provided that in the case of an assessee, who is a non-resident, capital gains arising from the transfer of a capital asset being shares in, or debentures of, an Indian company shall be computed by converting the cost of acquisition, expenditure incurred wholly and exclusively in connection with such transfer and the full value of the consideration received or accruing as a result of the transfer of the capital asset into the same foreign currency as was initially utilized in the purchase of the shares or debentures, and the capital gains so computed in such foreign currency shall be reconverted into Indian currency, so, however, that the aforesaid manner of

computation of capital gains shall be applicable in respect of capital gains accruing or arising from every reinvestment thereafter in, and sale of, shares in, or debentures of, an Indian company.

Provided further that where long-term capital gain arises from the transfer of a long-term capital asset, other than capital gain arising to a non-resident from the transfer of shares in, or debentures of, an Indian company referred to in the first proviso, the provisions of clause (ii) shall have effect as if for the words cost of acquisition and cost of any improvement, the words indexed cost of acquisition and indexed cost of any improvement had respectively been substituted:

n7 . Assessment year is defined by Section 2(9) of the Act as the period of twelve months commencing on the 1st day of April every year.

n8 . *In re Timken France SAS, (2007) 294 ITR 513 (AAR); 164 Taxman 354 (AAR).*

n9

[9]. **S. 112.Tax on long-term capital gains.**

(1) Where the total income of an assessee includes any income, arising from the transfer of a long-term capital asset, which is chargeable under the head Capital gains, the tax payable by the assessee on the total income shall be the aggregate of, ----

4. (a) .

(b) .

[(c) in the case of a non-resident (not being a company) or a foreign company,

(i) the amount of income-tax payable on the total income as reduced by the amount of such long-term capital gains, had the total income as so reduced been its total income; and

(ii) the amount of income-tax calculated on such long-term capital gains at the rate of twenty per cent;]

[(d)] in any other case [of a resident],

(i) the amount of income-tax payable on the total income as reduced by the amount of long-term capital gains, had the total income as so reduced been its total income; and

(ii) the amount of income-tax calculated on such long-term capital gains at the rate of [twenty] per cent.

Explanation. [***]

[**Provided** that where the tax payable in respect of any income arising from the transfer of a long-term capital asset, being listed securities [or unit] [or zero coupon bond], exceeds ten per cent of the amount of capital gains before giving effect to the provisions of the second proviso to section 48, then, such excess shall be ignored for the purpose of computing the tax payable by the assessee.]

n10 . CBDT or Board as defined in S.2 (12) of the Act is an income tax authority constituted under the Central Boards of Revenue Act, 1963 (54 of 1963).

n11

[11]. BASF Aktiengesellschaft v. Deputy DIT (International Taxation) [2007] 294 ITR (AT) 1 (Mumbai).

n12

[12]. Alcan Inc. v. Deputy Director of Income-tax (International Taxation) Mumbai [2007] 16 SOT 8 (Mum.).

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S Corporation Shareholder-Employees and the Reasonable Compensation Issue

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Terence M. Myers on S Corporation Shareholder-Employees and the Reasonable Compensation Issue

By Terence M. Myers

April 16, 2008

SUMMARY: The failure of S corporations to pay adequate compensation to shareholder-employees has become a major source of controversy in recent years.

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ARTICLE: While the IRS may challenge unreasonably *high* amounts of compensation for shareholder-employees of C corporations, the opposite is true for S-corporations: The IRS is on the attack against S corporations that pay their shareholder-employees unreasonably *low* compensation. That's because paying low amounts of compensation can save employment taxes for the S corporation and shareholder-employees without adverse income tax consequences. This commentary discusses where the tax savings come from, what the IRS line of attack is, and how to head it off.

The failure of S corporations to pay adequate compensation to shareholder-employees has become a major source of controversy in recent years. In tax year 2005 almost one million S corporations with one shareholder paid no officers compensation [IRS Compliance Data Warehouse, *Business Returns Transaction File* (Processing Year 2006)]. The National Taxpayer Advocate estimates that inadequate compensation for S corporation shareholders contributes almost \$5 billion annually to the so-called tax gap [National Taxpayer Advocate 2007 Annual Report to Congress, p. 314]. The IRS's ***Notice of Acceptance as an S Corporation*** now alerts taxpayers that when a shareholder-employee of an S Corporation provides services to the S Corporation, reasonable compensation generally needs to be paid.

Why the Controversy?

The issue of reasonable compensation has traditionally been associated with C corporations. C corporations would rather pay shareholders-employees deductible compensation than nondeductible dividends. But C corporations can claim a deduction for compensation only to the extent that it is reasonable [IRC § 162(a)(1)]. So disputes frequently arise between the IRS and corporations over whether compensation is unreasonably high and really a form of disguised dividends.

The issue with S corporations is the mirror image: Whether compensation to shareholder-employees is unreasonably low. And the disputes center on employment taxes, not income taxes.

Income taxes. The income tax liability of an S corporation shareholder is generally the same whether or not he or she receives dividend distributions from the corporation. An S corporation's income is passed through and taxed directly to its shareholders on a pro rata basis [IRC § 1366(a)]. If an S corporation distributes dividends, the dividends are not included in gross income. Instead, the dividends reduce a shareholder basis for his or her stock in the corporation. If dividends exceed basis, the excess is treated as payment in exchange for stock (e.g., capital gain) [IRC § 1368(b)].

If shareholders are employees and are paid salaries by the S corporation, the corporation can claim a deduction for the salaries in computing its taxable income [IRC § 1363(b)]. So the corporation's income passed through and taxed to the shareholders is correspondingly reduced. Of course, each shareholder must include in gross income the compensation he or she receives from the corporation.

The net effect is that, from an income tax standpoint, it makes little or no difference whether a shareholder-employee receives an amount from the corporation in the form of a dividend or a salary payment.

Employment taxes. Wages paid by an S corporation to a shareholder-employee are subject to FICA and FUTA taxes [IRC § 3101, § 3111 and § 3301]. For example, for 2008 the S corporation and the shareholder employee are each liable for a 6.2% tax on the first \$102,000 of wages for the Social Security (OASDI) portion of the FICA tax and a 1.45% tax on all wages for the Medicare (HI) portion of the FICA tax [Social Security Administration News Release, October 17, 2007]. In 2008, S corporations are also liable for a FUTA tax of 6.2% (less a credit of up to 5.4% for state unemployment tax) on the first \$7,000 of wages paid a shareholder-employee [IRC § 3301 as amended by the Energy Independence and Security Act of 2007 (P.L. 110-140)].

On the other hand, gross income from an S corporation that is *not* in the form of wages is not subject to employment taxes or self-employment taxes (the FICA equivalent for self-employeds and partners). In 1959, the IRS ruled that, unlike partners in a partnership, shareholders in an S corporation are not liable for self-employment tax on their share of the S corporation's income that they must include in their gross income. The IRS noted that the self-employment tax applies only to income from a trade or business. The IRS concluded that the election of S treatment by a corporation and the shareholders' consent to that election does not result in the shareholders being engaged in carrying on the corporation's trade or business [Rev. Rul. 59-221, 1959-1 CB 225].

Consequently, there is an incentive for a shareholder-employee to receive as much as possible in the form of dividend distributions and as little as possible in the form of salary. The employment tax savings can be significant.

Example 1. XYZ, an S corporation, has taxable income of \$120,000 in 2008 without taking into account compensation paid to its sole shareholder, Peter Allen. XYZ pays Allen \$100,000 in compensation and makes a \$20,000 dividend distribution. Allen includes in his gross income \$100,000 of compensation and \$20,000 of taxable income from XYZ, a total of \$120,000. XYZ owes \$7,650 of FICA tax on Allen's salary and another \$7,650 is deducted from Allen's salary, a total FICA liability of \$15,300.

Example 2. Same facts as before except that Allen receives \$20,000 in compensation from XYZ and receives a \$100,000 dividend distribution. Allen includes in gross income \$20,000 of compensation and \$100,000 of taxable income from XYZ, a total of \$120,000. XYZ owes \$1,530 in FICA tax on Allen's salary and another \$1,530 is deducted from Allen's salary, a total FICA liability of only \$3,060.

The IRS and the Courts. The IRS addressed this issue in a 1974 ruling. The ruling involved two shareholders of an S corporation who performed services for the corporation. The facts of the ruling were stacked in the IRS's favor: To avoid the payment of Federal employment taxes, they [the two shareholders] drew no salary from the corporation but arranged for the corporation to pay them dividends of 100x dollars, which is the amount they would have otherwise received as reasonable compensation for services performed.

The IRS pointed out that *Sections 3121(a) and 3306(b) of the Internal Revenue Code* define the term "wages," with

certain specific exceptions, as "all remuneration for employment." Since the "dividend" payments to the two shareholders were in lieu of reasonable compensation for their services, the IRS ruled that the payments were subject to employment taxes [*Rev. Rul. 74-44, 1974-1 CB 287*].

Subsequent court decisions confirm that the payment of no salary to a shareholder-employee will result in a recharacterization of dividends as wages. For example, in one case, an attorney incorporated his practice as a S corporation. Despite being the corporation's only full-time employee and despite providing substantial services to the corporation, the attorney received no compensation from the corporation, only dividend distributions. A federal district court held that the "dividends" functioned as remuneration for employment. According to the court, an employer should not be permitted to evade FICA and FUTA by characterizing *all* of an employee's remuneration as something other than wages" [*Joseph Radtke, S.C., DC-WI, 712 F. Supp 143, aff'd per curiam, CA-7, 895 F. 2d 1196*].

In some cases, shareholders and their corporations have tried a different tack. While providing significant services and receiving no compensation, the shareholders argued that there was no employment relationship--they were officers, not employees, and the corporations have little control over them. Courts have rejected this argument. For example, the Court of Appeals for the Third Circuit noted that an employee for FICA purposes is defined by the Internal Revenue Code as either an officer or a common-law employee [*IRC § 3121(d)*]. While an officer in name only may not be considered an employee for FICA services, any employee who provides significant services is.

Nu-Look Design, Inc., 3rd Circuit Ct. App., 356 F. 3d 290, aff'd, TC Memo. 2003-52].

What Is a Reasonable Compensation?

Obviously, paying no compensation to an S corporation shareholder who provides substantial services will be like waiving a red flag at the IRS. A Form 1120S showing no officer compensation will be an easy IRS target. An S corporation must provide at least some compensation to a shareholder-employee. On the other hand, for any set of job duties, there may be a rather broad range of compensation. The trick is to set the compensation low enough to maximize the employment tax savings but high enough to avoid IRS scrutiny.

Practice Tip. Some practitioners may advise their clients to use an arbitrary split between dividends and salary (e.g., 50% salary, 50% dividends) or a fixed amount of salary (e.g., \$50,000) as a rule of thumb. But this is not a one-size-fits-all situation. What is considered a reasonable amount of compensation in one situation may not be even close to reasonable in another situation.

Courts have taken a variety of factors into account in determining what is reasonable compensation in a particular set of circumstances. These factors include the salary history of the shareholder-employee, the salary levels of other employees of the corporation, the salary levels of employees performing the same type duties for similarly situated companies, the qualifications of the shareholder-employee and the contributions he or she made to the S corporation. There are a number of sites on the Web that provide information on average salaries by industry and geographical area. This may be a good starting point. Finally, once a salary level is set, the more documentation on how the level was arrived at, the better.

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LexisNexis Tax Practice Insights by State

2009 Emerging Issues 3523

LexisNexis Tax Practice Insights by State

By Selected state tax practitioners

April 15, 2008

SUMMARY: LexisNexis Tax Practice Insights are concise commentaries providing practical guidance and analysis to help practitioners navigate state tax law.

ARTICLE: Written by state and local tax experts, Practice Insights contain tips for dealing with complex issues, practice and planning strategies, risks and benefits of certain actions and alerts to common practice mistakes.

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Myers on Sale of a Home Office

2008 Emerging Issues 2014

Myers on Sale of a Home Office

By Terence M. Myers

March 11, 2008

SUMMARY: Section 280A of the Internal Revenue Code allows qualifying taxpayers to deduct expenses for the business use of a home. However, using a home for business can have an impact on tax treatment of a taxpayer's gain when the home is eventually sold. IRC Section 280A permits taxpayers to deduct expenses, including depreciation, for the business use of a home if certain requirements are met.

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ARTICLE: *Section 280A of the Internal Revenue Code* allows qualifying taxpayers to deduct expenses for the business use of a home. However, using a home for business can have an impact on tax treatment of a taxpayer's gain when the home is eventually sold. For example, will the home sale gain qualify for the exclusion under Section 121? Does the gain have to be allocated between the business portion of the home and the residential portion-and if so, how? This commentary takes a look at these and other questions that may arise in this situation.

Section 280A of the Internal Revenue Code permits taxpayers to deduct expenses, including depreciation, for the business use of a home if certain requirements are met. Section 121 of the Code provides an exclusion of gain on the sale of a principal residence if certain requirements are met. This creates a natural tension when a home is used for both residential and business purposes: Will deductions for the business use of a home preclude treatment of home as a residence under Section 121?

The quick answer is "no." However, that is not the end of the matter. Even when the exclusion is available, Section 121 provides for a recapture of depreciation claimed on the office that may override the exclusion at least in part. And when the business use is confined to a separate structure on the property, an allocation must be made; only gain attributable to the residential portion of the property qualifies for the Section 121 exclusion.

Home Office Deductions

Under Section 280A, a taxpayer can claim deductions for mortgage interest, property taxes, utilities, maintenance, insurance and depreciation for a qualifying business use of the home. (Mortgage interest and property taxes are, of course, also deductible by itemizers regardless of business use.) To qualify for the deductions:

1. A portion of the home must be used regularly and exclusively in a trade or business, and

2. The business portion of the home must be (a) the homeowner's principal place of business, (b) a place to meet with clients and customers in the normal course of business, or (c) a separate structure (not attached to the home) that is used in connection with a trade or business [*IRC Section 280A(c)(1)*].

In the case of an employee, the exclusive use test will be met only if the business use is for the convenience of the employer [*IRC Section 280A(c)(1)*].

When a taxpayer has more than one place of business, whether the home constitutes the "principal place of business" depends on the facts and circumstances of the situation. However, a home will be considered the taxpayer's principal place of business if (1) a portion of the home is used exclusively and regularly for administrative or management activities of the taxpayer's trade or business; and (2) the taxpayer has no other fixed location where substantial administrative or management activities are conducted [*IRC Section 280A(c)(1)*].

Only the expenses allocable to the qualifying business use are deductible (plus the mortgage interest and property taxes that are deductible without regard to the business use). The taxpayer may determine the expenses allocable to the business portion by any method that is reasonable under the circumstances. If the rooms in the home are of approximately equal size, the taxpayer may ordinarily allocate the general expenses for the home (e.g., utilities, depreciation) according to the number of rooms used for the business purpose. The taxpayer may also allocate general expenses according to the percentage of the total floor space in the unit that is used for the business purpose. Expenses that are attributable only to certain portions of the home (e.g., painting the business portion) are allocated in full to those portions of the home. Expenses that are not related to the use of the home for business purposes (e.g., expenditures for lawn care) are not deductible under Section 280A [Reg. Section 1.280A-2(i)(3)].

Expenses allocable to the business use of the home are deductible only to the extent of the gross income derived from the business activity. Any deduction not allowed by this limitation may be carried forward to a succeeding year, in which it may be used to offset income from the business activity [*IRC Section 280A(c)(5)*].

Sale of a Home Office and Section 121

Section 121 provides for an exclusion of gain up to \$250,000 (\$500,000 for joint filers) for the sale of a home if it was owned and used by the taxpayer as a principal residence for two of the five years preceding the sale. If a home is used for both business purposes and residential purposes, the exclusion may be limited. The availability of the exclusion depends on whether the business is conducted within the "dwelling unit" or outside of it.

Outside of the dwelling unit. Section 121 will not apply to the gain allocable to a structure separate from the residential structure unless the former structure satisfies the use requirement of Section 121. Thus, if a portion of the property was used as a home and a portion of the property separate from the home was used for business purposes, only the gain allocable to the residential portion is excludable under Section 121. [Reg. Section 1.121-1(e)(1)].

Example 1. In 2008 Bob Smith, a business consultant, purchases a residence that contains a main house, which he uses as his principal residence, and a guest house. He immediately converts the guest house into a professional office and claims deductions under Section 280A. He sells the residence in 2013 at a gain of \$100,000, \$70,000 of which is allocable to the main home and \$30,000 to the office. Since Bob has used the main home as his principal residence for at least two of the five years preceding the sale, the \$70,000 gain allocable to the main home is excludable under Section 121. None of the \$30,000 gain allocable to the office is eligible for the Section 121 exclusion.

Practice Tip. When practical, a taxpayer may want to consider converting a separate structure used for business back into residential use before a sale. If the structure becomes part of the taxpayer's principal residence at least two years before the sale, the gain allocable to the structure should qualify for the Section 121 exclusion.

An allocation is also required if there are two or more dwelling units within the same structure. For example, if a taxpayer owns a two-family house and uses one unit as a principal residence and the other unit as a principal place of business, then gain attributable to the unit used for business does not qualify for the Section 121 exclusion [Reg. Section 1.121-1(e)(4), Example 3].

For purposes of determining the amount of gain allocable to the residential and business portions of the property, a taxpayer must allocate the basis and the amount realized between the residential and the business portions of the property using the same method of allocation that the taxpayer used to determine depreciation on the business portion. [Reg. Section 1.121-1(e)(3)].

Within the dwelling unit. No allocation is required if the business portion of the property is within the dwelling unit. [Reg. Section 1.121-1(e)(1)]. Thus, if a taxpayer uses one or more rooms in the home for business purposes, claims deductions under Section 280A, and meets the Section 121 requirements, then all of the gain is eligible for the exclusion, subject to the recapture-of-depreciation provision. If the taxpayer is not eligible for Section 280A deductions (e.g., an employee whose home office is not for the convenience of his or her employer), then all of the gain is eligible for the exclusion without regard to the recapture-of-depreciation provision [Reg. Section 1.121-1(e)(4), Examples 5 and 6].

Recapture of Depreciation

The Section 121 exclusion does not apply to gain from the sale of a home to the extent of depreciation claimed for periods after May 6, 1997 [*IRC Section 121(d)(6)*]. Thus, even though no allocation between residential and business portions is required within the same dwelling unit, gain is not excludible to the extent of depreciation claimed on the business portion.

The nonexcludible gain is treated as "unrecaptured Section 1250 gain." As such, it falls into the 25% rate group for purposes of determining the tax on net capital gain [*IRC Section 1(h)(6)*]. Depreciation allocable to any portion of the property to which the Section 121 exclusion does not apply, such as a separate structure or a separate dwelling unit within the same structure, is not taken into account for this purpose [Reg. Section 1.121-1(d)(1)].

Example 2. Denise Tucker, an attorney, purchased a house in 2007. The house constitutes a single dwelling unit, but Denise uses a portion of the house as a law office. She claims depreciation deductions of \$4,000 for the law office portion during the period that she owns the house. Denise sells the house in 2011, realizing a gain of \$26,000. Denise must recognize \$4,000 of the gain as unrecaptured Section 1250 gain. She may exclude the remaining \$22,000 of the gain from the sale because she is not required to allocate gain to the business use within the dwelling unit.

Practice Tip. Because of the recapture provision, an employee who might be entitled to Section 280A deductions may want to consider whether the deductions are worth the price. An employee claims Section 280A expenses as miscellaneous itemized expenses. Because miscellaneous itemized expenses are deductible only to the extent that they exceed 2% of adjusted gross income, the employee may realize little tax savings. On the other hand, the gain attributable to the depreciation is not Section 121 eligible, even if the depreciation did not produce much tax benefit. Employees can deliberately disqualify themselves from Section 280A eligibility by violating its requirements, such as the exclusive use requirement.

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McGowan on Computing the Alternative Minimum Tax

2008 Emerging Issues 1994

McGowan on Computing the Alternative Minimum Tax

By John McGowan

March 5, 2008

SUMMARY: The alternative minimum tax (AMT), originally intended to make sure that richer taxpayers paid at least some individual income tax, has begun to trap unwary taxpayers. To prevent increased numbers of individual taxpayers from being liable Congress has been enacting a series of temporary measures. These measures or patches have increased the AMT exemption amount. Though Congress passed these temporary fixes, it won't help the vast majority of people who are already liable for the AMT. Here are some tips for avoiding, or at least minimizing, the AMT.

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ARTICLE: For individuals and other noncorporate taxpayers the alternative minimum tax (AMT) is computed by taking the taxpayer's regular taxable income for the tax year and (i) adding or subtracting AMT adjustments, and (ii) adding AMT preferences. See *IRC Section 55(a)*. The result is the taxpayer's alternative minimum taxable income (AMTI). AMT adjustments differ from AMT preferences. *Adjustments* are generally a substitution of AMT treatment of an item for regular tax treatment. A *preference* is generally the addition of the difference between AMT treatment and regular tax treatment.

In computing AMTI--and in computing AMT generally--the net capital gain and qualified dividend income of individuals and other noncorporate taxpayers may *not* be excluded, even though, for AMT purposes, these amounts are effectively taxed at the same rates that apply for regular tax purposes. Next, the exemption amount is subtracted from the taxpayer's AMTI. The result is the taxable excess or AMTI base. Next, noncorporate taxpayers apply the AMT rates as follows: 26% of the taxable excess up to \$175,000, plus 28% of the taxable excess above \$175,000. From the amount that results, the taxpayer's AMT foreign tax credit, if any, must be subtracted. The result is the tentative minimum tax. The excess of the taxpayer's tentative minimum tax for the tax year over the taxpayer's regular tax liability for the tax year is the AMT. Nowadays the AMT affects people with more common and popular deductions such as state and local income and property taxes.

Without Change AMT Would Outpace Regular Income Tax by 2013. Without change, the revenue raised by the AMT would grow rapidly over the next ten years increasing from \$15 billion in 2004 to \$210 billion by 2015 (11 percent of total individual income tax revenues.)

The primary reason the AMT is such a problem is because it is not indexed to inflation. In addition, AMT

exemptions and other AMT parameters are also not indexed for inflation. Regular income tax parameters, on the other hand, are indexed. Another contributing factor is that state and local tax deductions under the regular income tax generally increase with income. However, there is no similar increase under the AMT because such deductions are not allowed under the AMT. Thirdly, real economic growth increases taxpayers income which, for taxpayers in the income range where AMT rates are higher than regular income tax rates, increases the chances of being an AMT taxpayer. Next, taxpayers with large families are more likely to be subject to the AMT because the AMT does not allow deductions for personal exemptions.

The number of AMT taxpayers would increase steadily from 20 million in 2006 to 50 million in 2015. In fact, by 2015, almost 100% of individuals in the \$100,000-500,000 income range would pay AMT. To fully illustrate the effect, it should be noted that the AMT was on pace to collect more revenue than the regular income tax by 2013.

Major Triggers of the AMT. About two-thirds of the AMT comes from state and local taxes. In 2005, the states with the largest percentage of taxpayers owing AMT were New Jersey (6.8 percent), New York (6 percent), Connecticut (5.9 percent), Maryland (5 percent) and California (4.9 percent), according to Citizens for Tax Justice.

The most common items that can cause AMT liability are listed below. These items must be added back to taxable income in order to compute the AMT:

- . all personal exemptions
- . the standard deduction, if you claimed it
- . itemized deductions for state and local income taxes, and real estate taxes
- . itemized deductions for home equity loan interest (this does not include interest on a loan to buy, build, or improve your home)
- . itemized deductions for miscellaneous deductions
- . itemized deductions for any portion of medical expenses that exceed 7.5 percent of AGI but not 10 percent of AGI
- . deductions for accelerated depreciation that exceed what could have been claimed under straight line depreciation (for property put into service in 1999 or later, this item will not apply to depreciable real estate, and it will generally apply only to 3, 5, 7, and 10-year property on which you claimed the ordinary MACRS depreciation)
- . differences between gain or loss on the sale of property for AMT purposes and for regular tax purposes; these differences most commonly occur as a result of the different depreciation methods required under AMT, as described above
- . changes in income from installment sales, since the installment sale method generally can't be used for AMT purposes
- . changes in certain passive activity loss deductions
- . deductions relating to oil and gas investments, or drilling or mining operations
- . interest on certain private activity bonds that would otherwise be tax-exempt

If taxpayers have large amounts of any items in their list, and their adjusted gross income exceeds the exemption amounts, they should compute your AMT liability on IRS Form 6251, *Alternative Minimum Tax -- Individuals*, to determine whether they must actually pay any AMT.

Adjusted gross

income

Single

Married without children

Married with children

All 2006

All 2007 without AMT patch

Less than \$20,000

0.00%

0.00%

0.10%

0.00%

0.00%

20,000-40,000

0

0

0

0

0.5

40,000-50,000

0.1

0.2

0.2

0.2

4

50,000-75,000

0.5

0.2

0.3

0.5

12.5

75,000-100,000

1.4

0.9

1

1.6

49

100,000-200,000

13.3

4.8

11.8

10.2

81

200,000-500,000

67.8

63.9

82.6

74

95.3

500,000-1,000,000

44.4

52.3

44.1

47.3

49.8

More than \$1 million

28.9

28.5

15.9

23.1

22.3

Source: Joint Committee on Taxation

Who Pays the AMT? As tax cuts started phasing in after 2004, the AMT began affecting more people. That's because their tax under the regular system was dropping but the AMT, which had never been indexed for inflation, was not.

In 2005, people subject to AMT paid an average of \$4,350 on top of their regular tax. Large families can fall under AMT because it throws out the personal exemption normally received for each member of the household. In 2006, almost 12 percent of married couples with children earning \$100,000 to \$200,000 owed AMT, compared with roughly 5 percent of married couples in that income bracket without children, according to estimates from the Joint Committee on Taxation. For couples earning \$200,000 to \$500,000, almost 83 percent with children owed AMT, versus 64 percent without children. Before 2000, the AMT never affected more than 1 percent of taxpayers.

AMT Patch Passed by Congress. To prevent hordes of people from falling into the AMT, Congress has been enacting a series of temporary measures. These measures or patches have increased the AMT exemption amount, which is similar to a standard deduction. A higher exemption lowers the AMT and brings it closer to the regular tax. The exemption amount for married couples filing jointly was increased from \$45,000 for tax year 2000 to \$49,000 for 2001, \$58,000 for 2003 through 2005, and to \$62,550 for 2006. Without a patch, the exemption for 2007 would have reverted to the 2000 level -- \$45,000.

On December 20, 2007, Congress once again staved off pandemonium and passed the Tax Increase and Prevention Act (TIPRA) of 2007. With this legislation, Congress increased the exemption amount for married couples by about 6 percent to \$66,250 and by 4.4 percent for singles to \$44,350. The change will leave most people about where they were in 2007. Taxpayers should take note that this is a temporary fix only. Without Congressional action, the 2008 AMT exemption amounts for individuals will revert to the 2000 levels.

Though Congress passed this temporary fix for the alternative minimum tax, it won't help the vast majority of people who are already liable for the AMT. It should also be noted that the 2007 TIPRA does not tinker with the AMT phase-out rules. Thus, the 2007 AMT exemption amounts for individuals are as follows:

- . married individuals filing jointly and surviving spouses, \$66,250, less 25% of alternative minimum taxable income (AMTI) exceeding \$150,000 (zero exemption when AMTI is \$415,000);

- . unmarried individuals, \$44,350, less 25% of AMTI exceeding \$112,500 (zero exemption when AMTI is \$289,900); and

- . married individuals filing separately, \$33,125 less 25% of AMTI exceeding \$75,000 (zero exemption when AMTI is \$207,500), but AMTI of married individuals filing separately is increased by the lesser of \$33,125 or 25% of the excess of AMTI (without regard to the exemption reduction) over \$207,500.

Practice Tip. In an additional twist to this very complicated area, there is a tax provision that gives taxpayers back what the AMT otherwise takes away. Through the end of 2007, taxpayers may use nonrefundable personal credits to offset AMT liability. Nonrefundable personal credits include the dependent care credit, the credit for the elderly and

disabled, the credit for interest on certain home mortgages, the Hope credit for certain college expenses and the Lifetime Learning credit. For 2007, personal nonrefundable credits may offset both AMT and regular tax. Under pre-2007 TIPRA law, personal nonrefundable credits for 2007, other than the child credit, the adoption credit, and low income saver's credit, couldn't have exceeded the excess of regular tax liability over the tentative minimum tax (determined without regard to the alternative minimum foreign tax credit).

In addition, under the 2007 TIPRA, for tax years beginning in 2007, the combined total of the following credits is limited to the sum of: (1) regular tax liability reduced by the foreign tax credit, and (2) the AMT:

- . Code Sec. 21 dependent care credit;
- . Code Sec. 22 credit for the elderly and permanently and totally disabled;
- . Code Sec. 23 adoption credit;
- . Code Sec. 24 child tax credit;
- . Code Sec. 25 mortgage credit;
- . Code Sec. 25A Hope and Lifetime Learning credits;
- . Code Sec. 25B lower income saver's credit;
- . Code Sec. 25C nonbusiness energy property credit for energy-efficient improvements to a principal residence;
- . Code Sec. 25D residential energy efficient property credit for solar electric, solar hot water, and fuel cell property added to a residence; and
- . Code Sec. 1400C first-time D.C. homebuyer credit.

Finally, without the patch, approximately 23 million 2007 tax returns would have been socked by the AMT. With the patch, the AMT will strike about 4.2 million tax returns -- roughly the same as last year. The bottom line is that if a taxpayer paid AMT for tax year 2006, he or she will probably pay it for 2007, unless their income or family circumstances have changed.

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Campbell on Neil Jerome Proctor v. Commissioner

2008 Emerging Issues 1967

Campbell on Neil Jerome Proctor v. Commissioner

By Alan D. Campbell

February 29, 2008

SUMMARY: Alan D. Campbell comments on whether a taxpayer may deduct a portion of his military retirement pay that he paid to his former wife when the divorce decree did not address the issue of whether the payments would terminate on her death.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Facts of the Case. This commentary on the U. S. Tax Courts decision in *Neil Jerome Proctor v. Commissioner*, 129 T.C. No. 12 (2007) addresses the issue of whether payments made to a former spouse are deductible as alimony and includible in the gross income of the recipient if the divorce decree does not address the issue of whether the payments cease on the recipients death. This case shows the importance of researching the law under which the court ordered the alimony payments and the need for good tax planning in divorce cases.

Neil Jerome Proctor married Liza Holdman in 1979. They had two children, Dianne and Kimberly. Their marriage eventually failed. On December 10, 1993, the Superior Court of Pulaski County, Georgia, issued a divorce decree that terminated their marriage.

The divorce decree required Neil Jerome Proctor to pay to Liza Holdman \$675 a month for child support. In addition, he was to pay medical and dental insurance premiums for each of the two children and pay half of all of the childrens medical and dental costs not covered by insurance.

He was on active duty as a member of the U. S. Navy at the time of the divorce. The divorce decree required him to pay his former wife 25 percent of his disposable military retirement pay under the provisions of the Uniformed Services Former Spouses Protection Act (10 U.S.C. § 1408).

Neil Jerome Proctor retired from the U. S. Navy on June 30, 2000, and began receiving his retirement pay in August 2000. He did not make any payments to his former wife and she sought to have him held in contempt of court. The state court ordered him to pay Liza Holdman \$1,463 of the childrens past due dental bills, to pay \$68 a month toward his portion of Kimberlys current dental bills, and to pay Liza Holdman \$321 a month for her share of his

retirement pay. The state court later reduced the amount of retirement pay that he had to pay her from \$321 a month to \$231 a month. In 2002, he paid her \$2,774 for his part of the childrens dental expenses and her share of his retirement pay. Later in 2002, he made six additional payments of \$550 each or a total of \$3,300. Thus, he paid her a total of \$6,074 (\$2,774 + \$3,300) during 2002.

On his income tax return for 2002, he deducted the entire \$6,074 as alimony. The IRS denied all of his deduction for alimony and on November 9, 2005, sent him a notice of deficiency. He filed suit in the U. S. Tax Court on February 7, 2006, to contest the deficiency.

The Arguments. Payments made to a former spouse incident to a divorce can be alimony, child support, or a property settlement. The IRS argued that Neil Jerome Proctors payments to his former wife were not deductible as alimony because part of the payments represented child support and the remaining payments were a part of a property settlement incident to the divorce. The IRS argued that the divorce decree stated that the payments that he was to make to her were part of the division of their marital property. Therefore, they did not meet the requirement of Section 71(b)(1)(B) that the divorce decree not refer to the payments as other than alimony. The IRS also argued that the retirement payments did not meet the requirement that the payor have no liability to make payments after the death of the recipient. He argued that the entire \$6,074 was alimony.

Requirements for Alimony. Under Sections 215(a) and 62(a)(10), a taxpayer who makes alimony payments may deduct them in calculating adjusted gross income. Sections 61(a)(8) and 71(a) require the recipient of alimony payments to include such payments in gross income. Section 215(b) provides that alimony for purposes of Section 215 is alimony as defined in Section 71(b).

Section 71(b) lists four requirements that payments must meet to be treated as alimony payments. Section 71(b)(1)(A) provides that the payment must be received by a spouse under a decree of divorce or separate maintenance. Section 71(d) states that for purposes of Section 71, the term spouse includes a former spouse. Section 71(b)(1)(B) provides that the decree of divorce or separate maintenance must not treat the payment as one that is not alimony. Section 71(b)(1)(C) states that in the case of an individual who is legally separated from his or her spouse, that the individual who makes the payments must not be a member of the same household as the recipient spouse at the time of the payment. Section 71(b)(1)(D) provides that the payor must have no liability to make any more payments after the death of the recipient spouse or any substitute for such payments. Section 71(b)(1)(D) does not address how to determine whether the payor is liable to make payments to the recipients estate in the event of the recipients death.

Child Support. Section 71(c)(1) provides that child support is not included in the gross income of the recipient. Neither is child support deductible as alimony under Section 215. If the amount paid to the former spouse is less than the amount required to be paid in the divorce decree, Section 71(c)(3) treats the payment as child support up to the amount required to be paid for child support. In other words, an individual may not deduct any amount for alimony until the individual satisfies the child support obligation.

Section 71(c)(2) provides that any reduction in alimony that occurs based on a contingency related to a child or is associated with such a contingency is not treated as alimony. Reg. § 1.71-1T(c) provides that if the divorce decree calls for a reduction in alimony within six months of a childs reaching age 18, 21, or the local age of majority, then a rebuttable presumption exists that the reduction in the alimony is child support. The taxpayer can rebut this presumption with evidence that the reduction is not related to a contingency related to a child but to some other factor. Reg. § 1.71-1T(c) states that the presumption is rebutted conclusively if the alimony payments completely cease during the sixth post-separation year or at the end of a 72-month period.

Reg. § 1.71-1T(c) also gives the example of the rebuttal of the presumption if local law requires the alimony payments for a period of time measured by how long the marriage existed. If the taxpayer can prove that the divorce

decree calls for alimony payments to be reduced or eliminated based on how long the marriage existed and the date the payor reduces the payments or ceases making payments is within six months of a child attaining age 18, 21, or the local age of majority, then the taxpayer does not have to treat such a reduction in alimony as child support.

Property Settlement. Under Section 1041(a), a taxpayer does not recognize any gain or loss on the transfer of property to a spouse or to a former spouse incident to a divorce. Section 1041(b) treats such transfers as gifts. The transferees adjusted basis in the property is the adjusted basis of the transferor. Section 1041(c) provides that for a transfer to be incident to a divorce, the transfer must occur within one year of the cessation of the marriage or be related to its cessation. Section 1041(d) states that the rule of Section 1041(a) does not apply if the transferee is a nonresident alien.

The Courts Ruling. The court found that divorce decree required Neil Jerome Proctor to pay \$8,000 to Liza Holdman by the end of 2002 consisting of \$2,687 for the childrens medical expenses and \$5,313 for her share of his retirement pay. He actually paid her only \$6,074. The court held that \$2,687 of the \$6,074 that Neil Jerome Proctor paid to his former wife was child support under Section 71(c)(3). Therefore, he could not deduct any of the \$2,687 as alimony.

The court held that the remaining \$3,387 payments met all the requirements for alimony. The court cited its decision in *Benedict v. Commissioner*, 82 T.C. 573 (1984) that stated that labels in a divorce decree are not controlling for determining whether a payment is alimony. The court, citing its opinion in *Goldman v. Commissioner*, 112 T.C. 317 (1999), stated that a taxpayer would meet the requirement of Section 71(b)(1)(B) as long as the divorce decree does not explicitly state that the payments are not to be treated as alimony. The divorce decree did not contain such explicit language.

The court ruled that if a divorce decree does not state that the payments terminate in the event of the recipients death, that the payments meet that requirement if they terminate by operation of law. The court stated that Neil Jerome Proctor made the retirement payments under the provisions of the Uniformed Services Former Spouses Protection Act. This law states that the payments terminate based on the divorce decree but not later than the death of the payor or the payee, whichever occurs first. Because of this provision, the court concluded that the payments would terminate by operation of law on the death of Liza Holdman. Therefore, the court allowed Neil Jerome Proctor to deduct \$3,387 as alimony.

What Practitioners Should Do. Practitioners should remember the requirements that payments must meet to be treated as alimony. If the divorce decree does not address whether the payments cease upon the death of the recipient, the practitioner must research the issue to learn if the payments would terminate on the death of the recipient by operation of law.

Usually, the applicable state law will determine whether the payments would terminate by operation of law on the death of the recipient. The practitioner may want to contact an attorney who practices family law to learn whether payments would terminate by operation of law in a particular state upon the death of the recipient. In some cases such as this one, the payor is making the payments under applicable federal law. In such cases the practitioner will need to research applicable federal law or consult an attorney who has expertise in that area of the law.

Caution for Practitioners. Practitioners must be careful to determine whether payments made to a former spouse incident to a divorce are alimony, child support, or part of a property settlement. Practitioners must be especially careful to determine if payments would terminate on the death of the recipient if the divorce decree does not address this possibility.

Best Practice. Best practice dictates that a practitioner should provide guidance to clients who are in the process of getting a divorce. The practitioner should explain to the client the tax effects of alimony, child support, and property

settlements. The practitioner should inform the client who would be making alimony payments about the advisability of including a provision in the divorce decree that clearly states that payments will cease in the event of the death of the recipient.

Conclusion. The main lesson to be learned from this case is that if a divorce decree does not state that alimony payments will terminate on the death of the recipient, then the payments will meet that requirement if the payors obligation terminates on the death of the recipient by operation of law. Usually, state law will control. However, if the payments are under the authority of the Uniformed Services Former Spouses Protection Act, it will control. Under its provisions, payments to a former spouse terminate on the death of the former spouse and can therefore qualify as alimony.

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Campbell on George R. Willis and D. Thomas-Willis v. Commissioner

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Campbell on George R. Willis and D. Thomas-Willis v. Commissioner

By Alan D. Campbell

February 29, 2008

SUMMARY: Alan D. Campbell comments on the U. S. Tax Courts treatment of workers compensation benefits a taxpayer received that caused a reduction in Social Security disability benefits received. This Emerging Issues Analysis, written by Alan D. Campbell, co-author of the book *Tax Strategies for the Self-Employed*, discusses how practitioners can apply this important decision in preparing tax returns and in providing proper guidance to taxpayers.

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ARTICLE: Facts of the Case. The case of *George L. Willis and D. Thomas-Willis v. Commissioner*, *TC Memo 1997-290*, 73 *TCM* 3183 (1997) addresses the issue of whether a taxpayer must treat a reduction in Social Security benefits for workers compensation benefits the taxpayer received as Social Security benefits for federal income tax purposes. This case also shows the benefit of making the election under Section 86(e) for the receipt of lump-sum Social Security benefits.

George L. Willis suffered a career-ending back injury while working as a longshoreman. His employer paid him workers compensation benefits for temporary disability from July 4, 1985, until July 8, 1991. Thereafter, his employer paid him workers compensation benefits for permanent disability through 1992. His employer paid him the workers compensation benefits under the Longshore and Harbor Workers Compensation Act (33 U. S. C. §§ 901--950).

Because of his career-ending injury, George L. Willis applied for Social Security disability benefits. On January 4, 1991, the Social Security Administration notified him that it had awarded him Social Security disability benefits beginning in March 1990. He received Social Security disability benefits in 1992 in addition to the workers compensation benefits he received.

George L. Willis received a Form 1099-SSA from the Social Security Administration for 1992, which showed that he received \$20,412.70 in total Social Security benefits. The Form 1099-SSA reported that the Social Security Administration paid \$770 of his total Social Security benefits by check or direct deposit, \$318 was for benefits withheld to pay for Medicare premiums, and the remaining \$19,324.70 was due to a reduction in benefits for the workers compensation benefits he received.

The joint return that Mr. and Mrs. Willis filed for 1992 showed Social Security benefits received in the amount of

\$1,352 and the amount taxable as \$338. (The record does not indicate how they calculated the \$1,352 they reported as Social Security benefits received. The sum of the amount of benefits paid by check or direct deposit and the amount withheld to pay for Medicare premiums is \$1,088 (\$770 + \$318).) Their return for 1992 showed adjusted gross income of \$40,474.18.

The IRS issued Mr. and Mrs. Willis a notice of deficiency for tax year 1992 in the amount of \$1,320. The IRS based the notice of deficiency on the failure of Mr. and Mrs. Willis to include \$8,833 of the Social Security benefits Mr. Willis received in their gross income under the provisions of Section 86. They contested the deficiency in the U. S. Tax Court.

The Arguments. The IRS determined that Mr. and Mrs. Willis should have included the \$19,324.70 workers compensation benefits that George L. Willis received in the Social Security benefits he received under Section 86(d)(3). The IRS determined that the Social Security disability benefits were taxable as determined under Section 86. At trial, the IRS conceded that the amount of Social Security benefits that Mr. and Mrs. Willis should have included in gross income was only \$7,378 rather than \$8,833 because of the limitation of Section 86(e).

George L. Willis argued that the workers compensation benefits should not be treated as Social Security benefits because his employer paid the workers compensation benefits from a self-insured fund. He did not cite any authority for his argument.

Tax Treatment of Workers Compensation Benefits. A taxpayer may generally exclude workers compensation benefits for personal injuries or sickness from gross income under Section 104(a)(1). Reg. § 1.104-1(b) states that workers compensation benefits are the benefits received by an employee under a workers compensation act or under a similar statute.

The Social Security Administration may reduce an individuals Social Security benefits because of the receipt of workers compensation benefits under Section 224 of the Social Security Act (42 U. S. C. § 424a). In such cases, Section 86(d)(3) treats the reduction in Social Security benefits because of the receipt of workers compensation benefits as though the taxpayer actually received Social Security benefits. Therefore, such workers compensation benefits are potentially taxable as Social Security benefits under Section 86.

Tax Treatment of Social Security Benefits. Section 86 generally requires a taxpayer to include Social Security benefits in gross income equal to the lesser of (1) one-half of the Social Security benefits received or (2) the sum of taxpayers modified adjusted gross income and one-half of the Social Security benefits received over a base amount. The base amount is \$32,000 on a joint return. The base amount is zero for a taxpayer who is married and files a separate return unless the taxpayer lived apart from his or her spouse for the entire year. For all other taxpayers, the base amount is \$25,000. However, taxpayers who have relatively large amounts of modified adjusted gross income, have to include up to 85 percent of Social Security benefits in gross income. Section 86 does not treat Social Security disability benefits any differently from other Social Security benefits.

Section 86(e) allows a taxpayer to elect to treat any lump-sum Social Security benefits received as though the taxpayer received such benefits in the years to which the benefits are attributable. If the taxpayer makes this election, the taxpayer includes in the current tax years gross income the sum of the Social Security benefits the taxpayer would have included in gross income for the previous tax years to which the benefits are attributable.

The Courts Ruling. The court noted that Section 61(a) provides that gross income includes all income unless a specific exclusion applies. The court also noted that Section 104(a)(1) generally excludes workers compensation benefits from gross income.

However, the court ruled that under Section 86(d)(3), Mr. and Mrs. Willis had to treat the workers compensation

benefits that caused the reduction in Social Security benefits as Social Security benefits. Therefore, they could not exclude the workers compensation benefits from gross income under Section 104(a)(1). The court ruled that they had to include the \$19,324.70 workers compensation benefits in the Social Security benefits George L. Willis received.

The court stated that Congress added Section 86 by the Social Security Amendments of 1983 (P. L. 98-21, 97 Stat. 80). The court cited the House Ways and Means Committee Report to this act, which states clearly that Social Security benefits that are potentially taxable include any workers compensation benefits that caused a reduction in Social Security disability benefits.

The court rejected the taxpayers argument that it should not treat the reduction in Social Security benefits because of the workers compensation benefits as Social Security benefits because the employer paid them from a self-insured fund. The court stated that neither Section 86(d)(3) nor its legislative history provided any exceptions.

What Practitioners Should Do. In light of the courts holding, a practitioner should remember that Section 86(d)(3) treats a reduction in Social Security benefits for workers compensation benefits received as Social Security benefits. In addition, a practitioner should remember that Social Security disability benefits are taxable in the same way that other Social Security benefits are taxable.

Best Practice. Best practice is providing guidance to a taxpayer who receives a reduction in Social Security disability benefits for workers compensation benefits that Section 86(d)(3) treats such workers compensation benefits as potentially taxable Social Security benefits. A practitioner should help the client calculate the estimated tax liability from the receipt of such benefits and determine the amount of the estimated tax payments the client needs to make to avoid the penalty for underpayment of estimated tax under Section 6654. Best practice dictates that a practitioner consider making the election under Section 86(e) if the taxpayer received lump-sum Social Security benefits, or workers compensation benefits deemed to be Social Security benefits under Section 86(d)(3), attributable to one or more previous tax years.

Conclusion. One lesson a practitioner can learn from this case is that a taxpayer must treat a reduction in Social Security disability benefits because of workers compensation benefits received as though such workers compensation benefits are Social Security benefits. Another lesson a practitioner can learn from this case is that if a taxpayer received a lump-sum payment of Social Security benefits attributable to one or more previous years, the practitioner should consider making the election under Section 86(e).

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Dialani on Taxability of Foreign Companies with Back Office Companies in India

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Dialani on Taxability of Foreign Companies with Back Office Companies in India

By Jyoti Dialani

February 28, 2008

SUMMARY: India boasts of a large population of young English speaking and Information Technology graduates hired at attractively low costs. This has resulted in a tremendous outflow of technical and other back office operations projects by various corporations in the United States to India, more popularly referred to as outsourcing activities. Such Indian enterprises bidding for these projects, also called Business Process Outsourcing (BPO) units, have been held by various judicial decisions in India as forming a Permanent Establishment (PE) of the American corporations resulting in huge tax liabilities to the U.S. companies offshoring such projects. However, a recent decision of the Supreme Court of India in the case of Morgan Stanley has finally settled this long drawn legal controversy and has provided the much awaited relief to foreign companies (FCs) having captive BPO units established in India. In this commentary, Jyoti Dialani, a Tax Counsel in India, throws some light on the issues surrounding the tax liabilities of FCs with BPO units in India and elucidates the impact of this landmark decision on the controversial issue surrounding the taxability of FCs by highlighting the aspects of various forms of PEs and the attribution of profits over and above the arms length price to such PEs.

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ARTICLE: Controversy laid to rest

A recent landmark judgment of the Supreme Court of India has finally brought an end to a long drawn legal battle on the controversial issue surrounding the taxability of Foreign Companies (FCs) who have incorporated Business Process Outsourcing (BPO) companies in India. On January 24, 2008, the Supreme Court dismissed a review petition filed by the Income-tax Department on a judgment passed by it in July 2007 on taxing the Indian back offices of foreign companies. The verdict was passed by the Supreme Court in the case of the U.S. investment bank, Morgan Stanley, where it had held that the company would not be liable to pay tax in India on its global income earned on account of its captive BPO unit in India. By dismissing the review petition filed by the Income-tax Department against the said verdict, the Supreme Court has cleared all doubts on the issue pertaining to taxability of such FCs in India. The Income-tax Department had asked the court to reconsider its July judgment on the reasoning that despite an arms length relationship being established between the FC and its domestic BPO unit, a FC can yet be taxed on its global income in India if it is proved that such BPO unit has made a contribution to its income and forms a Permanent Establishment (PE) in India of such parent FC. The Indian revenue authorities sought to tax that part of the parents global profits attributable to such Indian operations. The Supreme Court has held that though it does have a Service PE only restricted

to certain services, no part of global profits of Morgan Stanley would be taxable in India as the transaction between Morgan Stanley US and Morgan Stanley India were at arms length. Therefore, by rejecting the petition, the Supreme Court has made it clear that the Income-tax Department cannot claim anything beyond an arms length pricing relationship between the two companies and as such, in the absence of a PE, no part of the FCs global profits can be brought to tax in India. This ruling has brought about a huge tax relief to the BPO industry.

Genesis and growth of BPO industry in India

Business Process Outsourcing has been a popular management tool as it involves entrusting back office routine operations to outsourced companies at a lower cost and concentrating on complex managerial and specialized jobs. Over the years, outsourcing has seen a rapid increase and demand in diverse sectors from traditional call center operations to slightly complex information technology operations and IT enabled services. India, being a source of a large English speaking and IT qualified young talent at a considerably low cost, has turned into a very attractive destination to outsource technical and other back office operations projects by various corporations in the United States. In the current competitive business environment, outsourcing BPO services to India has turned into an extremely popular business practice to enhance profitability by reducing costs without compromising on quality. This has naturally led to a tremendous growth in the number of BPO companies established in India by their European and U.S. parent corporations. NASSCOMⁿ² has conducted a study on the benefits of outsourcing to the American economy. The study has shown that U.S. businesses have benefited significantly in terms of reducing costs by offshoring their services to India. The US (BFSI)ⁿ³ sector's costs are now 7-10% lower than that of its European counterparts as a result of outsourcing services. US BFSI companies have saved \$6 billion over the last four years through outsourcing operations to India. These promising reports will only lead to a further increase in outsourcing of services by the U.S. European companies to low-cost countries like India. This also brings to the fore the question of taxability of such parent companies in India through the operations carried out by their Indian BPO units.

History of taxability of Foreign Companies with BPO outfits in India

Over the years, with the burgeoning growth in the BPO industry in India, the Income tax Department has been taxing many foreign companies having establishments for BPO services in India on their global income on the ground that such BPO units contribute to the income of such FCs and also form PEs of such entities. The Tax Department has been persistent in its efforts to tax such foreign companies on their global profits. There has been a spate of judicial rulings by various tribunals and high courts in India on the issue of taxability of such foreign companies with BPO units based on either existence of a PE or a Business Connection (BC). Several decisions have been rendered against the foreign companies and in favor of the Income-tax Department. One recent case which was rendered by the Mumbai ITATⁿ⁴ in the case of Sony is *DDIT (International Taxation), Mumbai v. Set Satellite (Singapore) (Pte.) Ltd.*,ⁿ⁵ where it was held that global corporations are taxable in India, even if transactions with their Indian subsidiaries are at arms length. The Tribunal held that the tax liability of a foreign enterprise in respect of its PE is not extinguished by making an arms length payment to its BPO unit. However, this latest ruling of the Supreme Court in the case of Morgan Stanley and the subsequent dismissal by the Court of the review petition filed by the Income-tax Department has overruled the principle laid down by the Mumbai Tribunal in the case of Sony, and has certainly mitigated to a large extent the controversy on the issue of taxability of such foreign enterprises having outsourced services to companies in India.

Chronology of facts leading to the Morgan Stanley verdict

The Supreme Court has dismissed a review petition on January 24, filed by the Department against its earlier decision in the case of *DIT (International Taxation) v. Morgan Stanley and Co. (and vice versa)*.ⁿ⁶ The Supreme Court Judges decide review petitions internally without a public hearing. The Judges are vested with discretionary powers to issue notices for initiation of review process. The decision of the Supreme Court discussed in this commentary has been rendered in a Special Leave Petition (SLP) filed by the Income-tax Department against the ruling by the AARⁿ⁷ in the case of Morgan Stanley and Co.ⁿ⁸ In response to the objections raised by the Department, MSCO., being the Applicant before the AAR, filed cross objections before the Court in the same petition. Thus, the ruling of the AAR, which originated the legal process, was challenged by both the Department as well as the Applicant before the Supreme Court in the SLP.

Facts of the case. Morgan Stanley & Co., USA (MSUS), referred to as MSCO. by the Supreme Court (hereinafter for the sake of consistency to be referred to as such), one of the companies of the Morgan Stanley (MS) Group, was the Applicant before the AAR. The MS Group is one of the worlds leading financial services companies with specializations in investment banking and mergers and acquisitions. The main lines of business are securities investment management, investment banking and credit services. MSCO. is a wholly-owned subsidiary of Morgan Stanley, US under the General Corporate Law of the State of Delaware and it is a tax resident of the U.S.A. It is a leading investment bank having a number of group companies in various parts of the world. MSCO. also provides financial advisory services, corporate lending and securities underwriting which are undertaken by various divisions. One of the group companies is Morgan Stanley Advantage Services Private Limited (MSAS), which is incorporated in India and is set up by the Morgan Stanley Group to support the group members front office and infrastructure unit functions in their global operations for providing support services. MSAS is a wholly-owned subsidiary of MSCO.

MSCO. and MSAS, who was the Indian subsidiary and BPO unit, entered into an agreement on December 1, 2003, under which the former had outsourced support services such as IT support, account reconciliation, research, etc., to the latter. Under the agreement, MSAS did not undertake the important revenue generating functions of MSCO., nor was it supposed to bear any significant market risk with respect to its transactions with MSCO. The client's interaction was entirely to be carried out by the employees of MSCO. MSCO. also proposed to send its staff to India for stewardship activities and other similar activities to ensure that the high standards of quality are met as Morgan Stanley group entities are to be satisfied that the services received by them from other group companies meet the overall global value benchmarks of Morgan Stanley standards. The stewardship activities included monitoring the overall outsourcing operations at MSAS without involvement in any day-to-day management or other specific services to or for MSAS. MSCO. was also supposed to send its staff on deputation on the request of MSAS for periods ranging between several months to a couple of years to work under its control and supervision. The staff would, however, continue to be employed or engaged and their remuneration would be directly paid by MSCO. MSAS was merely required to reimburse the compensation cost to MSCO. without any profit element. The consideration to be paid to MSAS by MSCO. for the services rendered was the sum of the costs and a mark-up of a certain percentage of the costs as agreed upon by the parties. The term costs was defined in the agreement to include direct and indirect costs incurred by MSCO. in providing the services, including all costs relating to underutilization of capacity, such as idle time cost of employees, rent for vacant space, etc. For the financial year 2003-2004, M/s Ernst & Young Private Limited had conducted a transfer pricing study for MSCO. The Transactional Net Margin Method (TNMM) was selected as the most appropriate method with operating profit margin being the profit level indicator in respect of services rendered by MSAS to MSCO. The average margin earned by the comparable companies providing similar services was worked out to 28.33%. Under the agreement, MSAS was charging MSCO. a margin of 29% on the costs incurred by it.

Questions raised in the application. Based on the above mentioned facts, MSCO. sought advance rulings of the AAR on the following questions:

1. Whether MSCO. would be regarded as having a Permanent Establishment (PE) in India under the provisions of Article 5 of the Agreement for Avoidance of Double Taxation (Treaty)ⁿ⁹ and Prevention of Fiscal Evasion with

respect to taxes on Income and Capital Gains entered into between the Government of the Republic of India and the Government of the United States of America (hereinafter referred to as the Treaty), and specifically:

(a) Whether MSCo. would be regarded as having a PE in India under Article 5 of the Treaty on account of the services rendered by MSAS under the Services Agreement dated April 14, 2005, entered into by it with MSCo. (Agreement)?

(b) Whether MSAS would be regarded as constituting an Agency PE of MSCo. under Article 5(4) of the Treaty?

(c) Whether MSCo. would be regarded as having a PE in India under Article 5(2)(l) (Service PE) of the Treaty if it were to send some of its employees to India to undertake certain stewardship activities?

(d) Whether MSCo. would be regarded as having a PE in India under Article 5(2)(l) (Service PE) of the Treaty if it were to send some of its employees to India on deputation in the employment of MSAS?

(e) Whether MSCo. would have a PE in India for any other reason?

2. Whether, on the facts and in the circumstances of the case and in light of the provisions of Section 92C of the Income Tax Act, 1961 n10 (the Act) read with Rules 10B and 10C of the Income-tax Rules, 1962 n11 (the Rules), the Transactional Net Margin Method (TNMM) is the most appropriate method for the determination of the arm's length price in respect of transactions between MSCo. and MSAS?

3. Whether on the facts and in the circumstances of the case, a mark-up of 29% (using the TNMM for the benchmarking analysis) on the operating costs incurred by MSAS for providing services to MSCo. would meet the arm's length test as prescribed under Chapter X n12 of the Act?

4. Based on the facts and in the circumstances of the case, even in the event MSAS constitutes a PE of MSCo. in India, as long as MSAS is remunerated for its services at arm's length, whether any further income can be attributed in the hands of the PE of MSCo.?

5. Based on the facts and in the circumstances of the case, in the event MSCo. is deemed to have a PE in India as a result of sending employees to India or due to deputation of employees to MSAS, whether given the function which would be performed and risks that could be undertaken by such a PE, would a remuneration based on a margin on total operating cost of the PE be the appropriate profit attributable to such a PE?

Ruling of the AAR. Since question no. 3 was dropped by MSCo., the AAR declined to pronounce any ruling on it. As regards the ruling on question no. 2, the same was rejected by the AAR, in view of the first proviso to sub-section (2) of Section 245R n13 read with Chapter X of the Act which prohibits the AAR from allowing any application where the question raised is pending before any income-tax authority or tribunal or where the same involves determination of fair market value of any property. Since, in this particular case, the issue raised in question no. 2 was pending before the Assessing Officer and the question also involved valuation of tangible properties and services, the AAR rejected the question. Hence, there was no ruling of the AAR on the issue of transfer pricing.

Contentions of MSCo. on the issue of existence of a Permanent Establishment

Whether there existed a Fixed Place PE? On question no. 1, which was divided into five sub-questions but mainly raised an issue about the existence of a PE of MSCo. in India, MSCo. contended that it had no fixed place of business in India through which it could be said to carry on its business as the premises of MSAS in India were being used for carrying on the business of MSAS and not of MSCo. It was emphasized by MSCo. that it had merely

outsourced certain activities to MSAS and hence, it was submitted that it did not carry out its business either wholly or in part in India. It was therefore contended that MScO. did not have a fixed PE in India.

Whether there existed a Service PE? On the question of existence of a Service PE, it was submitted by MScO. that the services rendered by MSAS did not constitute Service PE within the meaning of Article 5(2)(l) of the Treaty. Since MScO. intended to send its staff to MSAS for certain stewardship functions, it was only to ensure that MSAS adheres to the stringent quality benchmarks and other requirements of the Morgan Stanley Group with a view to protect the business interest of shareholders of MScO. It was further submitted that the employees of MScO. were not to be involved in the management of MSAS. MScO. contended that a Service PE is constituted if services are furnished by an enterprise through employees or other personnel in the other Contracting State to a third party on being solicited by the recipient. A distinction was raised between such a situation and a case where an entity sends staff without the services being solicited by the recipient, in which case it could only be for the benefits of the entity and it cannot be said that services are rendered to the entity that hosts them. Since MScO. intended to send its staff for its own benefit and it also intended to bear the economic burden of salary and other costs while they were in India, the staff could be said to render quality and risk management services to MScO. and not to MSAS. Also, the staff sent would work under the supervision of the Board of Directors of MSAS, and MScO. was not to exercise any control over the operations of MSAS other than the level of control a client would exercise over his service provider. Accordingly, it was argued on behalf of MScO. that since it did not furnish any services within the meaning of Article 5(2) (1) of the Treaty, it cannot be said that a Service PE is constituted.

Whether there existed an Agency PE? On the question of the existence of an Agency PE under Article 5(4) of the Treaty, it was contended that MSAS was not an agent of MScO. as it did not act on behalf of the latter. It was submitted that while rendering services to MScO., MSAS was acting in furtherance of its own business and that the relation between MScO. and MSAS was a principal-to-principal relationship. It was also argued that MSAS did not have any authority to conclude any contracts on behalf of MScO. and it also did not maintain stock of goods on behalf of MScO., nor did it secure orders in India for MScO., which functions are included in Article 5(4) of the Treaty as ingredients which constitute an Agency PE.

Contentions of the Income-tax Department

The Department contended that MSAS performed essential and significant activities of MScO., which were crucial and critical for the business carried on by MScO. as well as the other group companies. It was submitted that the functions performed by MSAS were essential core functions for the enterprise and hence they could not be described as preparatory and auxiliary in nature. It referred to a certain clause in the agreement whereby MSAS would render services wholly and exclusively to MScO. and its group. MSAS was also subject to detailed instructions and control with respect to conduct of the business. On the basis of these facts, it was argued by the Department that MSAS was a dependent agent of MScO. It was also pointed out that there was unlimited access of the customers to the premises of and other business premises to the employees of bank division, auditors and security division. On giving notice and even without notice, the representatives of the Morgan Group could undertake investigation as directed by the customers. Analyzing certain clauses of the agreement which show that there is unrestricted access to the premises of MSAS, the Department contended that MSAS was working for and on behalf of MScO. and was a mere projection of the company and the group. It was also pointed out that MSAS was kept free from business risks and it had no independent existence. MScO. along with other Morgan Stanley entities would be in a position to exert a decisive influence on the business of MSAS who would be working under direct control and supervision and subject to the instructions of the Morgan Stanley group. Based on these facts, it was submitted that there was no independent existence of business of MSAS except as dependent agent of MScO. MScO. would depute staff to MSAS which would work for more than 90 days in a year and thus exercise direct control and supervision over the activities of MSAS, which would constitute Service PE in India under Article 5(2)(l) of the Treaty. The Department summed up its submissions that MSAS had a Fixed Place PE under Article 5(1), Service PE under Article 5(2)(l) as well as Agency PE under Article 5(4) of the Treaty.

Decision of the AAR

After hearing submissions by both sides, the AAR analyzed the provisions of Article 5 of the India-U.S. Tax Treaty. It reproduced the relevant part of the treaty -- the definition of Permanent Establishment -- as follows:

2. The term "permanent establishment" includes especially:

(a) to (k) xx xx xx xx xx xx xx xx

(I) the furnishing of services, other than included services as defined in Article 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel, but only if:

(i) activities of that nature continue within that State for a period or periods aggregating to more than 90 days within any twelve months period; or

(ii) the services are performed within that State for a related enterprise [within the meaning of paragraph 1 of article 9 (associated enterprises)]

3. x x x x x

4. Notwithstanding the provisions of paragraphs 1 and 2, where a person other than an agent of an independent status to whom paragraph 5 applies is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned state, if:

(a) he has and habitually exercises in the first-mentioned State an authority to conclude contracts on behalf of the enterprise, unless his activities are limited to those mentioned in paragraph 3 which, if exercised through a fixed place of business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph;

(b) he has no such authority but habitually maintains in the first-mentioned State a Stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise, and some additional activities conducted in that State on behalf of the enterprise have contributed to the sale of the goods or merchandise; or

(c) he habitually secures orders in the first mentioned State, wholly or almost wholly for the enterprise.

5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's length conditions, he shall not be considered an agent of independent status within the meaning of this paragraph.

Having examined the definition, the AAR observed that for the purposes of this Convention, the term permanent establishment means a fixed place of business through which the business of an enterprise is wholly or partly carried on. It also examined the commentary of OECD on Article 5 which states that there must be a fixed place of business which takes in not only fixed premises but also machinery or equipment. The expression a fixed place indicates a certain degree of permanence. It noted that paragraph 2 of the Article being an inclusive provision, takes in various places and services enumerated in clauses (a) to (I). Clause (I) postulates furnishing of services by an enterprise within a Contracting State through employees or other personnel. This clause is subject to certain alternative conditions enumerated therein such as rendering of such services within the State for a period or periods aggregating to more than ninety days within any twelve-month period or the performance of services within that State for a related enterprise. The paragraph also mentions the circumstances where the enterprises are treated as related enterprises. Paragraphs 4 and 5 are complementary. An agent of an independent status to whom paragraph 5 applies is excluded from paragraph 4. Paragraph 4 commences with a non-obstante clause and says that notwithstanding the definition of the expression PE outlined in paragraphs 1 and 2, a person, other than an agent of independent status to whom paragraph 5 applies, acting in a Contracting State on behalf of an enterprise of the other Contracting State shall be deemed to have a permanent establishment in the first mentioned State, if any one of clauses (a), (b) and (c) thereof applies. Clause (a) deals with a person who has and habitually exercises authority to conclude contracts on behalf of the enterprise in the first mentioned State unless (i) the activities are limited to those mentioned in paragraph 3 (excluded activities) and (ii) if they are exercised through a fixed place of business, would not make that fixed place of business a permanent establishment under the provisions of that paragraph. Clause (b) deals with a person who acts without authority. Clause (c) says that the person habitually secures orders in the first mentioned state wholly or almost wholly for the enterprise. It is seen that paragraph 5 contains an exclusionary clause which says that an enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status provided that such agents are acting in the ordinary course of business. Nonetheless, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise and the transactions between the agent and the enterprise are not made under arm's length conditions, he shall not be considered as an agent of an independent status.

Having studied the business activities of MSCo., the agreement and the support services provided by MSAS and taking into consideration submissions of both parties, the AAR observed that MSCo. would be in a position to exercise close control and supervision on the working of MSAS. It also noted that the features in the agreement vividly brought out that the business of MSAS was inextricably linked with the business of MSCo. and other two entities of the Morgan Stanley group so as to make activities of MSAS a projection of Morgan Group.

On existence of Fixed Place PE. The AAR pointed out the requirements of Article 5(1) of the Treaty as follows:

- a) There should be a fixed place of business, and
- b) The business of the enterprise should be carried on wholly or partly through that place.

The AAR further observed that the place of business of MSAS was a fixed place but there was nothing to show that the business of MSCo. was carried on through the place of business of MSAS. The AAR did not accept the contention that rendering of services as mentioned by MSAS to MSCo. and other group companies which may be usefully utilized by them in running their business amounts to carrying on business through the fixed place of business of MSAS. On the basis of the analysis drawn, the AAR ruled that the germane condition of carrying on business through fixed place of business of MSAS, not being fulfilled, Article 5(1) of the Treaty will not be attracted. Accordingly, it ruled that in regard to question no. 1(a), MSAS cannot be treated as the permanent establishment of MSCo. and/or Morgan Group.

On existence of Agency PE. The AAR examined and summarized the ingredients to constitute an Agency PE as mentioned in Para 4 of Article 5 of the Treaty and recorded its observations as follows:

For MSAS to constitute a PE of MSCo. or the Morgan Group, it has to be shown that

(1) MSAS is acting in India on behalf of MSCo./Morgan Group of US;

(2) MSAS is a person other than an agent of independent status;

(3) MSAS

(a) has and habitually exercises an authority to conclude contracts on behalf of MSCo./Morgan Group;

(b) has no such authority but habitually maintains a stock of goods or merchandise from which it regularly delivers goods on behalf of MSCo./Morgan Group or

(c) habitually secures orders in India wholly or almost wholly for MSCo./Morgan Group.

The AAR further noted that the service agreement between MSCo. and MSAS clearly proved that the latter was carrying on activities in India on behalf of the former and that the functions and the activities of MSAS were wholly and exclusively dependent on MSCo. both legally and economically. Keeping in mind these principles, the AAR examined whether the service agreement creates any Agency PE between MSCo./Morgan Group and MSAS for the purpose of paragraph 4 of Article 5 of the Treaty and pointed out it is not necessary that MSAS should be an agent of MSCo./Morgan Group. It is enough if it satisfies the above mentioned three requirements which are cumulative. On requirement (1) it was held that MSAS is acting in India on behalf of MSCo./Morgan Group. On requirement (2), the AAR observed that according to MSCo., MSAS is not an agent and according to the Commissioner, it is not an agent of independent status. Also, none of the three requisites of requirements (3) being satisfied, the AAR held that paragraph 4 of Article 5 was not attracted on the question of Agency PE and, accordingly, it ruled that MSAS was not the Agency PE of MSCo./Morgan Group.

On existence of Service PE. On the issue of the existence of Service PE, the AAR studied the terms of agreement and observed that employees of MSCo. are to be sent to MSAS whether for stewardship activity or on deputation basis for more than ninety days. It further noted that once employees are sent on deputation for stewardship activities, they would be actively involved in the key managerial activities of MSAS. Therefore, it was held that the ingredients of paragraph 2(1) of Article 5 are satisfied and, therefore, MSAS would constitute the Service PE of MSCo./Morgan Group.

On the question of attribution of further income in the hands of MSAS over and above the arms length price. On question no 4, i.e., even in the event MSAS constitutes a PE of MSCo. in India, as long as MSAS is remunerated for its services at arm's length, whether any further income can be attributed in the hands of the PE of MSCo, the AAR clearly held that no further income can be attributed in the hands of such PE. The AAR held that Section 92C n14 of the Act requires that international transactions between associated enterprises should be at arm's length price. It would satisfy the requirement of Section 92C of the Act if MSAS is remunerated for its services at arm's length price. Further, Article 7 of the Treaty is clear that where the enterprise carries on business in the other

Contracting State through a permanent establishment situated therein, so much of the profits of the enterprise as is attributable to that permanent establishment, may be taxed. Making a reference to Annexure III of the application, the AAR held that as long as MSAS is remunerated for its services at arms length price and as long as all its actual income is brought to tax, there should be no additional profits attributable to either MSCO. or MSAS in India.

Conclusion of the AAR. Although the AAR held that MSAS formed a Service PE of MSCO. in India under Article 5(2)(l) of the Treaty as it sent its employees to MSAS for stewardship activities and deputation for more than the specified period, it ruled in favor of MSCO. as it held that no further income could be attributed to MSAS as long as the latter is remunerated by MSCO. at arms length for its services rendered in India and all its income is taxed. On the issue of appropriateness of the TNMM for determination of an arms length price in the case of MSCO., the AAR did not give any ruling as it refused to entertain the same for reasons stated hereinbefore.

Appeal against the AAR ruling. The Department went in appeal against the above ruling of the AAR by way of filing a SLP and the Applicant, being MSCO. in this case, filed its cross objections in the same petition. The Department challenged the said ruling of the AAR on the question of income attributable to the PE.

Observations of the Supreme Court. The Supreme Court observed that with globalization, many economic activities spread over to several tax jurisdictions and this makes the concept of PE important under Article 5(1) of the Treaty. It observed that there exists a PE if there is a fixed place through which the business of an enterprise, which is a multinational enterprise (MNE), is wholly or partly carried on. MSCO., a multinational entity, had outsourced some of its activities to MSAS in India. It further stated that a general definition of a PE in the first part of Article 5(1) postulates the existence of a fixed place of business whereas the second part of Article 5(1) postulates that the business of the MNE is carried out in India through such fixed place. Since the Supreme Court was faced with the question whether the activities undertaken by MSAS consisted of back office operations of MSCO. and, if so, whether such operations would fall within the ambit of the expression the place through which the business of an enterprise is wholly or partly carried out in Article 5(1), the Court conducted a detailed examination of the relevant Articles 5 and 7 of the Treaty and held that the second requirement of Article 5(1) of the Treaty was not satisfied as regards back office functions. The Court examined the terms of the Agreement along with the advance ruling application made by MSCO. and held that it was clear that MSAS in India would be engaged in supporting the front office functions of MSCO. in fixed income and equity research and in providing IT enabled services such as data processing, support center and technical services as also reconciliation of accounts. It held a view that in order to decide whether a PE stood constituted, one has to undertake what is called a functional and factual analysis of each of the activities to be undertaken by an establishment. Accordingly, the Supreme Court confirmed the ruling of the AAR that Article 5(1) is not applicable as MSAS was only performing back office operations in India. The Court accordingly decided that to the extent of the back office functions, the second part of Article 5(1) was not attracted and there was no PE of MSCO. in India. The Court also discussed one more aspect on the issue of fixed place PE, namely, the exclusion of PE under Article 5(3). Under Article 5(3)(e), activities which are preparatory or auxiliary in character and carried out at a fixed place of business will not constitute a PE. Article 5(3) commences with a non-obstante clause. It states that notwithstanding what is stated in Article 5(1) or under Article 5(2), the term PE shall not include maintenance of a fixed place of business solely for advertisement, scientific research or for activities which are preparatory or auxiliary in character.

Decision of the Supreme Court

Fixed Place PE

The Supreme Court held that the above mentioned back office functions performed by MSAS in India fell under Article 5(3)(e) of the Treaty and hence, it would not constitute a Fixed Place PE under Article 5(1) of the Treaty as

regards its back office operations.

Agency PE

On the question of Agency PE, the Court agreed with the AAR that MSAS did not constitute an Agency PE as it had no authority to enter into or conclude the contracts in India. The contracts would be entered and concluded in the United States. The implementation of those contracts only to the extent of back office functions would be carried out in India and, therefore, MSAS would not constitute an Agency PE.

Service PE

Stewardship activities. On the aspect of stewardship activities performed by the staff of MSCo. in India, the Court observed that a customer like MSCo. who has worldwide operations is entitled to insist on quality control and confidentiality from the service provider. A service provider may also be required to act according to the quality control specifications imposed by its customer and to maintain confidentiality. Stewardship activities involve briefing of the MSAS staff to ensure that the output meets the requirements of MSCo. These activities include monitoring of the outsourcing operations at MSAS. The object is to protect the interest of MSCo. These stewards are not involved in day-to-day management or in any specific services to be undertaken by MSAS. The stewardship activity is basically to protect the interest of the customer and it cannot be said that MSCo. has been rendering the services to MSAS. It held a view that MSCo. was merely protecting its own interests in the competitive world by ensuring the quality and confidentiality of MSAS services. Accordingly, it overruled the decision of the AAR that stewardship activity would fall under Article 5(2)(l). The Court then concluded that the stewardship activities did not give rise to Service PE and hence allowed the appeal filed by the Appellant (MSCo.) to that extent.

Activities performed by deputationists. On the question of deputation, the Supreme Court took a view that an employee of MSCo. when deputed to MSAS does not become an employee of MSAS. A deputationist has a lien on his employment with MSCo. As long as the lien remains with MSCo., the said company retains control over the deputationist's terms and employment. The concept of a Service PE finds a place in the U.N. Convention. It is constituted if the multinational enterprise renders services through its employees in India, provided the services are rendered for a specified period. In the present case, it extended to two years on the request of MSAS. It is important to note that where the activities of the multinational enterprise entails it being responsible for the work of deputationists and the employees continue to be on the payroll of the multinational enterprise or they continue to have their lien on their jobs with the multinational enterprise, a Service PE can emerge. Applying these tests to the facts of this case, the Court held that a deputationist, on completion of his tenure, is repatriated to his parent job. He retains his lien when he comes to India. He lends his experience to MSAS in India as an employee of MSCo. as he retains his lien and in that sense there is a Service PE under Article 5(2)(l). Accordingly, it held that to the extent of the deputationists services, MSCo. is rendering services through its employees to MSAS. It agreed with the ruling of the AAR and held that on the aspect of the services rendered by deputationists, there exists a Service PE in India (MSAS) and, accordingly, the appeal of the Department on that count was allowed.

Decision on effect of Transfer Pricing provisions on computation of Arms Length Price

On the issue decided by the AAR on the appropriateness of the computation method of the arms length price based on TNMM, the Supreme Court observed that Article 7 of the Treaty brings to tax the profits earned by the Foreign Company (FC). Under the said IT Act, the taxable unit is the FC, though the quantum of income taxable is income attributable to the PE of the said FC in India. It further observed that the income attributable to the said PE is the income attributable to the foreign company's operations in India, which implies the income attributable to the activities carried on by the FC through its PE in India. Therefore, there is a difference between the taxability of the PE in respect of its income earned by it in India which is in accordance with the Income-Tax Act, 1961 and which has nothing to do with

the taxability of the FC, which is also taxable in India under Article 7, in respect of the profits attributable to its PE. Under Article 7, the taxability is of the FC as what is taxable is profit earned by such FC. Under the said IT Act, the taxable unit is the foreign company, though the quantum of income taxable is income attributable to the PE of such company in India. Further, examining various methods for determining appropriate transfer pricing under Section 92C(1) of the Act, such as Comparable Uncontrolled Price Method (CUPM), Resale Price Method (RPM), Transactional Net Margin Method (TNMM), etc., the Court proceeded to note the method adopted by MSCo. on the basis of the opinion of Ernst and Young, Consultants, who suggested TNMM as the most appropriate method for determination of arm's length price in respect of a transaction between MSCo. and MSAS. Accordingly, the average mark-up (on costs) of comparable companies providing similar services was taken into account at 29% and the same was agreed upon by MSAS and MSCo. It was also accepted by the Transfer Pricing Officer and by the Assessing Officer. The Court examined the provisions of the Income-tax Act as well as the provisions of the Treaty between India and the United States and the relevant transfer pricing provisions contained in the Act as well as in the relevant Rules. It pointed out that there is a difference between the definition of PE as contained in Section 92F(iiiia) as well as in the relevant provision of the Treaty. It observed that under the Act, the definition is inclusive as against the definition in the Treaty, which is exhaustive. This indicates that the intention of the Legislature was to cover Service PE, Agency PE, Software PE, Construction PE, etc., in the definition of a PE. Making a reference to the transfer pricing provisions in the Act and various Rules and the fact that the TPO and the AO had accepted the TNMM as appropriate, the Court held that TNMM was the appropriate method in the case of Service PE as it apportions the total operating profit arising from the transaction on the basis of sales, costs, assets, etc.

The Court also noted that one of the main points for determination in the case was whether the AAR was right in ruling that as long as MSAS was remunerated for its services at arms length, there should be no additional profits attributable to MSAS in India. In order to determine the issue, the Court referred to the relevant provisions of Article 7 of the U.N. Model Convention, which relates to attribution of business profits. The Court then observed that Article 7 of the U.N. Model Convention *inter alia* provides that only that portion of business profits is taxable in the source country which is attributable to the PE, and how such business profits should be ascertained. The Article further provides for a PE to be treated as if it is an independent enterprise (profit centre) dehors the head office and which deals with the head office at arm's length. Therefore, its profits are determined on the basis as if it is an independent enterprise. The profits of the PE are determined on the basis of what an independent enterprise under similar circumstances might be expected to derive on its own. It was observed that the Article advocates the arms length approach for attribution of profits to a PE. The Court further added that the object behind enactment of transfer pricing regulations is to prevent shifting of profits outside India. It pointed out that under Article 7(2), not all profits of MSCo. would be taxable in India but only those which have economic nexus with PE in India. A foreign enterprise is liable to be taxed in India only on so much of its business profit as is attributable to the PE in India. The Court observed that under the ruling delivered by the AAR, remuneration to MSAS was justified by a transfer pricing analysis and, therefore, no further income could be attributed to it. The Court also held that the said ruling equates an arm's length analysis (ALA) with attribution of profits. It holds that once a transfer pricing analysis is undertaken, there is no further need to attribute profits to a PE. The impugned ruling is correct in principle in so far as an associated enterprise, that also constitutes a PE, has been remunerated on an arm's length basis taking into account all the risk-taking functions of the enterprise. In such cases nothing further would be left to be attributed to the PE. The situation would be different if transfer pricing analysis does not adequately reflect the functions performed and the risks assumed by the enterprise. In such a situation, there would be a need to attribute profits to the PE for those functions/risks that have not been considered. Therefore, in each case the data placed by the taxpayer has to be examined as to whether the transfer pricing analysis placed by the taxpayer is exhaustive of attribution of profits, and that would depend on the functional and factual analysis to be undertaken in each case. It also added that taxing corporates on the basis of the concept of economic nexus is an important feature of attributable profits (profits attributable to the PE).

Conclusion of the Supreme Court

The Court concluded its judgment by holding that the AAR was right in ruling that MSAS would be a Service PE

in India under Article 5(2)(l), but only to the extent of the services to be performed by the deputationists deployed by MSCO. and not on account of stewardship activities.

On the issue of income attributable to the PE (MSAS), it held that the Transactional Net Margin Method was the appropriate method for determination of the arm's length price in respect of a transaction between MSCO. and MSAS and accordingly accepted as correct, the computation of the remuneration based on cost plus mark-up worked out at 29% on the operating costs of MSAS.

On the issue of attribution of further profits to the PE of MSCO. where the transaction between the two are held to be at arms length, the Court ruled that the AAR was correct in principle provided that an associated enterprise (that also constitutes a PE) is remunerated on an arms length basis taking into account all the risk-taking functions of the multinational enterprise. In such a case nothing further would be left to attribute to the PE.

Highlights of the Judgment

(a) The condition of carrying on business through a fixed place of business being not fulfilled, MSCO. did not have a permanent establishment (PE) in India under the provisions of Article 5(1) of the India-U.S. Tax Treaty.

(b) MSAS had no authority to enter into or conclude the contracts on behalf of MSCO. and, therefore, it cannot be said to form a PE under Article 5(4) of the Treaty under the Agency Rule.

(c) By sending its employees for stewardship activities, MSCO. was merely protecting its own interest and therefore it could be concluded that it was rendering services to MSAS so as to constitute a Service PE under Article 5(2)(l) of the India-U.S. Tax Treaty.

(d) On the issue of deputation of employees, the Supreme Court held that the employees of MSCO. who were deputed to MSAS were not employees of MSAS. The Court further observed that the deputationists had a lien on their employment with MSCO. and so long as the lien continued with MSCO., it retained control over the deputationists terms and employment. Since such deputationists lent their experience to MSAS in India as employees of MSCO., it was concluded that there was a Service PE under Article 5(2)(l) of the Treaty but only to the extent of income attributed to the deputation of employees.

(e) On the issue of attribution of profits to a PE of MSCO., the Court held that where the transactions are held to be at arm's length, nothing further can be attributed to the PE, provided that the computation of transfer price to the associated enterprise takes into account all the risk-taking functions of such a FC.

Conclusion

On the basis of the judgment of the Supreme Court, the following conclusions can be drawn and applied to foreign companies with BPO presence in India:

On the existence of PE of any FC in India

(i) A subsidiary company set up in India by a FC for performing its back office functions will not give rise to Fixed Place PE or Agency PE provided the facts and functions specified in the agreement are similar to the case under discussion.

(ii) If the FC sends its employees to such BPO in India for stewardship activities with a view to protect its interest in terms of confidentiality, quality control, etc., and not to exercise any managerial control, it will not give rise to Service PE.

(iii) If the FC sends its employees on deputation to such BPO in India for the purpose of rendering services to such BPO unit of the group, it will give rise to Service PE more so if such employees render services on behalf of the FC and such employees retain their lien on their employment with the foreign company.

On the issue of attribution of further profits to such PE over and above the arms length price paid to the BPO

If a BPO unit of a FC, which forms a PE of such FC, is paid on an arms length basis for the services rendered, no further profits can be attributed to the PE.

Review Petition dismissed

A review petition was filed by the Income-tax Department before the Supreme Court in respect of the judgment and the same has been rejected by the Court on January 24, 2008 as stated hereinabove. This has provided the much needed certainty to the issues decided upon in this decision of the Apex Court much to the relief of the increasing foreign companies who have their BPO units set up in India.

Return to Text

n1 . A term used for in-house work being done for the parent organization source: en.wikipedia.org.

n2

[2]. NASSCOM (www.nasscom.in) is a global trade body with more than 1,200 members, of which over 250 are global companies from across the US, UK, EU and APAC.

n3

[3]. Banking, Financial Services and Insurance.

n4 . Income Tax Appellate Tribunal ITAT is the Appellate Tribunal as defined in S. 2(4) of the Act as constituted under S. 252 of the Act, which is a judicial authority that is also the final fact finding authority whose decisions are final on facts. Appeals from such decisions can be preferred before the High Court only on substantial questions of law.

n5

[5]. Deputy Director of Income-tax, International Taxation, Range 2(1), Mumbai v. Set Satellite (Singapore) (Pte.) Ltd., (2007) 106 ITD 175 (Mum.).

n6

[6]. DIT (International Taxation) v. Morgan Stanley and Co. (and vice versa), (2007) 292 ITR 416 (SC).

n7

[7]. An authority constituted by the Central Government under S. 245-O of the Act for giving determinations called advanced rulings in relation to a transaction undertaken or proposed to be undertaken by a non-resident applicant on issues pertaining to tax liabilities on proposed transactions.

n8

[8]. *In re Morgan Stanley and Co.*, (2006) 284 ITR 260 (AAR).

n9

[9]. The PDF version of the text of the full treaty can be found at <http://www.irs.gov/pub/irs-trty/india.pdf>.

n10

[10]. The updated version of the bare Act can be found at <http://law.incometaxindia.gov.in/TaxmannDit/DisplayPage/dpage1.aspx>.

n11

[11]. The entire Rules can be found at <http://law.incometaxindia.gov.in/TaxmannDit/DisplayPage/dpage2.aspx?md=24&typ=cn&yr=2007>.

n12

[12]. Chapter X of the Act contains Sections 92 to 94 dealing with avoidance of double taxation.

n13

[13]. **Procedure on receipt of application.**

245R. (1) On receipt of an application, the Authority shall cause a copy thereof to be forwarded to the Commissioner and, if necessary, call upon him to furnish the relevant records:

Provided that where any records have been called for by the Authority in any case, such records shall, as soon as possible, be returned to the Commissioner.

(2) The Authority may, after examining the application and the records called for, by order, either allow or reject the application:

[Provided that the Authority shall not allow the application where the question raised in the application,

(i) is already pending before any income-tax authority or Appellate Tribunal [except in the case of a resident applicant falling in sub-clause (iii) of clause (b) of section 245N] or any court;

(ii) involves determination of fair market value of any property;

(iii) relates to a transaction or issue which is designed *prima facie* for the avoidance of income-tax [except in the case of a resident applicant falling in sub-clause (iii) of clause (b) of section 245N.

n14 . **Computation of arms length price.**

92C. (1) The arms length price in relation to an international transaction shall be determined by any of the following methods, being the most appropriate method, having regard to the nature of transaction or class of transaction or class of associated persons or functions performed by such persons or such other relevant factors as the Board may prescribe, namely:

(a) comparable uncontrolled price method;

(b) resale price method;

(c) cost plus method;

(d) profit split method;

(e) transactional net margin method;

(f) such other method as may be prescribed by the Board.

(2) The most appropriate method referred to in sub-section (1) shall be applied, for determination of arms

length price, in the manner as may be prescribed :

[Provided that where more than one price is determined by the most appropriate method, the arms length price shall be taken to be the arithmetical mean of such prices, or, at the option of the assessee, a price which may vary from the arithmetical mean by an amount not exceeding five per cent of such arithmetical mean.]

(3) Where during the course of any proceeding for the assessment of income, the Assessing Officer is, on the basis of material or information or document in his possession, of the opinion that

(a) the price charged or paid in an international transaction has not been determined in accordance with sub-sections (1) and (2); or

(b) any information and document relating to an international transaction have not been kept and maintained by the assessee in accordance with the provisions contained in sub-section (1) of section 92D and the rules made in this behalf; or

(c) the information or data used in computation of the arms length price is not reliable or correct; or

(d) the assessee has failed to furnish, within the specified time, any information or document which he was required to furnish by a notice issued under sub-section (3) of section 92D,

the Assessing Officer may proceed to determine the arms length price in relation to the said international transaction in accordance with sub-sections (1) and (2), on the basis of such material or information or document available with him:

Provided that an opportunity shall be given by the Assessing Officer by serving a notice calling upon the assessee to show cause, on a date and time to be specified in the notice, why the arms length price should not be so determined on the basis of material or information or document in the possession of the Assessing Officer.

(4) Where an arms length price is determined by the Assessing Officer under sub-section (3), the Assessing Officer may compute the total income of the assessee having regard to the arms length price so determined:

Provided that no deduction under section 10A [*or section 10AA*] or section 10B or under Chapter VI-A shall be allowed in respect of the amount of income by which the total income of the assessee is enhanced after computation of income under this sub-section:

Provided further that where the total income of an associated enterprise is computed under this sub-section on determination of the arms length price paid to another associated enterprise from which tax has been deducted [*or was deductible*] under the provisions of Chapter XVIIIB, the income of the other associated enterprise shall not be recomputed by reason of such determination of arms length price in the case of the first mentioned enterprise.

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Zanglein on the Supreme Court decision in LaRue v. DeWolff, Boberg & Associates

2008 Emerging Issues 1950

Zanglein on the Supreme Court decision in LaRue v. DeWolff, Boberg & Associates

By Jayne Zanglein

February 26, 2008

SUMMARY: The U.S. Supreme Court held that ERISA Section 502(a)(2) permits a participant to sue on a 401(k) plans behalf to recover for violations of ERISAs fiduciary duties under ERISA Section 409. Previously, an individual could not sue individually.

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ARTICLE: The U.S. Supreme Court issued its much-anticipated decision in *LaRue v. DeWolff, Boberg & Associates*, 2008 U.S. LEXIS 2014 (Feb. 20, 2008), holding that a participant can sue under ERISA Section 502(a)(2) for losses sustained in an individual account plan. To reach this conclusion, the Court had to clarify its previous ruling in *Massachusetts Mutual Life Ins. Co. v. Russell*, 473 U.S. 134 (1985). *Russell* is best known for the proposition that consequential damages are inappropriate in a case seeking individual recovery for breach of fiduciary duty under ERISA Section 409 because recovery for a violation of Section 409 inures to the benefit of the plan as a whole. *Id.* at 140. Justice Stevens authored the majority opinion, joined by Justices Souter, Ginsburg, Breyer, and Alito. Justices Roberts and Kennedy filed a separate concurrence, as did Justices Thomas and Scalia.

Lower Courts Rulings. LaRue brought an action against his former employer alleging that the employer, in its role as plan administrator, breached its fiduciary duties when it failed to carry out his investment instructions with respect to his 401(k) plan. According to LaRue, this failure to invest his assets as instructed resulted in a \$150,000 loss to his individual account. LaRue sued for appropriate equitable relief under ERISAs catch-all section, 502(a)(3), claiming that the omission was a breach of fiduciary duty.

The district court granted defendants motion for judgment on the pleadings, holding that restitution was an inappropriate remedy under ERISA Section 502(a)(3) because it represented potential value, not actual earnings. *LaRue v. DeWolff, Boberg & Associates*, 2005 WL 5568764 (D.S.C. June 23, 2005). Furthermore, the plan did not possess the \$150,000. The court relied on the Supreme Courts decision in *Great-West Life & Annuity Ins. Co. v. Knudson*, 534 U.S. 204, 213-14 (2002), which held that restitution is appropriate where money or property identified as belonging in good conscience to the plaintiff could clearly be traced to particular funds or property in the defendants possession... [F]or restitution to lie in equity, the action generally must seek not to impose personal liability on the defendant, but to restore to the plaintiff particular funds or property in the defendant's possession.

On appeal, plaintiff contended, for the first time, that he was entitled to appropriate equitable relief under ERISA Section 502(a)(2), which allows a participant to sue for appropriate relief for breaches of fiduciary duties under Section 409. The Fourth Circuit relied on *Russell* to hold that ERISA Section 502(a)(2) provides remedies only for entire plans, not for individuals. Recovery under this section must inure to the benefit of the plan *as a whole*, not to particular persons with rights under the plan. *LaRue v. DeWolff, Boberg & Associates*, 450 F.3d 570, 572-73 (4th Cir. 2006). The Fourth Circuit held that although it is true that LaRue's claim could be seen as accruing to the plan in [a] narrow sense such a view threatens to undermine the careful limitations Congress has placed on the scope of ERISA relief. *Id.* at 574.

LaRue filed a motion to reconsider and the Secretary of Labor filed a request to file an untimely amicus brief. The Fourth Circuit granted both motions. *LaRue v. DeWolff, Boberg & Associates*, 458 F.3d 359 (4th Cir. 2006). On rehearing, the court rejected the Secretary's interpretation of ERISA Section 502(a)(2), stating that *Russell* does not support such a broad and atextual interpretation. *Id.* at 362. The panel observed, that [i]f Congress meant to authorize individual damages claims under Section 502(a)(2), it had only to say so. *Id.* The panel concluded that it did not have the authority to modify the plain language of the statute and the clear language of *Russell*.

The Supreme Courts Majority Opinion Limits *Russell* to Defined Benefit Plans. The Supreme Court vacated the Fourth Circuit's decision. Justice Stevens, writing for the majority, noted that Congress authorized six types of civil actions under ERISA Section 502. One of these potential causes of action--Section 502(a)(2)--permits a participant to sue on the plans behalf to recover for violations of ERISA's fiduciary duties under ERISA Section 409. In *Variety Corp. v. Howe*, 516 U.S. 489 (1996), the Supreme Court had held that ERISA Section 409's fiduciary duties relate to the plans financial integrity and reflect a special congressional concern about plan asset management. The majority held that, unlike the misconduct alleged by *Russell* (failure to timely pay benefits), the misconduct alleged by LaRue falls squarely within that category. *LaRue*, 2008 U.S. LEXIS 2014.

The Supreme Court also clarified that *Russell* was decided in an era where defined benefit plans dominated the retirement scene. Today, defined contribution plans are far more prevalent than defined benefit plans. The Court held that *Russell*'s entire plan language was spoken in the context of a defined benefit plan. In such a plan, a plan administrators misconduct will not affect the participant unless it causes a risk of default by the entire plan. *LaRue*, 2008 U.S. LEXIS 2014.

In contrast, in a defined contribution plan, a fiduciary's action may cause a participant's individual account to be reduced without causing any loss to the plan as a whole. The Supreme Court limited *Russell*'s holding to defined benefit plans. The Court noted that [w]hether a fiduciary breach diminishes plan assets payable to all participants and beneficiaries, or only to persons tied to particular individual accounts, it creates the kinds of harms that concerned the draftsmen of Section 409. The Court concluded that ERISA Section 502(a)(2) authorizes recovery for fiduciary breaches that impair the value of plan assets in a participant's individual account. It does not matter whether the participant's assets equal 1% or 99% of the total [plan] assets.

The Roberts-Kennedy Concurrence: ERISA Section 502(a)(2) Is Not Available if LaRue Can Sue Under ERISA Section 502(a)(1)(B). Justices Roberts and Kennedy concurred to make clear that if LaRue's claim falls under ERISA Section 502(a)(1)(B), which permits a participant to sue to recover benefits due to him under the terms of his plan, to enforce his rights under the terms of the plan, or to clarify his rights to future benefits under the terms of the plan, then LaRue should not be allowed to bring an action for relief under ERISA Section 502(a)(2). In support, Justice Roberts cited *Variety*, in which the Supreme Court held that relief under ERISA Section 502(a)(3) was not appropriate where the participant can seek relief under another ERISA provision. *Variety*, 516 U.S. 489, 515.

Justice Roberts would apply the same interpretation to ERISA Section 502(a)(2), which would effectively bar LaRue from any relief and might require LaRue to exhaust his internal remedies before filing suit. If LaRue were required to bring action under ERISA Section 502(a)(1)(B), the standard of review may differ; if the plan grants the administrator discretion, then the court will review for abuse of discretion under *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 115 (1989). Justice Roberts encouraged the lower court, on remand, to determine whether LaRue's action

more properly lies under ERISA Section 502(a)(1)(B). If the lower court were to follow this advice, LaRue would be without a remedy for what might turn out to be a serious breach of fiduciary duty.

The Thomas-Scalia Concurrence: Remedy Should Not Depend on the Type of Plan Involved. Justices Thomas and Scalia also concurred, but wrote separately to point out that interpretation of ERISA is not contingent on trends in the pension plan market or the ostensible concerns of ERISA's drafters. The plain language of ERISA Section 502(a)(2) authorizes the restoration of any losses to the plan. Justice Thomas stated that [b]ecause a defined contribution plan is essentially the sum of its parts, losses attributable to the account of a individual participant are necessarily losses to the plan.

Practice Tip. In a footnote, Justice Thomas noted that any losses recovered by LaRue must be returned to the plan. This footnote is odd, as it appears to contradict the strong language of Justice Thomas's concurrence. Under this footnote, if LaRue recovers the \$150,000 on behalf of the plan, then the money would be paid directly to the plan and LaRue may not reap the full benefit of the recovery. For example, the recovered amount might be allocated in the same fashion as forfeitures, and LaRue would receive only a portion of the recovery.

Concluding Remarks. This case represents a remarkable shift in the Supreme Court's thinking. It allows a plan participant to sue for individual losses in a defined contribution plan where the loss is attributable to a fiduciary's breach. The facts in *LaRue* have not yet been proven and so it is possible that *LaRue* has paved the way for others to recover, but he may still lose in the end, especially if the lower court heeds Justice Roberts's suggestion that LaRue should be limited to an ERISA Section 502(a)(1)(B) claim. In any event, the Supreme Court has opened the door for many more suits for breach of fiduciary duties in defined contribution plans.

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Dialani on Tax Deduction at Source From Payments to Non-Residents

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Dialani on Tax Deduction at Source From Payments to Non-Residents

By Jyoti Dialani

February 26, 2008

SUMMARY: All international commercial transactions with India necessitating payments from India to any foreign entity are subject to withholding tax provisions under the Indian tax law if the sum so received by the payee forms its taxable income under the law governed by the double tax avoiding agreements between the two contracting states. Income of any foreign enterprise attributable to any Business Connection (BC) or Permanent Establishment (PE) in India is also subject to deduction of tax in India by the payer. Since the tax law in India is harsh on the non-deduction of such tax at source, it is imperative to adopt a cautious approach and take all measures to comply with mandatory requirements of the law. This commentary, written by Indian Tax Counsel Jyoti Dialani, presents an in-depth analysis of the legislative provisions impacting such transactions as well as the relevant DTAA provisions while interpreting the latest judicial decisions on the issue giving clear insight on the legal position on Tax Deduction at Source (TDS) from payments made to foreign enterprises by Indian entities.

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ARTICLE: Scope

Tax Deduction at Source (TDS), also known as Withholding Tax in some nations, is a method of ensuring timely collection and recovery of income tax by the Income Tax Department from payments constituting taxable income in the hands of the recipients which are included in the scope of the provisions attracting TDS liability. Such tax is paid by deduction or collection at source or by advance payment at the time of payment notwithstanding the regular assessment in respect of any such income to be made in a later assessment year. Chapter XVII, Part B of the Indian Income Tax Act, 1961 (the Act), which deals with TDS provisions, enumerates the various heads of income and the law governing the deduction of tax from such incomes in Sections 192 to 206A. This commentary aims to bring to light the basic law governing TDS with specific reference to payments made to non-residents or foreigners governed by Section 195 of the Act. Recent developments in the law and procedure governing TDS relevant to non-residents will surface through an analysis of some current judicial decisions on the issue specifically dealing with transactions affected by the India-U.S. Tax Treaty (Double Taxation Avoidance Agreement).

Tax deduction at source from payments to a non-resident (Section 195 of the Act)

Section 195 of the Act specifically governs the law relating to deduction of tax from payments made to a non-resident. It is a mandatory provision casting a responsibility on the person making any payment to a non-resident to deduct the prescribed tax at source. The scope of this section encompasses almost every payment made to a non-resident, which may be chargeable to tax except any payment of salary paid to a non-resident. Tax Deduction at Source on salary payable to a non-resident and taxable in India is governed by Section 192 of the Act.

Analysis of Section 195

Section 195 n1 reads as follows:

Other sums.

195. *[(1) Any person responsible for paying to a non-resident, not being a company, or to a foreign company, any interest [***] or any other sum chargeable under the provisions of this Act (not being income chargeable under the head Salaries [***]) shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rates in force:*

[Provided that in the case of interest payable by the Government or a public sector bank within the meaning of clause (23D) of section 10 or a public financial institution within the meaning of that clause, deduction of tax shall be made only at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode:]

[Provided further that no such deduction shall be made in respect of any dividends referred to in section 115-O.]

Explanation. For the purposes of this section, where any interest or other sum as aforesaid is credited to any account, whether called Interest payable account or Suspense account or by any other name, in the books of account of the person liable to pay such income, such crediting shall be deemed to be credit of such income to the account of the payee and the provisions of this section shall apply accordingly.]

*(2) Where the person responsible for paying any such sum chargeable under this Act (other than [***] [***] [***] [***] salary) to a non-resident considers that the whole of such sum would not be income chargeable in the case of the recipient, he may make an application to the [Assessing] Officer to determine, [by general or special order], the appropriate proportion of such sum so chargeable, and upon such determination, tax shall be deducted under sub-section (1) only on that proportion of the sum which is so chargeable.*

[***]

[(3) Subject to rules made under sub-section (5), any person entitled to receive any interest or other sum on which income-tax has to be deducted under sub-section (1) may make an application in the prescribed form to the [Assessing] Officer for the grant of a certificate authorising him to receive such interest or other sum without deduction of tax under that sub-section, and where any such certificate is granted, every person responsible for paying such interest or other sum to the person to whom such certificate is granted shall, so long as the certificate is in force, make payment of such interest or other sum without deducting tax thereon under sub-section (1).]

(4) A certificate granted under sub-section (3) shall remain in force till the expiry of the period specified therein or, if it is cancelled by the [Assessing] Officer before the expiry of such period, till such cancellation.

(5) The Board may, having regard to the convenience of assesseees and the interests of revenue, by notification in the Official Gazette, make rules specifying the cases in which, and the circumstances under which, an application may be made for the grant of a certificate under sub-section (3) and the conditions subject to which such certificate may be granted and providing for all other matters connected therewith.]

An interpretation of the provision brings out the following:

. Person responsible for deduction of tax

The onus to deduct tax from payments made to a non-resident is on every person making such payment or the payer.

Person -- Meaning

Such a person as defined in Section 2(31) n2 of the Act may be any entity such as an individual, a company, a firm, an association of persons or a body of individuals, etc.

. Payee liable for tax

The payee, being the recipient of any such income, must be a non-resident of India and may be any entity, such as an individual, a firm or a company, etc.

. Payments attracting the provision

The provision applies to any payment made to such a non-resident entity except salaries.

. Time of deduction of tax

Such tax must be deducted at the time of payment or credit of the amount to the payee, whichever is earlier.

. Taxability of payment in the hands of non-resident payee

The payment must be in the nature of income chargeable to income tax in the hands of such a non-resident. A bare reading of the provisions of Section 195(1) of the Act reveals that the payment from which tax is deductible at source must be any sum chargeable to tax under the provisions of the Act. Therefore, the provisions will not apply to payments of any sums that are not chargeable to tax or exempt from tax in the hands of the recipient non-resident.

Thus, the provision presupposes deduction of tax is only from income which is chargeable to tax in the hands of such non-resident payee. The Central Board of Direct Taxes ⁿ³ has by a Circular ⁿ⁴ clarified that tax need not be deducted from payment which is tax exempt income in the hands of the recipient non-resident. Such an exemption from tax liability may be due to the nature of income which may be exempt from tax under the law or by reason of application of certain provisions of DTAA with the country.

Various judicial authorities have taken a view that the provisions of Section 195 are attracted only to those payments which constitute taxable income in the hands of the non-resident. The person making payments of such amounts is not required to deduct any tax at source from such payments made to a non-resident who is not taxable in India, either by reason of nature of such income being tax exempt or by virtue of the DTAA with the country of such payee.

The Supreme Court has in the case of *Transmission Corporation of A.P. Ltd. and Another v. Commissioner of Income Tax* ⁿ⁵ held *The scheme of Ss. (1), Ss. (2) and Ss. (3) of S. 195 and S. 197 leaves no doubt that the expression any other sum chargeable under the provisions of this Act would mean sum on which income-tax is leviable. In other words, the said sum is chargeable to tax and could be assessed to tax under the Act. The consideration would be whether payment of the sum to the non-resident is chargeable to tax under the provisions of the Act or not. That sum may be income or income hidden or otherwise embedded therein. The scheme of tax deduction at source applies not only to the amount paid which wholly bears income character such as salaries, dividend, interest on securities etc., but also to gross sums, the whole of which may not be income or profits of the recipient.*

The view of the Supreme Court has now been followed by the Bombay ITAT (Income Tax Appellate Tribunal) ⁿ⁶ in the following decisions:

. Maharashtra State Electricity Board v. DCIT, ⁿ⁷ (2004) 90 ITD ⁿ⁸ 793 (Mum.)

. *Raymond Ltd. v. DCIT*, (2003) 86 ITD 791 (Mum.)

The Authority for Advanced Rulings (AAR) ⁿ⁹ has ruled in the case of *Tekniskil (Sendirian) Bernhard*, ⁿ¹⁰ *Where the non-resident is not chargeable to income-tax in India on the income by way of royalty / fees for technical services, which effectively would form part of business profits of the non-resident in its hands and the fact that the non-resident has no permanent establishment in India, is not in dispute, the question of deduction of tax at source would not arise merely because the non-resident gets income from a resident in India. The Act would not, therefore, apply to non-resident in such cases to levy income-tax and / or to require deduction of tax at source to be made u/s. 195(1) ignoring the agreement for avoidance of double taxation between India and respective foreign country.*

A similar view has been held by the Karnataka State High Court in the case of *Hyderabad Industries Ltd. v. ITO* n11 on the issue of deductibility of tax at source from an amount which does not form part of the total income of an assessee. The Karnataka High Court held a view that any amount which is not included in the total income of a person must not be subjected to TDS provisions as the same is not income chargeable to income tax.

In the background of a common view expressed by most judicial authorities, it is recommended for such non-resident entity to bear in mind that the person making any payment to him need not deduct tax at source from payments which are tax exempt in the hands of such non-resident.

Incomes which are tax exempt in the hands of a non-resident

Chapter III, Section 10 of the Act provides a list of incomes which are tax exempt as they do not form part of the total income. Some of the incomes are listed as follows:

- . Income of an individual who is not a citizen of India, by way of remuneration received by him as an official of an embassy or high commission of a foreign State as provided in Section 10(6).
- . Income received by a non-resident (not being a company) or a foreign company from Government or an Indian concern as provided in Section 10(6B).
- . Income earned by the Government of a foreign State or a foreign enterprise earning income from an Indian company engaged in the business of operation of aircraft, where the tax on such income is payable by the Indian company under the terms of an agreement as provided in Section 10(6BB).
- . Income earned by a foreign company by way of royalty or fees for technical services in respect of projects with the Central Government connected with security of India for services provided in or outside India as provided in Section 10(6C).
- . Income earned by an individual assigned to duties in India in connection with any projects as per the agreements between the Central Government and the Government of a foreign State as provided in Section 10(8).
- . Any remuneration or fee earned by a consultant out of funds made available to an international organization under a technical assistance grant agreement between the agency and the government of a foreign State [Section 10(8A)] or any income earned by an individual assigned to duties in India in connection with technical assistance programme and project under any agreement between the Central Government and the agency [Section 10(8B)].
- . Any payment made by an Indian company engaged in the business of operation of aircraft for acquisition of an aircraft or an aircraft engine on lease from the Government of a foreign State or a foreign enterprise as provided in Section 10(15A).

The above list is not exhaustive as any other income of a non-resident, which is tax-exempt in India, need not be subject to the TDS provisions of Section 195 of the Act.

Consequences of violation of Section 195

Since the provisions of Section 195 are mandatory and the consequences of non-deduction of tax are severe, taxable payments to non-residents, which are not subjected to TDS, are not allowable as deduction in the hands of the payer for computing the latter's profits, and the law also imposes interest and penalty on such tax amounts. Further, Section 164 of the Act regards the payer as the agent of such a non-resident payee and in such a situation, the former can be made liable to pay the tax dues of the payee on his behalf. Having regard to the harsh consequences of a violation, the payers are usually careful and adopt a cautious approach by deducting tax from payments to non-residents in the event of ambiguity on the issue of their taxability in India.

Pro-rata tax incidence

Since tax need not be deducted from a payment which is tax-free income in the hands of the recipient, Section 195(2) provides a discretion to the payer in cases where only a part of the payment is taxable, to make an application to the Assessing Officer (A.O.) to determine that part of the amount which may be chargeable to tax. Accordingly, on receipt of such a determination from the AO, the payer has to deduct tax only from such amount so determined at the time of making the payment.

In the case of *Associated Cement Co. Ltd. v. CIT* n12 on the question of the responsibility of the payer, the Supreme Court has held to deduct tax from payments to contractors and sub-contractors under Section 194C that it was neither possible nor permissible for the payer to determine the income component of the payment so made in the hands of the payee. However, the harsh consequences of non-deduction of tax cast a responsibility on the payer to use the option of an application under Section 195(2) to the AO for determination of taxable income whenever the former is not certain of the taxable portion of the payment being made.

Applicability of Section 195(2) on certain transactions

Certain examples of transactions where the payer is not sure of the taxability or the portion of payment which may be taxable and hence can take recourse to the option under Section 195(2) are:

. Payments to Permanent Establishment (PE) of a non-resident in India

Since all payments made to a PE of a non-resident bear the nature of taxable income unless specifically exempt under the Act, the payer faces a difficulty in computing the part of payment which will amount to income chargeable to tax for the purpose of TDS as the total taxable income is computed only after the end of the financial year. In such situations, to prevent a possible violation of the law, the payer can make the application to the AO for determination of the taxable component before deducting tax from the payment to the PE.

. Payments in respect of purchase of immovable property in India from a non-resident (Capital Gains tax)

In case of a transaction of purchase of immovable property from a non-resident, the seller of such property will be liable to pay capital gains tax on the profit on sale of such property. However, the purchaser of the property will not be aware of the proportion of the sale price constituting capital gains as the particulars of the property such as the cost price, the cost on renovations/alterations incurred by the seller, if any, are not available with the purchaser. This creates a difficulty for the purchaser in computation of capital gains for the purpose of TDS.

In both situations, the payer may be afforded the option under Section 195(2) of the Act to make an application to the AO to determine, by a general or special order, the amount chargeable to tax. On receipt of such order, the payer is

advised to deduct tax at the prescribed rate only from that amount determined as taxable in the hands of the payee by the AO.

. Applications by payee under Section 195(3) and under Section 197 of the Act

Similarly, if as per the payee, the whole of such amount is not chargeable to tax, or tax is chargeable at a lower rate, he can make an application under Section 195(3) of the Act to the AO for a certificate for non-deduction of tax from such payment or under Section 197 for grant of certificate for deduction of tax at a lower rate than the rate prescribed. A recent decision of the Chennai (formerly known as Madras) Tribunal in *Poompuhar Shipping Corporation Ltd. v. ITO* n13 has held that the assessee was obligated to make an application under Section 195(2) for determination of tax liability in respect of payments made to the non-resident in the event of uncertainty. The Tribunal also emphasized that the assessee cannot in such a situation *sou motu* determine the taxability and consequently deductibility or non-deductibility of tax at source. Thus, it is strongly recommended that such foreign company ensures that the payer company in India carries out proper procedures as prescribed by the Act before making any deduction of tax at source.

. Application under Section 245Q of the Act before AAR

Section 245Q of the Act provides an alternative to the above option whereby a payer or payee is provided an option to make an application to the AAR for determination of issues raised in the application. Such a ruling of the AAR which is given on the peculiar facts of the case of such a transaction is binding on the applicant as also on other similar transactions. Such rulings are usually relied on by parties in respect of similar future transactions before other lower judicial and quasi-judicial authorities.

Tax deduction at source on interest payments to branches of foreign banks in India

Every interest payment to any branch of a foreign bank is also subject to the TDS provisions of Section 195. However, such banks, as a matter of practice, apply and obtain from the jurisdictional AO annual certificates exempting the payers of interest to such banks from deducting tax at source.

Precedence of beneficial rate: Income Tax Act versus Double Tax Avoidance Agreement

Clause (iii) of Section 2(37A) of the Act provides that the rates to be applied for the purposes of Section 195 are specified in the relevant Finance Act for the year or the rates specified in the DTAA with the country. Section 90(2) of the Act, which governs DTAA agreements with foreign countries, specifies that remittances to a country must be subjected to deduction of tax at the rate provided in the Finance Act of the relevant year or at the rate provided in the DTAA, whichever rate is beneficial to the assessee. The CBDT clarified in its Circular n14 that the beneficial rate is to be adopted for the purpose of TDS. The CBDT also clarified in another Circular n15 that when there is a contradiction between a specific DTAA provision and a general provision of the Act, the specific DTAA provision will override the general provision in the Act. Similarly, in the absence of a specific provision in the DTAA, the specific provision in the Act will override the general provisions in the DTAA. This explains that the authorities give precedence to specific provisions over general provisions. This view has been further reinforced and accepted in a number of judicial pronouncements n16 by various high courts, AAR and appellate tribunals in different cases.

Applicability of Education Cess and Surcharge on TDS

The Act lays down a further levy of a Surcharge @ 2.5% 10% as per the nature of payment and an Education Cess @ 3% on the amount of tax. In the case of *CIT v. Srinivasan (K.)* n17 the Supreme Court has held that income tax includes a surcharge. Applying this principle, if the rate of TDS is applied as prescribed in a DTAA, tax will be deductible only at such a rate without applicability of Surcharge and Education Cess as the rate prescribed in the DTAA is supposed to be the maximum rate leviable. Hence, Education Cess and Surcharge cannot be imposed on cases where rate of tax as given in DTAA is adopted.

Exceptions to applicability of Section 195

Section 195 cannot be applied in a blanket manner to all such payments to non-residents which are taxable as the CBDT has clarified in its Circular n18 that the special provision of Section 172 shall apply to payments made to foreign shipping companies or their agents and not the TDS provisions of Section 194C and Section 195. Section 172 provides for recovery of tax from foreign shipping companies or their agents who act on behalf of the foreign or non-resident shipping companies. As the Act embodies a specific provision for the levy and recovery of tax from non-resident shipping companies, the person making payments of freight or other charges to the foreign shipping companies or their agents is not required to deduct tax under Section 195 or Section 194C.

Residence status of payer

Section 195 provides for the deduction of tax from payments made to a non-resident payee whose income is taxable in India. In situations where both the payer and payee are non-residents in India also, the mandatory provisions of Section 195 are applicable. This ruling is delivered by the Authority for Advanced Rulings in AAR P. No. 22 of 1996 in the case of *White Consolidated Industries, Inc. (USA)*, n19 in which a royalty paid by Whirlpool Corporation, a U.S. corporation, to White Consolidated Industries, a U.S. subsidiary of a Swedish company, in respect of use of a trademark of Kelvinator in India was held as taxable income in India.

Practical difficulties in deduction of tax at source

Certain employees of foreign companies who are deputed to India are paid their salaries by their employer companies abroad. However, since the income of such an employee accrues in India, it is taxable in India after consideration of the DTAA with the country. The foreign company cannot deduct tax at source at the time of credit of the salary of the employee by virtue of the fact that it does not have any presence in India. A solution to avoid a possible contravention of the law in such situations is for the employee to *sou motu* pay his advance tax every month and discharge his obligation. This view has been held by the Delhi Bench of the ITAT in the case of *Babcock Power (Overseas Projects) Ltd. v. Assistant Commissioner of Income Tax*, n20 where the Tribunal observed that TDS being only a provisional payment, if a deductee has made a direct payment and has filed his return of income, *de hors* Explanation to Section 191, it cannot be said that default continues.

Recent developments in the law affecting TDS provisions relating to payments made to non-residents in respect of imports

The Reserve Bank of India (RBI) has issued a Circular, n21 which casts an obligation on every assessee importing goods from non-residents to submit a certificate from a qualified Chartered Accountant (CA) regarding any remittances made to such non-residents. This has cast a responsibility on the assessee to obtain a certificate from a CA detailing the payments of any kind including import of capital goods and the consequent deductibility of tax from such payments. The CA has to examine all the details of such import transaction with the objective to determine whether the foreign/non-resident exporter has a Business Connection (BC) or a Permanent Establishment (PE) in India. If the CA arrives at a conclusion based on the particulars examined that there is a BC or a PE in India, the profits attributable to such BC/PE have to be computed by the CA and consequently the TDS figure also has to be determined by the CA. Accordingly, tax must be deducted by the assessee-importer from payments made to the non-resident based on the

existence of either a Permanent Establishment or a Business Connection.

Taxability of a foreign entity in India

For every Indian enterprise doing any business with any non-resident or foreign company, it is important to understand whether such a foreign entity is taxable in India in order to comply with the mandatory provisions of TDS from payments made.

Whether or not a foreign entity is taxable in India depends on two factors: *Residence* and *Source*. The jurisdiction for taxation of any entity is determined by these two connecting factors, i.e., *Residence* and *Source*.

A company is subjected to tax either on the basis of its *residence* link or a *source* link with another country. A company which does business with a country will be subjected to tax in its own country as its residence link is with its home country. A company carrying out business in a foreign country will be subjected to tax in such a foreign country due to a source link with the country. It will also be subjected to tax in its own country on account of the residence link.

Taking the above principle further for application to a situation where an Indian entity is engaged in the business of importing goods from a foreign entity, such a foreign entity is not taxable in India by virtue of residence. The Indian entity is not required to deduct tax at source from payments made in respect of imports. However, with the issuance of the above named RBI circular, the position regarding taxability of such foreign entity in India has undergone a change and it is for the Indian entity doing business with a foreign entity to know about the existence of a BC or a PE of such a foreign entity.

Business Connection

Section 9 of the Act is a deeming provision, which brings within its scope all incomes that are deemed to either accrue or arise in India. Section 9(1)(i) provides:

Income deemed to accrue or arise in India.

9. (1) *The following incomes shall be deemed to accrue or arise in India:*

*(i) all income accruing or arising, whether directly or indirectly, through or from any business connection in India, or through or from any property in India, or through or from any asset or source of income in India, [***] or through the transfer of a capital asset situate in India.*

The term Business Connection used in the provision above has been further explained by the Legislature by insertion of an Explanation 2 by the Finance Act, 2003, w.e.f. April 1, 2004

The explanation provides:

Explanation 2. For the removal of doubts, it is hereby declared that business connection shall include any business activity carried out through a person who, acting on behalf of the non-resident,

(a)has and habitually exercises in India, an authority to conclude contracts on behalf of the non-resident, unless his activities are limited to the purchase of goods or merchandise for the non-resident; or

(b)has no such authority, but habitually maintains in India a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the non-resident; or

(c)habitually secures orders in India, mainly or wholly for the non-resident or for that non-resident Alright,

Ive uploaded it again. It should be good now.and other non-residents controlling, controlled by, or subject to the same common control, as that non-resident:

Provided that such business connection shall not include any business activity carried out through a broker, general commission agent or any other agent having an independent status, if such broker, general commission agent or any other agent having an independent status is acting in the ordinary course of his business:

Provided further that where such broker, general commission agent or any other agent works mainly or wholly on behalf of a non-resident (hereafter in this proviso referred to as the principal non-resident) or on behalf of such non-resident and other non-residents which are controlled by the principal non-resident or have a controlling interest in the principal non-resident or are subject to the same common control as the principal non-resident, he shall not be deemed to be a broker, general commission agent or an agent of an independent status.

From the above explanation, the Legislature has made it clear that for the existence of a BC, it is essential that the person acting on behalf of the agent has an authority that he exercises habitually to conclude contracts on behalf of such non-residents or such an agent and, in the absence of such authority, maintains a stock of goods or merchandise in India from which he regularly delivers goods on behalf of such non-resident. The proviso to the Explanation further clarifies that if such activity is carried out through any agent having an independent status who does it in the ordinary course of his business, the foreign entity cannot be held to have any business connection with India. There is an additional proviso, which clarifies who can be called an agent with independent status. Any agent who works wholly or mainly for a non-resident or who is under the same common control as his principal non-resident cannot be called an agent of independent status for the purposes of this Act.

Further, Explanation 3 has been added to Section 9(1), which clarifies that any income earned from any activity through any Business Connection under Explanation 2, carried out through an agent specified in the explanation, will be deemed to accrue or arise in India only to an extent which can be attributable to the operations carried out in India. Explanation 3 to Section 9(1) reads as follows:

Explanation 3. Where a business is carried on in India through a person referred to in clause (a) or clause (b) or clause (c) of Explanation 2, only so much of income as is attributable to the operations carried out in India shall be deemed to accrue or arise in India;

The provision makes it clear in the Explanation 1(b) to Section 9(i) that no income of a non-resident can be deemed to accrue or arise in India if its activities in India are confined to the purchase of goods in India for the purposes of export, and hence there is no business connection with India. Similarly, as per Explanation 2(a) to Section 9(1)(i), if the agents activities are limited to only the purchase of goods or merchandise for the non-resident, there is no business connection of such a non-resident in India and hence any income to the non-resident cannot be said to accrue or arise in India.

In the case of *CIT v. R.D. Aggarwal and Co.*,ⁿ²² the Supreme Court has held that business connection means something more than business and that it presupposes an element of continuity between the business of the non-resident and the activity in the taxable territory, rather than a stray or an isolated transaction. Therefore, a history of continuous business transactions is a necessary element to determine a business connection. However, as the CBDT clarified in its Circular,ⁿ²³ whether a non-resident has a business connection in India on the basis of whether the profits or gains accrue or arise to such a non-resident in India as per Section 9 of the Act depends on the facts of each case and has to be determined accordingly.

Permanent Establishment

In accordance with Article 7 of the India-U.S. Tax Treaty (Double Taxation Avoidance Agreement) or any other typical tax treaty, the profits of an enterprise of a Contracting State are taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated in that State. Also, whenever such profits are taxable in such other Contracting State, the extent of their profitability is limited only to that part of the profits, which can be attributable to those arising from the PE. In situations where the foreign enterprise is taxed in its source country by virtue of existence of a PE, such an enterprise is, by application of the provisions of the DTAA, also given a credit to the extent of the amount of taxes paid in its country of residence and the balance tax is paid by it on the whole of its profits in its home country after giving effect to the credit of tax. The view of determination of tax liability based on profits attributable to the PE was further pronounced by the Supreme Court in the case of *Ishikawajima-Harima Heavy Industries Ltd. v. DCIT*ⁿ²⁴ where it held that the country which was the State of the permanent establishment must tax only that part of profits which were economically attributable to the permanent establishment, i.e., those which resulted from the permanent establishments business activities.

A recent decision of the Special Bench constituted by the Delhi Tribunal in the case of *Motorola Inc., Ericsson Radio Systems A.B. and Nokia Networks OY v. DCIT*ⁿ²⁵ has, on the issue of whether TDS provisions are attracted to the transactions in the case, analyzed the facts of each case and based on the peculiar facts concluded on the existence of a PE and a BC to determine attraction of TDS. In the case of Motorola, the Tribunal held that since the sale of software and hardware was effected outside India and even though the non-resident had assumed overall responsibility for the proper execution of the turnkey contract, as the title and the risk arising from such a sale passes to the Indian purchaser outside India, there is no business connection between the non-resident supplier and the Indian purchaser. Therefore, the payments were held as not chargeable to tax in India and outside the purview of tax deduction under Section 195. Also, on the facts of the case, the Tribunal held that since the activities of Motorolas employees in India were in the nature of preparatory and auxiliary, which activities have been excluded from the definition of a PE under a treaty, no PE of Motorola was held to exist in India.

In the case of Ericsson, it was held that there existed no PE as the company did not have a fixed place of business in India. Also, the transactions between the foreign company and its Indian subsidiaries were held to be at arms length and hence there was also no agency PE.

Having analyzed the facts of Nokia, the Tribunal held that the company did have a PE in India and hence the income attributable to the PE was held to be taxable in India. As a result, tax was held to be deductible at source.

Conclusion

Since ignorance of the law is no excuse as to any law governing mandatory compliances by Indian entities that does affect the concerned foreign entities regardless of whether or not there is a BC/PE, it is recommended that before entering into any transaction, the minute details governing the taxability of such a non-resident entity and the consequent liability and responsibility under the law must be kept note of and followed. If there is an existence of a BC or a PE of a non-resident entity in India, the resident making any payment to such a non-resident will be required to deduct tax at source at the rate prescribed under the Act. Therefore, it is important to know the existence or otherwise of a PE or a BC of such a non-resident entity in India. If by virtue of either a BC or a PE, such an entity is held to be taxable in India, another important aspect will be to determine the portion of income which will be attributable to such a BC or PE and, accordingly, tax must be deducted at source only on such income attributable thereto.

Also, because the provisions of Section 195 are very harsh, violation thereof leads to serious repercussions and hence need to be strictly adhered to. A resident making any payment to a non-resident which constitutes taxable income in the hands of the recipient is required to deduct tax at source from such payments, including payments made in respect of the import of goods or services. In the case of import of goods by any Indian entity from a non-resident enterprise, where such transaction of sale is effected and completed outside India, it has been a common view held by many courts that profits arising out of such a transaction will not be taxable in the hands of the non-resident and hence the provisions of TDS are not attracted. However, if such a non-resident has a PE or a BC in India, any profits arising out of any transaction, which can be attributable to such a BC or PE, will be subjected to tax deduction at source.

In light of the background of the cases and provisions discussed above and the current position of the law and developments therein, it is strongly recommended that every non-resident entering into any transaction with any Indian entity takes a detailed note of the liabilities in terms of tax on profits arising from the transaction as well as the compliances involved. As a measure of caution, since it is not possible for the Indian entity to compute the proportion of profits taxable in India as a result of attribution due to a PE or a BC, the non-resident may ensure that such a resident entity takes recourse to the option available under Section 195(2) of the Act to obtain a certificate from the AO to determine the taxable income in its hands and the amount of TDS to be deducted accordingly.

Return to Text

n1 1. The official link to the Government of India, Ministry of Finance website hosting the updated bare Income Tax Act, 1961 can be found at <http://law.incometaxindia.gov.in/TaxmannDit/DisplayPage/dpage1.aspx>.

n2 . *In this Act, unless the context otherwise requires*

(31) person includes

(i) an individual,

(ii) a Hindu undivided family,

(iii) a company,

(iv) a firm,

(v) an association of persons or a body of individuals, whether incorporated or not,

(vi) a local authority, and

(vii) every artificial juridical person, not falling within any of the preceding sub-clauses.

[Explanation. For the purposes of this clause, an association of persons or a body of individuals or a local authority or an artificial juridical person shall be deemed to be a person, whether or not such person or body or authority or juridical person was formed or established or incorporated with the object of deriving income, profits or gains;]

n3 . CBDT or Board as defined in S. 2(12) of the Act is an income tax authority constituted under the Central Boards of Revenue Act, 1963 (54 of 1963).

n4

[4]. Circular No. 786 dated February 7, 2000.

n5

[5]. Transmission Corporation of A.P. Ltd. and Another v. CIT, (1999) 239 ITR 587 (SC) [ITR is Income Tax Reports publishing judgments delivered by High Courts and Supreme Courts on a fortnightly basis].

n6

[6]. ITAT is the Appellate Tribunal as defined in S. 2(4) of the Act as constituted under S. 252 of the Act, which is a judicial authority being also the final fact finding authority whose decisions are final on facts. Appeals from such decisions can be preferred before the High Court only on substantial questions of law.

n7

[7]. Deputy Commissioner of Income Tax, a quasi-judicial authority, whose orders can be appealed against before the ITAT.

n8

[8]. Income Tax Decisions, a journal publishing judicial decisions passed by Appellate Tribunals.

n9

[9]. An authority constituted by the Central Government under S. 245-O of the Act for giving determinations called advanced rulings in relation to a transaction undertaken or proposed to be undertaken by a non-resident applicant on issues pertaining to tax liabilities on proposed transactions.

n10

[10]. *In re Tekniskil (Sendirian) Bernhard*, (1996) 222 ITR (AAR) 551.

n11

[11]. Income Tax Officer, the Assessing Officer who makes the first assessment on an assessee by passing an assessment order making any changes to the returned income by additions or alterations to the profits or income returned. *Hyderabad Industries Ltd. v. ITO*, (1991) 188 ITR 749 (Kar.).

n12

[12]. *Associated Cement Co. Ltd. v. CIT*, (1993) 201 ITR 435 (SC).

n13

[13]. Poompuhar Shipping Corporation Ltd. v. ITO, (2007) 108 TTJ 970 (Mad.) (TTJ is Tax Tribunal Judgments, reports publishing judgments of Appellate Tribunals).

n14

[14]. CBDT Circular No. 728 dated October 30, 1995.

n15

[15]. CBDT Circular No. 333 dated April 2, 1982.

n16

[16]. CIT v. Kulandagan Chettiar (P.V.A.L.), (2004) 267 ITR 654 (SC), Union of India v. Azadi Bachao Andolan, (2003) 263 ITR 654 (SC), CIT v. Hindustan Paper Corp. Ltd., (1994) 77 Taxman 450 (Cal.), CIT v. VR S.R.M. Firm, (1994) 208 ITR 400 (Mad.).

n17

[17]. CIT v. Srinivasan (K.), (1972) 83 ITR 346 (SC).

n18

[18]. CBDT Circular No. 723 dated September, 1995.

n19

[19]. White Consolidated Industries, Inc. (USA) AAR P. No. 22 of 1996, (1999) 238 ITR 99.

n20

[20]. Babcock Power (Overseas Projects) Ltd. v. Assistant Commissioner of Income Tax, (2002) 81 ITD 423 (Del.).

n21

[21]. Circular A.P. (DIR Series) No. 03/2007-08-RB dated July 19, 2007.

n22

[22]. CIT v. R.D. Aggarwal and Co., (1965) 56 ITR 20 (SC).

n23

[23]. CBDT Circular No. 23 dated July 23, 1969.

n24

[24]. Ishikawajima-Harima Heavy Industries Ltd. v. DCIT, (2007) 288 ITR 408 (SC).

n25

[25]. Motorola Inc., Ericsson Radio Systems A.B. and Nokia Networks OY v. DCIT, (2008) 95 ITD 269 (Del.) (SB).

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Campbell on Will L. and Rachel A. Thomas v. Commissioner

2008 Emerging Issues 1935

Campbell on Will L. and Rachel A. Thomas v. Commissioner

By Alan D. Campbell

February 21, 2008

SUMMARY: Alan D. Campbell comments on whether a taxpayer may exclude Social Security disability benefits from gross income as benefits from a health and accident insurance policy. He discusses how practitioners can apply this decision on the taxation of Social Security disability benefits in calculating the taxpayers income tax liability and describes the effects that Social Security benefits can have on other parts of a clients income tax return.

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ARTICLE: Facts of the Case. The case of *Will L. and Rachel A. Thomas v. Commissioner*, 81 TCM 1653, TC Memo 2001-120 (2001) addresses whether a taxpayer may exclude Social Security disability benefits from gross income as benefits received under an accident and health insurance plan. The case also addresses whether taxing Social Security disability benefits violates the Equal Protection Clause of the U. S. Constitution.

In March 1987, the Social Security Administration determined that Will L. Thomas was totally disabled as a result of a diabetic condition. He began to receive Social Security disability benefits at that time.

For tax year 1997, Will L. Thomas received Social Security disability benefits in the amount of \$14,097. He filed a joint return with his wife Rachel A. Thomas. Mr. and Mrs. Thomas reported their gross income from various sources on their income tax return, but they did not include any amount on Lines 20a and 20b of Form 1040. These lines called for the taxpayer to enter the Social Security benefits received and the taxable amount of those benefits, respectively. Instead, Mr. and Mrs. Thomas noted on Line 21, which is the other income line of Form 1040, that they claimed exemption on the disability benefits.

The IRS determined that Mr. and Mrs. Thomas had to include \$8,876 of the \$14,097 of Social Security disability benefits received by Mr. Thomas in their gross income as calculated under *IRC Sec. 86*. The IRS sent Mr. and Mrs. Thomas a notice of deficiency, and they filed suit in the U. S. Tax Court to contest the deficiency.

Argument about the Nature of Social Security Disability Benefits. Mr. and Mrs. Thomas argued that the Social Security disability benefits were fully excluded from their gross income as benefits received from a health and accident insurance policy under *IRC Sec. 104(a)(3)* and *IRC Sec. 105(e)*. They also argued that *IRC Sec. 86* violates the Equal Protection Clause of the U. S. Constitution. They claimed that because employees of the several states may exclude

payments for sickness or disability under *IRC Sec. 105(e)*, the law should exclude Social Security disability benefits received before age 65 from gross income. Otherwise, they argued that *IRC Sec. 86* violated the Equal Protection Clause of the U. S. Constitution.

Equal Protection Clause. The Equal Protection Clause of the 14th Amendment to the U. S. Constitution provides that no state shall deny to any person within its jurisdiction the equal protection of the laws. The U. S. Tax Court noted in its decision in *Robert D. Mueller v. Commissioner*, 79 TCM 1887, TC Memo 2000-132 (2000) *affd* 2001-1 USTC 50,391 (CA-7, 2001) (unpublished opinion) that the 14th Amendment is incorporated into the Fifth Amendment to the U. S. Constitution as the Supreme Court of the United States held in *Weinberger v. Wiesenfeld*, 420 U.S. 636 (1975) and as the U. S. Tax Court held in *Hamilton v. Commissioner*, 68 TC 603 (1977). In *Hamilton*, the U. S. Tax Court ruled that the 14th Amendment does not apply to federal tax statutes.

However, the U. S. Tax Court stated in its decision in *Robert D. Mueller v. Commissioner* that the Due Process Clause of the Fifth Amendment is a limitation on the ability of the federal government to impose a tax. Thus, federal tax laws are not valid if they classify taxpayers in an arbitrary and capricious manner.

Rational Basis Standard. The U. S. Tax Court stated in its decision in *Robert D. Mueller v. Commissioner* that it applies a rational basis standard to determine whether a statute violates a taxpayers right to equal protection under the law. The rational basis standard provides that a classification is valid if it serves a legitimate governmental interest. The court cited the decision of the Supreme Court of the United States in *Regan v. Taxation With Representation*, 83-1 USTC 9365, 461 U.S. 540 (1983) as precedent for using that standard. However, the U. S. Tax Court noted in *Mueller* that it would use a higher standard of review if the statute (1) impermissibly interferes with the exercise of a fundamental right or (2) employs a suspect classification, such as race.

The Courts Ruling. The court rejected the argument that Social Security disability benefits are benefits received under a health and accident insurance policy. The court specifically rejected the argument of Mr. and Mrs. Thomas that Social Security disability benefits are excluded from gross income as benefits under an accident and health insurance policy under *IRC Sec. 104(a)(3)*. The court reasoned that when Congress repealed the former *IRC Sec. 105(d)* that excluded certain disability benefits from gross income and enacted *IRC Sec. 86* that Congress did not intend for Social Security disability benefits to be treated as benefits paid under a health and accident insurance policy as provided in *IRC Sec. 104(a)(3)*. Specifically, the court noted that Congress provided in *IRC Sec. 86(d)(1)(A)* that Social Security benefits are benefits received under Title II of the Social Security Act. Payments made under Title II of the Social Security Act include Social Security disability benefits.

The court reasoned that this provision indicated the clear intent of Congress that taxpayers were not to treat Social Security disability benefits as benefits paid under an accident or health plan, which are excluded from gross income under *IRC Sec. 104(a)(3)*. Further, the court stated that Congress did not intend to exclude Social Security disability benefits from gross income under any other provision of the Internal Revenue Code.

The court held that a taxpayer must include Social Security disability benefits in gross income as determined under *IRC Sec. 86*. Before 1984, *IRC Sec. 105(d)* excluded certain payments made to a former employee on account of the individuals disability from the individuals gross income. However, the Social Security Amendments of 1983 (P.L. 98-21) repealed this limited exclusion of disability payments from gross income. Since 1984, the tax treatment of Social Security disability benefits has been the same as other Social Security benefits.

The court also specifically rejected the argument that *IRC Sec. 86* violated the Equal Protection Clause of the U. S. Constitution. The court cited its opinion in *Druker v. Commissioner*, 77 TC 867 (1981) *affd* in part, *revd* in part 83-1 USTC 9116, 697 F.2d 46 (CA-2, 1982) that no system of taxation is totally free from discriminatory effects. The court also cited its decisions in *Clark v. Commissioner*, 76 TCM 219, TC Memo 1998-280, *affd* 99-1 USTC 50,581, 187 F.3d 641 (CA-8, 1999) and *Roberts v. Commissioner*, 75 TCM 2273, TC Memo 1998-172, *affd* 99-1 USTC 50,589, 182 F.3d 927 (CA-9, 1999) that *IRC Sec. 86* does not violate the U. S. Constitution.

Tax Treatment of Social Security Benefits. IRC Sec. 86 requires a taxpayer to include up to 85 percent of Social Security benefits in gross income to the extent that the sum of the taxpayers modified adjusted gross income and one-half of the Social Security benefits exceed certain threshold amounts. *IRC Sec. 86* does not treat Social Security disability benefits any differently from Social Security retirement benefits.

Other Tax Effects. Social Security benefits included in gross income can have additional tax effects. For example, a taxpayer must reduce the deductions for medical expenses under *IRC Sec. 213*, casualty and theft losses under *IRC Sec. 165*, and miscellaneous itemized deductions under *IRC Sec. 67* by 7.5 percent, 10 percent, and 2 percent of adjusted gross income, respectively. Adjusted gross income also affects the calculation of the ceilings for various kinds of charitable contributions under *IRC Sec. 170*. If a taxpayer or the taxpayers spouse is an active participant in a qualified pension plan, the taxpayers deduction for contributions to an IRA is limited by the taxpayers modified adjusted gross income under *IRC Sec. 219(g)*. The phaseout of certain itemized deductions under *IRC Sec. 68* is based on adjusted gross income as is the phaseout for personal and dependency exemptions under *IRC Sec. 151*.

The amount of a taxpayers adjusted gross income can also affect the amount of the following tax credits:

- . Child care credit (*IRC Sec. 21*)
- . Credit for the elderly and totally and permanently disabled (*IRC Sec. 22*)
- . Adoption expenses credit (*IRC Sec. 23*)
- . Child tax credit and additional child credit (*IRC Sec. 24*)
- . Hope and lifetime learning credits (*IRC Sec. 25A*)
- . Earned income credit (*IRC Sec. 32*)

What Practitioners Should Do. In light of the courts holding, a practitioner should remember that *IRC Sec. 86* treats Social Security disability benefits the same as other Social Security benefits. The practitioner should ask the client if the client received any Social Security benefits during the year. If the client received any Social Security benefits, the practitioner should ask to see Form 1099-SSA, which the client should have received from the Social Security Administration. The practitioner should report the Social Security benefits the client received, calculate the correct amount of the Social Security benefits included in gross income, and include them in gross income on the clients income tax return.

A practitioner should provide guidance to clients about how the law determines the amount of Social Security benefits included in gross income. In addition, the practitioner should explain how the inclusion of a portion of the Social Security benefits received in gross income affects the other parts of the clients income tax return.

Best Practice. Best practice dictates that a practitioner inquire about a taxpayers Social Security benefits in the questionnaire the practitioner requires the taxpayer to complete before preparing the taxpayers income tax return. Some taxpayers may have the erroneous belief that the law always excludes Social Security benefits from gross income. The law excludes all Social Security benefits from gross income only if the sum of the taxpayers modified adjusted gross income and one-half of the Social Security benefits received is below the applicable threshold. Best practice also means providing guidance to clients about the tax effects of Social Security benefits during tax planning engagements. Best practice is providing guidance to the client about how to reduce modified adjusted gross income to reduce the amount of Social Security benefits included in gross income.

Conclusion. The main lesson to be learned from this case is that a practitioner must be careful to report Social

Security benefits properly. The increase in gross income from the portion of Social Security benefits included in gross income can have other tax effects.

Cross-Reference. See Campbell, Alan D. Alan D. Campbell on *Robert D. Mueller v. Commissioner*. LexisNexis Expert Commentary.

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Maximizing the Benefits of the Exclusion of Gain on the Sale of a Home

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Maximizing the Benefits of the Exclusion of Gain on the Sale of a Home

By Alan D. Campbell and Cleophus Gaines Jr.

February 21, 2008

SUMMARY: This Emerging Issues Analysis, written by Alan D. Campbell, co-author of the book *Tax Strategies for the Self-Employed*, and Cleophus Gaines, Jr. discusses how practitioners can help their clients receive the maximum benefit from the limited exclusion of gain on the sale of a home.

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ARTICLE: Many taxpayers are aware that they may exclude a gain on the sale of their home up to \$250,000, or up to \$500,000 on a joint return, from their gross income if they meet all the requirements of the law. ⁿ¹ However, many of them do not know how to maximize the benefits of this exclusion. They might consider this exclusion only at the time they are about to sell their home or at the time they are preparing their tax return after having sold their home. This article explains the limited exclusion of gain on the sale of a principal residence and describes and illustrates how to maximize its benefits.

Limited Exclusion of Gain

An individual may exclude up to \$250,000 of gain realized on the sale or exchange of the taxpayers principal residence provided that the individual meets the ownership and use tests. ⁿ² These tests state that a taxpayer must have owned and used the home as a principal residence for at least two of the five years before its sale. The law treats short temporary periods of absence such as for vacation as periods of use even if the taxpayer rented the home while away temporarily. ⁿ³ In addition, if the taxpayer has owned and used the home as a principal residence for at least one year during the five year period ending on the date of the sale or exchange, the law deems the taxpayer to have used the home for any period in which the taxpayer resides in a licensed facility for care of the taxpayer, such as a nursing home. ⁿ⁴

A married couple who files a joint return may exclude up to \$500,000 of such gain provided that at least one of them meets the ownership test ⁿ⁵ and both spouses meet the use test. ⁿ⁶ In addition, neither spouse must have used the exclusion within the two-year period before the sale of their principal residence. ⁿ⁷ Example 1 illustrates the exclusion for a married couple who files a joint return.

Example 1. Brad and Angelina Thompson purchased their home for \$175,000 on October 15, 2002. They made \$25,000 of improvements to the home. They sold the home on September 24, 2007, for \$550,000. They realized a gain of \$350,000 (\$550,000 (\$175,000 + \$25,000)). They will file a joint return for 2007. They may exclude all of the \$350,000 gain from their gross income because the gain is less than \$500,000 and they meet the ownership and use tests.

If a couple files a joint return and they do not satisfy the conditions for the \$500,000 maximum exclusion, the couple may exclude the sum of the exclusions the law would allow each of them if they were not married. The law treats each spouse as owning the home during the period that either spouse owned the home. ⁿ⁸ If an unmarried individual sells or exchanges his or her principal residence and he or she had a spouse who is deceased on the date of the sale or exchange, the period the unmarried individual owned and used the home includes the period during which the deceased spouse owned and used the home. ⁿ⁹ If a married couple files separate returns and they sold or exchanged a home that they owned jointly, each spouse may exclude up to \$250,000 of the gain provided that each spouse meets the other requirements for the exclusion. ⁿ¹⁰

An individual or married couple may claim the exclusion only once every two years. ⁿ¹¹ The taxpayer may elect not to use the exclusion. ⁿ¹² A taxpayer might want to elect not to use the exclusion if the taxpayer made two sales or exchanges within a two-year period and the first sale or exchange had a smaller gain than the taxpayer realized on the second sale or exchange. Example 2 illustrates the sale of two qualifying homes within a two-year period.

Example 2. Kate Jones purchased her home on Court Street on December 18, 2002, for \$200,000. She moved out of the home on July 16, 2005, and rented it to a tenant. She purchased another home on Green Street on July 25, 2005, for \$250,000 and occupied it as her principal residence. She made \$25,000 in improvements to the home on Green Street. On January 12, 2007, she sold the home on Court Street that was occupied by the tenant for \$250,000. She realized a capital gain of \$50,000 (\$250,000 \$200,000), which is eligible for the exclusion. She must include the depreciation recapture in her gross income. She sold the home on Green Street for \$450,000 on December 11, 2007. She realized a capital gain of \$175,000 (\$450,000 (\$250,000 + \$25,000)) on the sale of the home on Green Street. She meets the ownership and use tests on both homes. However, Kate may exclude the capital gain on only one of the two homes. Because the gain on the sale of the home on Green Street is larger, she should exclude the gain on it. Therefore, she would recognize the \$50,000 capital gain on the sale of the home on Court Street.

Certain Expatriates

An expatriate to whom Section 877(a)(1) applies may not use the Section 121 exclusion. Such an expatriate is an individual who lost his or her U. S. citizenship within 10 years before the tax year in which the sale of the principal residence occurs and who did so with the intent to avoid tax. ⁿ¹³ In addition, the average annual net income tax for the five years before the date on which the individual lost U. S. citizenship must have been more than \$124,000 (as indexed for inflation after calendar year 2004), and the individual must have had a net worth of \$2,000,000 or more on the date the individual lost U. S. citizenship. ⁿ¹⁴

Transfer of a Home Incident to a Divorce

If an individual transferred a home to a spouse or former spouse incident to a divorce, the period the transferee is deemed to have owned the home as a principal residence includes the period the transferor owned the home. ⁿ¹⁵ An individual is deemed to have used a home as a principal residence during the period the individual owned the home while the individuals spouse or former spouse occupied the home under a decree of divorce or separation. ⁿ¹⁶

Cooperative Housing Corporation

If a taxpayer owns stock in a cooperative housing corporation, the taxpayer is deemed to have owned the home during the period that the taxpayer owned the stock. In addition, the taxpayer will meet the use requirement for the period during which the taxpayer lived in the house or apartment allowed by the taxpayers stock ownership. n17

Deferral of Gain Under Old Law

If a taxpayer had deferred the gain on the sale of a principal residence under Section 1034 under the old law, the period during which the taxpayer is deemed to have owned and used the home on which the taxpayer had deferred the gain on the sale or exchange of the old home is included. n18 Congress repealed Section 1034 as a part of the Taxpayer Relief Act of 1997 n19 effective for sales or exchanges after May 6, 1997. Example 3 illustrates this rule.

Example 3. Bob Williams bought his home for \$100,000 on December 10, 1992. He sold it for \$300,000 on December 18, 1996. To defer the full amount of the \$200,000 (\$300,000 \$100,000) realized gain, Williams bought a new home on December 28, 1996, for \$305,000, which is greater than or equal to the amount realized on his old home as required by Section 1034 to defer all of his \$200,000 realized gain. His adjusted basis in the new home was \$105,000 (\$305,000 \$200,000). Williams sold the new home for \$350,000 on February 10, 1998. Because Section 121(g) allows Williams credit for the time he owned and used the old home as his principal residence for which he deferred the gain he realized under Section 1034, Williams is deemed to have owned and used the home for 62 months (from December 10, 1992, to February 10, 1998). Thus, Williams excluded all of the \$245,000 (\$350,000 \$105,000) gain he realized on the sale of his new home from his gross income because he met the ownership and use tests.

Buying a Home Below Fair Market Value

A taxpayer can use the exclusion more effectively by buying a home below fair market value. Homes that are good candidates for purchase below fair market value include homes on which a foreclosure action is pending (*lis pendens*), homes for sale at a foreclosure auction, and repossessed homes (commonly called REOs for real estate owned by a financial institution). A person can also often purchase homes for sale during the probate of a decedents estate below fair market value. Other possibilities are homes for sale by couples going through a divorce. Example 4 illustrates how a taxpayer can maximize the Section 121 exclusion by buying an REO.

Example 4. Shelly Koslowski bought a home that had been repossessed by a bank (an REO) for \$170,000 on April 10, 2005, and immediately moved into the home. The home had a fair market value of \$200,000. She spent \$25,000 in improvements to the home during April 2005. She sold the home for \$250,000 on October 8, 2007, and realized a gain of \$55,000 (\$250,000 (\$170,000 + \$25,000)). She may exclude all \$55,000 of the gain even though \$30,000 (\$200,000 \$170,000) of the gain was due to the fact that she purchased the home below its fair market value.

Sweat Equity

A taxpayer may use his or her own labor to add value to the taxpayers principal residence. The increase in value that a taxpayer receives from performing work on the home is called sweat equity. By increasing the value of the home through sweat equity, a taxpayer can convert what would be ordinary income subject to income tax and payroll taxes to tax-free income to the extent that the value of the sweat equity is excluded from gross income on the sale or exchange of

the home. Example 5 illustrates the benefits of buying an REO and improving it using sweat equity.

Example 5. Miguel Lopez, a single individual, bought a repossessed home (an REO) for \$150,000. The home needed extensive repairs. Lopez made the repairs himself. The repairs increased the value of the home by \$60,000, but Lopez's cost of materials was only \$32,000. Lopez moved into the home and lived in it as his principal residence for three years. Lopez then sold the home for \$420,000 net of closing costs. He realized a gain of \$238,000 (\$420,000 (\$150,000 + \$32,000)). Lopez may exclude all of his \$238,000 gain from his gross income even though part of the gain was due to his own labor in improving the home.

Building a Home Acting As a General Contractor

Another way to convert the taxpayers own efforts into tax-free income is by building a home acting as ones own general contractor. An individual may save a significant amount of money in building a home by acting as his or her own general contractor. A number of books are available that provide guidance in how to do so. Example 6 illustrates how a taxpayer can maximize the benefits of the Section 121 exclusion by building a home acting as ones own general contractor.

Example 6. Doug Wright purchased land for \$80,000 and built a home on the land acting as his own general contractor. Wright's cost for materials and subcontracted labor was \$300,000. When the home was complete, the home and land together had a fair market value of \$480,000. Thus, \$100,000 or 20.83 percent of the fair market value of the home was due to his acting as his own general contractor. Wright moved into the home on August 5, 2005, and occupied it as his principal residence. He sold the home for \$520,000 on September 18, 2007. He realized a gain of \$150,000 (\$520,000 (\$80,000 + \$300,000)). He may exclude all of the \$150,000 gain from his gross income even though \$100,000 (\$480,000 (\$80,000 + \$300,000)) of the \$150,000 gain was attributable to his own labor acting as his own general contractor.

What Is A Principal Residence For Tax Purposes?

The exclusion applies only to the gain realized on a sale or exchange of the taxpayers principal residence. Whether a home is the taxpayers principal residence is a question of fact that the taxpayer must determine based on all the facts and circumstances. A principal residence may include a houseboat, a house trailer, or an apartment or condominium the taxpayer occupies as a tenant-stockholder in a cooperative housing corporation. n20 Example 7 illustrates how a houseboat can qualify as a principal residence for the Section 121 exclusion.

Example 7. George and Kathy Bush purchased a houseboat and lived in it on the Gulf of Mexico. They purchased the houseboat for \$500,000 on April 22, 2005, and began to occupy it as their principal residence on the same day. They sold the houseboat for \$695,000 on May 6, 2007. They realized a gain of \$195,000 (\$695,000 \$500,000). They may exclude all of the \$195,000 gain because the houseboat qualified as their principal residence.

If the taxpayer uses two or more homes as residences, the home where the taxpayer spends more time is usually the taxpayers principal residence. However, other facts relevant to the determination of which home is the principal residence include where the taxpayer works, the principal place where the taxpayers family lives, the taxpayers mailing address, location of the taxpayers banks, and location of religious organizations and recreational clubs to which the taxpayer belongs. n21 The IRS will not issue an advance ruling on whether a residence is the taxpayers principal residence. n22

Home Acquired By Gift

A home acquired by gift is eligible for the exclusion provided the taxpayer meets the ownership and use tests. The basis of a home acquired by gift is generally the donors adjusted basis in the property increased by any gift taxes attributable to the excess of the fair market value of the property over the donors adjusted basis at the date of the gift. n23 However, if the fair market value of the home was less than the donors adjusted basis at the time of the gift, the donees basis for gain is the donors adjusted basis in the home without any adjustment for any gift tax paid. n24

Home Acquired By Inheritance

The basis of a home acquired by devise or inheritance is the fair market value of the home on the date of the decedents death. An exception applies if the executor elects the alternate valuation date. In that case, the basis in the home is its fair market value six months after the date of the decedents death or the date the estate distributed the home to the taxpayer if earlier. n25

For sales or exchanges for property acquired from a decedent who dies after December 31, 2009, the \$250,000 exclusion applies by taking into account the time the decedent owned the home and used it as a principal residence. Specifically, the exclusion applies to the sale of a home acquired by the decedents estate, n26 to any person who acquired the home from the decedent, n27 or to a revocable trust established by the decedent, which was a qualified revocable trust immediately before the death of the decedent. n28

For sales of a home acquired from a decedent who dies before January 1, 2010, the \$250,000 exclusion will not apply unless the taxpayer who sold the home meets the ownership and use tests. If the taxpayer does not meet the ownership and use tests, any realized gain will usually be minimal because the basis of the home to the estate, trust, or other person who acquires the home will be its fair market value on the date of the decedents death or on the alternate valuation date. n29 In addition, the gain on the sale of the home would be long-term capital gain. n30

Home Acquired In a Like-Kind Exchange

If the taxpayer receives a home in exchange for business or investment real estate and uses the home received as the taxpayers principal residence, the exchange does not qualify as a like-kind exchange because the property the taxpayer relinquishes and the property the taxpayer receives must be used in a trade or business or held for investment. n31 However, the taxpayer might obtain a house in a like-kind exchange, use it for business or investment purposes, and then begin to use the home as the taxpayers principal residence. If the taxpayer did not recognize all of the gain realized in the like-kind exchange, the taxpayer must have owned the home for at least five years after the taxpayer acquired it in the like-kind exchange to exclude the gain up to \$250,000 or up to \$500,000 on a joint return. n32 Example 8 illustrates the rule about using the Section 121 exclusion for a house obtained in a like-kind exchange.

Example 8. Paul Freeman, a single individual, exchanged land that he held for investment, which had an adjusted basis of \$300,000 and a fair market value of \$500,000, for a condominium with a fair market value of \$500,000. He realized a gain of \$200,000 (\$500,000 \$300,000), but he did not recognize any of the gain because it was a like-kind exchange. He rented the condominium to a tenant for two years. The tenant then moved out, and Freeman moved into the condominium and used it as his principal residence. After he lived in the condominium for more than three years, he sold it for \$580,000. He realized a gain of \$280,000 (\$580,000 \$300,000). Because Freeman had owned the condominium for more than five years and had used it as his principal residence for more than two years, he may exclude \$250,000 of the gain on its sale from his gross income. He will recognize the remaining gain of \$30,000

(\$280,000 \$250,000) as a long-term capital gain. He will also recognize any depreciation recapture as unrecaptured Section 1250 gain, which is subject to a maximum tax rate of 25 percent. n33

Involuntary Conversions

The law treats an involuntary conversion of the taxpayers home as a sale or exchange for purposes of the \$250,000 (\$500,000 on a joint return) exclusion. n34 The gain realized on the involuntary conversion of the home is also eligible to be deferred under Section 1033. To calculate the amount realized to calculate the gain realized for purposes of Section 1033, a taxpayer subtracts the Section 121 exclusion from the total amount realized. n35 If the taxpayer defers any gain on the home under Section 1033 by buying a replacement home within the time allowed, the holding period of the new home includes the holding period of the home that was involuntarily converted. n36 Example 9 illustrates the use of the Section 121 exclusion and the deferral of gain under Section 1033 for a gain realized on the taxpayers principal residence due to an involuntary conversion.

Example 9. Rick Pillow purchased his home for \$150,000 on June 12, 2001. His home was destroyed by a tornado on May 7, 2007. Pillows insurance company issued him a check for the replacement cost of his home, which was \$600,000 because of a significant increase in value in the homes in Pillows subdivision. Pillow realized a gain of \$450,000 (\$600,000 \$150,000) from the involuntary conversion. He first uses the \$250,000 Section 121 exclusion. He can defer the remaining gain of \$200,000 under the involuntary conversion provisions of Section 1033 by buying qualified replacement property by December 31, 2009.

If the taxpayer defers any gain realized on the involuntary conversion of the taxpayers principal residence after reducing the gain realized by any gain excluded under Section 121, the taxpayer is deemed to have owned and used the new principal residence for any period for which the taxpayer owned and used the involuntarily converted home as a principal residence. n37

Land Sold With the Principal Residence

Vacant land adjacent to the taxpayers principal residence is generally considered a part of the principal residence and is eligible for the exclusion if the taxpayer owned and used the adjacent land as part of the residence. The taxpayer does not have to sell the vacant land at the same time or to the same buyer for the gain on the sale of the vacant land to be eligible for the exclusion. However, the taxpayer must sell the vacant land within the period two years before to two years after the sale or exchange of the home for the exclusion to apply. n38 The usual rule limiting the exclusion to one sale every two years n39 does not apply to sales of adjacent land and the home itself. n40 The maximum exclusion of \$250,000 for an individual or \$500,000 for a married couple filing a joint return applies to the combined sales of the adjacent land and the home. n41 If a taxpayer sells vacant land adjacent to the home and then sells the home in a later tax year, the taxpayer must report include any gain on the sale of the land in gross income if the taxpayer has not sold the home before the due date of the return. If the taxpayer then sells the home within two years of the date of selling the adjacent vacant land, the taxpayer may file an amended return and claim the exclusion on the sale of the vacant land. n42

If a taxpayer sells the land on which his or her principal residence is located at a gain and then moves the house to another location instead of selling it, the taxpayer must recognize the gain. The gain realized equals the amount realized on the sale of the land minus the adjusted basis of the land only. n43

Depreciation Recapture

A taxpayer may not deduct any depreciation for using a home solely for personal purposes. However, some taxpayers use a portion of their home for a home office, and they claim depreciation on the portion of the home used as a home office. Other taxpayers may have previously used their principal residence as rental property or for business purposes. These taxpayers would have claimed depreciation deductions when they used the home as rental property or for business purposes.

Any gain due to the recapture of depreciation claimed on the home after May 6, 1997, is not eligible for the exclusion. ⁿ⁴⁴ The taxpayer may exclude any gain due to depreciation claimed on the home on or before May 6, 1997, up to the \$250,000 or \$500,000 limit. Examples 10 and 11 illustrate the rules on depreciation recapture.

Example 10. Michael Smith, a single taxpayer, purchased his home for \$252,000 on April 16, 1998. He sold the home for \$412,000 on May 8, 2007. He had claimed \$5,000 in straight-line depreciation under the Modified Accelerated Cost Recovery System (MACRS) of Section 168 on a portion of the home he used as a home office. He realized a total gain of \$165,000 (\$412,000 (\$252,000 \$5,000)). He must recapture the \$5,000 in depreciation as unreaptured Section 1250 gain, which is subject to a maximum tax rate of 25 percent under Section 1(h)(6). The remaining gain of \$160,000 is excluded from his gross income under Section 121.

Example 11. Bob and Susan Reynolds purchased their home for \$150,000 on July 18, 1994, and sold it for \$450,000 on April 16, 2007. Bob used part of the home as a home office. He claimed \$3,000 in straight-line depreciation on the home before May 7, 1997. He claimed \$7,000 in straight-line depreciation on the home after May 6, 1997. Therefore, their adjusted basis in the home is \$140,000 (\$150,000 \$3,000 \$7,000). Their total gain is \$310,000 (\$450,000 \$140,000). They recognize a gain of \$7,000 due to depreciation recapture for the depreciation claimed after May 6, 1997. The \$7,000 gain is unreaptured Section 1250 gain, which is subject to a maximum tax rate of 25 percent under Section 1(h)(6). They may exclude the remaining gain of \$303,000, including the \$3,000 in depreciation recapture for depreciation claimed on and before May 6, 1997, from their gross income.

If the taxpayer uses a separate building on the property for business or rental purposes, the taxpayer must allocate the amount realized on the sale of the home and separate building between the home and the separate building. The gain on the separate business or rental building is not eligible for the Section 121 exclusion. ⁿ⁴⁵

Installment Sale

If a taxpayer sells a principal residence on which the taxpayer had claimed depreciation deductions after May 6, 1997, on the installment basis and realizes a gain, then the taxpayer must recognize the gain due to depreciation recapture for depreciation claimed after May 6, 1997. ⁿ⁴⁶ The taxpayer must recognize this gain regardless of the amount of cash received in the year of the sale. The gain recognized due to depreciation recapture is unreaptured Section 1250 gain, which is taxed at a maximum rate of 25 percent under Section 1(h)(6).

Failure To Meet The Two-Year Requirement

If a taxpayer fails to meet the requirement to have owned and lived in the home as a principal residence for at least two years during the five-year period before the date of sale, the taxpayer may be able to use a pro rated amount of the exclusion under certain circumstances. These circumstances include a change in place of employment, health, or other unforeseen circumstances as provided in the regulations. ⁿ⁴⁷ In addition, the IRS has ruled that an unforeseen adoption of a foreign child qualified as an unforeseen circumstance. ⁿ⁴⁸

A taxpayer might not be able to meet the requirement to have owned and used the home as the taxpayers principal residence for at least two of the five years ending on the date of sale or exchange because the taxpayer became physically or mentally incapable of self-care. If the taxpayer has owned and used the home as the taxpayers principal residence for at least one year during the five-year period ending on the date of sale, the law deems the taxpayer to have used the home as the taxpayers principal residence during the time the taxpayer owned the home and was in a facility, such as a nursing home, licensed by a state or local government to care for an individual in the taxpayers condition. n49

Armed Forces, Foreign Service, and Intelligence Community

A member of the armed forces, the foreign service of the United States, or intelligence community may elect to have the five-year period suspended during the time that such taxpayer is on qualified official extended duty. n50 The law does not require any special form or attachment to make the election. The taxpayer makes the election simply by filing an income tax return for the taxable year of the sale or exchange of the taxpayers principal residence and not reporting the gain to the extent of the allowable exclusion. n51 Extended duty is any period of active duty greater than 90 days or for an indefinite period. n52 For the extended duty to be qualified official extended duty, the taxpayer must be serving at a duty station that is at least 50 miles from the taxpayers property or while the taxpayer is residing under government orders in government quarters. n53 Example 12 illustrates the suspension of the five-year period for a taxpayer who was on official extended duty as a member of the Foreign Service of the United States.

Example 12. Penny Camp purchased a home in Texas for \$150,000 in 1997 and used it as her principal residence for the next three years. For the following seven years, she was on qualified official extended duty in Peru as a member of the Foreign Service of the United States. In 2007, she sold the house for \$225,000 and realized a \$75,000 gain. She did not use the house as her principal residence for two of the five years before she sold it. However, she may elect to suspend the running of the five-year period of use during her seven-year period of service with the Foreign Service in Peru. If she makes the election, the seven-year period is disregarded in determining whether she used the house for two of the five years before its sale. Therefore, she may exclude the \$75,000 gain on the sale of her house under Section 121.

The taxpayer may not extend the five-year period for more than 10 years. n54 The election may be in effect with respect to one property only. n55 The taxpayer may revoke the election at any time. n56

Members of the intelligence community must be on official extended duty at a duty station outside the United States to be eligible to elect to extend the five-year period. n57 The following employees are considered to be members of the intelligence community for purposes of the election to extend the five-year period: n58

The Office of the Director of National Intelligence

The Central Intelligence Agency

The National Security Agency

The Defense Intelligence Agency

The National Geospatial-Intelligence Agency

The National Reconnaissance Office

Any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs

Any of the intelligence element of the Army, the Navy, the Air Force, the Marine Corps, the Federal Bureau of Investigation, the Department of the Treasury, the Department of Energy, and the Coast Guard.

The Bureau of Intelligence and Research of the Department of State

Any of the elements of the Department of Homeland Security concerned with the analysis of foreign intelligence information

Sale to an S Corporation

A taxpayer may need to move for a job change or other reasons. The taxpayer might not be able to sell the home for a reasonable price if the real estate market is soft. In such cases, the taxpayer will usually rent the house. The taxpayer must sell the house within three years of moving out of it or all of the gain will be taxable. If the real estate market is still soft at the end of three years after moving out, the taxpayer could form an S corporation and sell the house to the S corporation. The sale to the S corporation owned by the taxpayer qualifies as a sale for purposes of the Section 121 exclusion. However, a sale to a single member LLC owned by the taxpayer will not qualify for the Section 121 exclusion because a single member LLC is usually taxed as a disregarded entity. A sale to an LLC owned by the taxpayer would qualify for the Section 121 exclusion if the LLC has elected to be taxed as a corporation. n59

Remainder Interests and Life Estates

The sale of a remainder interest in the taxpayers home generally qualifies for the Section 121 exclusion. n60 However, the sale of a remainder interest to certain related parties is not eligible for the exclusion. n61 In addition, the sale of a life estate, a term for years, or any other interest in the home sold separately is not eligible for the exclusion. n62

Second Homes

A potential tax pitfall on a second home is that any gain on the sale of a home that is not the taxpayer's principal residence is taxable. n63 It would be taxable as a capital gain because a personal use asset such as a second home is a capital asset. n64

The exclusion of gain up to \$250,000 (\$500,000 on a joint return) on the sale of the taxpayer's home applies only to the sale of a home that the taxpayer owned and used as the taxpayer's principal residence for at least two of the five years before its sale. A taxpayer may have only one principal residence at a time. n65

A good tax savings strategy would be for the taxpayer to sell the primary home and exclude the gain up to the limit. Then, the taxpayer would move into the second home and use it as a principal residence for at least two of the five years before the taxpayer sells it. By doing so, the taxpayer could use the Section 121 exclusion on both homes. The potential to exclude the gain on the sale of both homes up to the limit using this strategy is a major tax benefit.

Rental Property

Although the gain on the sale or exchange of rental property is not eligible for the Section 121 exclusion, a taxpayer can take advantage of the exclusion by converting the rental property to the taxpayers principal residence and living there for at least two years during the five-year period before the sale of the home. The gain due to depreciation recapture for depreciation claimed after May 6, 1997, is taxable as unrecaptured Section 1250 gain, which is taxed at a maximum rate of 25 percent under Section 1(h)(6)). Any gain due to depreciation recapture for depreciation claimed on

or before May 6, 1997, is eligible for the exclusion. Example 13 illustrates moving into a home, previously used as rental property, and using the home as the taxpayers principal residence to qualify for the Section 121 exclusion.

Example 13. Frank bought land and a house on July 1, 1995, for \$120,000 and immediately rented it to a tenant. He kept it as rental property until July 1, 2003. He claimed depreciation on it through May 6, 1997, in the amount of \$5,800. He claimed depreciation on it from May 7, 1997, through June 30, 2003, in the amount of \$18,200. On July 1, 2003, he moved into the house and occupied it as his principal residence until he sold it on May 1, 2007, for \$260,000. He realized a total gain of \$164,000 (\$260,000 (\$120,000 \$5,800 \$18,200)). Frank excludes the \$5,800 gain due to depreciation recapture for depreciation claimed through May 6, 1997, from his gross income. He must recognize the \$18,200 unrecaptured Section 1250 gain due to depreciation recapture for depreciation claimed after May 6, 1997. He may exclude the \$140,000 gain from the excess of the sales price over the original cost of the home. Therefore, he excludes \$145,800 (\$5,800 + \$140,000) of the \$164,000 total gain realized from his gross income.

Conclusion

A taxpayer should consider the Section 121 exclusion before purchasing a home because a taxpayer can build wealth by making strategic use of the Section 121 exclusion. Some of the ways a taxpayer can do so include purchasing a home below fair market value, improving and adding value to a home through sweat equity, and moving into a home previously used as rental property and living in it for at least two years during the five-year period before the sale of the home. Another strategy is to sell the home to an S corporation if the taxpayer has moved out of the home and the taxpayer would soon fail the use test. The Section 121 exclusion is one of the most valuable tax benefits in the Internal Revenue Code. Tax practitioners should not treat it as an afterthought. Rather, tax practitioners should engage in tax planning with their clients to maximize the benefits of the limited exclusion of gain on the sale of a home under Section 121.

[Return to Text](#)

n1 . Section 121(b)(1).

n2

[2]. Section 121(a).

n3

[3]. Reg. § 1.121-1(c)(2)(i).

n4

[4]. Reg. § 1.121-1(c)(2)(ii).

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[5]. Section 121(b)(2)(A)(i).

n6

[6]. Section 121(b)(2)(A)(ii).

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[7]. Section 121(b)(2)(A)(iii) and 121(b)(3)(A).

n8

[8]. Section 121(b)(2)(B).

n9

[9]. Section 121(d)(2).

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[10]. Reg. § 1.121-2(a)(2).

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[11]. Section 121(b)(3)(A).

n12

[12]. Section 121(f).

n13

[13]. Section 121(e) and 877(a)(1).

n14

[14]. Section 877(a)(2).

n15

[15]. Section 121(d)(3)(A).

n16

[16]. Section 121(d)(3)(B).

n17

[17]. Section 121(d)(4)(B).

n18

[18]. Section 121(g).

n19

[19]. P. L. 105-34.

n20

[20]. Reg. § 1.121-1(b)(1).

n21

[21]. Reg. § 1.121-1(b)(2).

n22

[22]. *Rev. Proc. 2006-3*, IRB 2006-1, 122 (January 3, 2006).

n23

[23]. Section 1015(a) and (d).

n24

[24]. Section 1015(a).

n25

[25]. Section 1014(a).

n26

[26]. Section 121(d)(11)(A).

n27

[27]. Section 121(d)(11)(B).

n28

[28]. Section 121(d)(11)(C).

n29

[29]. Section 1014(a).

n30

[30]. Section 1223(9).

n31

[31]. Section 1031(a)(1).

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[34]. Section 121(d)(5)(A).

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[36]. Section 121(d)(5)(C).

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[37]. Section 121(d)(5)(C).

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[38]. Reg. § 1.121-1(b)(3)(i).

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[39]. Section 121(b)(3).

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[42]. Reg. § 1.121-1(b)(3)(ii)(C).

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[43]. *Rev. Rul. 83-50, 1983-1 CB 41.*

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[44]. Section 121(d)(6).

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[45]. Reg. § 1.121-1(e)(1).

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[46]. Section 453(i).

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[47]. Section 121(c)(2).

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[48]. *IRS Letter Ruling 200613009* (April 4, 2006).

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[49]. Section 121(d)(7).

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[50]. Section 121(d)(9)(A).

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[54]. Section 121(d)(9)(B).

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[55]. Section 121(d)(9)(D)(i).

n56

[56]. Section 121(d)(9)(D)(ii).

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[57]. Section 121(d)(9)(C)(vi).

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[58]. Section 121(d)(9)(C)(iv).

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[59]. Reg. § 1.121-1(c)(3)(ii).

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[60]. Section 121(d)(8)(A).

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[61]. Section 121(d)(8)(B).

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[62]. Section 121(d)(8)(A).

n63

[63]. Sections 61(a) and 121(a).

n64

[64]. Section 1221.

n65

[65]. Reg. § 1.121-1(b)(2).

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Fink on strategies for making tax-free gifts.

2008 Emerging Issues 1925

Fink on strategies for making tax-free gifts.

By Philip R. Fink

February 20, 2008

SUMMARY: IRC Section 2503(b) allows individuals to make gifts of a present interest up to \$12,000 per year, per donee, without making a taxable gift. A married couple can make a joint gift of \$24,000 per year, per donee, without making a taxable gift. Accordingly, individuals who make relatively small gifts for such occasions as birthdays and anniversaries do not have to keep records. However, a well conceived gift gifting strategy may play a large role in estate planning for a wealthy individual.

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ARTICLE: *IRC Section 2503(b)* allows individuals to make gifts of a present interest up to \$12,000 per year, per donee, without making a taxable gift. A married couple can make a joint gift of \$24,000 per year, per donee, without making a taxable gift. The amount of the exclusion is an inflation adjusted amount, so it may increase in future years. Accordingly, individuals who make relatively small gifts for such occasions as birthdays and anniversaries do not have to keep records. However, a well conceived gifting strategy may play a large role in income and estate tax planning for a wealthy individual.

If an individual creates a trust, the tax law considers that a transfer of property into trust is in essence two gifts. That is, that part of the transfer that represents the income interest is one gift, and that part of the transfer which represents the remainder interest is another gift.

Future interest. A gift of a future interest is one in which the donee must wait until he or she can enjoy the gift. If the donor creates a trust where the income beneficiary does not have the right to receive the current income of the trust, the gift into trust is considered to be a gift of a future interest. That part of the gift which is a remainder interest is always considered to be a gift of a future interest.

Example. Frank creates a trust for the benefit of his daughter, Melissa, who is 14 years old. The trust provides that the trustee must wait until Melissa is 40 years old before the trustee can make any distributions to Melissa. Since Melissa must wait before she can derive any benefit from the trust, her interest is a future interest, and, the value of the property that was transferred into trust as a future interest is a taxable gift.

Present interest. A gift of a present interest is a gift where the donee has the immediate use of a gift without

restriction. In the case where a donor makes a gift into trust, that part of the gift that represents the income interest is considered to be a gift of a present interest if the trustee is required to distribute all of the trusts income at least annually to the income beneficiary.

Example. Harvey creates a trust. His son, Matt, age 42, is the income beneficiary, and his granddaughter, Jessica, age 17, is the remainder beneficiary. The terms of the trust require the trustee to distribute the annual income of the trust to Matt during his lifetime. At Matt's death, the trust will terminate and all of the property will be distributed to Jessica. That part of the gift into trust which represents the income interest is a gift of a present interest. That part of the transfer into trust which represents the remainder interest is a gift of a future interest.

Drafting tip Crummey power. If the trust gives a beneficiary a Crummey power, the transfer of a gift into the trust will be eligible for the gift tax exclusion even though it would normally not be considered a gift of a present interest. A Crummey power is one in which a beneficiary has the right to demand distribution of property (up to a specified amount) that was transferred into trust by the donor. Typically, the trust will specify the length of time after the donor's transfer that the beneficiary has to demand such a withdrawal. The courts have allowed a beneficiary a window of opportunity of as little as 14 days. This is a great way for a donor to achieve the best of both worlds. First, the donor is entitled to a gift tax exclusion. Second, the income from the property can be accumulated for an indefinite period of time and distributed to the beneficiary when he or she is more mature.

Example. Sam transfers \$24,000 of property to a trust for the benefit of his daughter, Rachel, age 16. This is a joint gift with his wife. The provisions of the trust specify that the trustee in its discretion can make distributions when Rachel reaches age 35. When Rachel reaches 50, the trust will terminate, and the remaining property in the trust will be distributed to her. In addition, Rachel has the right in the first 30 days after the transfer to withdraw the \$24,000. Sam's transfer into trust qualifies as a present interest; and therefore, he is entitled to an annual exclusion of \$24,000. If it were not for the Crummey provision, the transfer would be considered to be a gift of a future interest since Rachel is not entitled to an annual distribution of the trusts income.

Lifetime credit. Those individuals who make gifts in excess of \$12,000 (\$24,000 in the case of a joint gift) per year to a particular donee will have a taxable gift. Every taxpayer has a lifetime gift tax credit of \$345,800 that can be used to offset any gift tax liability. Thus, even if an individual makes a gift of a present interest in excess of \$12,000, or a gift of a future interest to the extent that they have an unused lifetime credit, they can use it to offset their gift tax liability.

Drafting tip exclusion versus discretion. In drafting the trust instrument, consideration must be given to the tax benefit of being able to use the gift tax exclusion versus giving the trustee discretion to make distributions to an income beneficiary. That is, in order for the donor to be entitled to the gift tax exclusion, the trustee must be required to distribute all of the trusts income at least on an annual basis. On the other hand, if the trustee has the discretion to make distributions, or is required to make distributions sometime in the future beyond one year, then the donor is not entitled to the annual exclusion. Accordingly, it depends on the priority of the donor. If he or she would like to be able to take advantage of the exclusion, then the language of the trust must require the trustee to distribute all of the trusts income at least on an annual basis. To the contrary, if the donor would like the trustee to have discretion as to how much should be distributed, if any at all, then the donor will not be entitled to the gift tax exclusion.

Using the gift tax exclusion as an income tax and estate tax savings technique. A well designed gift giving strategy can be an effective income tax and estate tax planning device. That is, individuals who make annual gifts of \$12,000 (\$24,000 for a joint gift) apiece to family members will reduce the amount of their taxable estates. In addition, if the gifts represent income producing property and are made to family members who are in a lesser income tax

bracket, there can be a considerable amount of income tax savings.

Example. If Bruce and Kathy were to die today they would have a combined federal and state estate tax rate of 45%. Their combined federal and state income tax rate is 40%. They have three married children and two grandchildren. Assume that for five years they make gifts of \$24,000 to each of their children, their spouses and their grandchildren. Assume that the gifts are corporate bonds that have an interest rate of 6%, and that all of the donees are in the 15% income tax bracket. For all five years, Kathy and Bruce would have given a total amount of gifts of \$960,000. That would save estate taxes in the amount of \$384,000. In addition, in the five year period, there would have been a total income tax savings of \$34,560.

Requirements for filing a gift tax form. Any gift of a future interest must be reported on a gift tax form (Form 709). If an individual makes gifts of a present interest of \$12,000 or less per donee, no gift tax return needs to be filed. If a husband and wife make a joint gift of a present interest in excess of \$12,000, a gift tax return must be filed. A husband and wife may not file a joint gift tax return. Each individual is responsible for his or her own Form 709. However, if a husband and wife each make separate gifts of a present interest that do not exceed \$12,000 to the same donee, no gift tax return is required to be filed.

Note. The generation skipping tax (GST) may apply to certain gifts to skip persons. A skip person is a donee of a generation that is two or more generations below the donors generation.

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Alan D. Campbell on Andrea McQuarrie v. Commissioner

2008 Emerging Issues 1917

Alan D. Campbell on Andrea McQuarrie v. Commissioner

By Alan D. Campbell

February 14, 2008

SUMMARY: Alan D. Campbell comments on the U. S. Tax Courts treatment of gambling winnings when gambling losses exceed the gambling winnings and their effects on the amount of Social Security benefits included in gross income. This Emerging Issues Analysis discusses how practitioners can apply this important decision in preparing tax returns, avoid preparer penalties, and advise clients properly.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Facts of the Case. *Andrea McQuarrie v. Commissioner, TC Memo 2006-93, 91 TCM 1127 (2006)* involves the effects of gambling winnings in calculating gross income. Andrea McQuarrie worked as a driver for Greyhound Lines, Inc. for a couple of months during 2003. She then became disabled and collected \$10,312 in Social Security disability benefits during 2003. She also won two jackpots of \$1,200 and \$1,600 from playing slot machines at casinos. The casinos reported her gambling winnings on Forms W-2G, Certain Gambling Winnings.

On her income tax return for 2003, Andrea McQuarrie reported wages of \$12,126, pension distributions of \$1,657, and unemployment compensation of \$4,566 for total gross income of \$18,349. She claimed a deduction of \$3,000 for qualified tuition and related expenses. Therefore, she reported adjusted gross income of \$15,349. She filed as a head of household and claimed a standard deduction of \$7,000 instead of itemizing her deductions on Schedule A of Form 1040. She claimed an earned income credit of \$3,868 and an additional child tax credit of \$163 and requested a refund of \$6,108.

She did not include her gambling winnings in her gross income because her gambling losses exceeded her gambling winnings. Therefore, she also did not include any of her Social Security disability benefits in her gross income. The IRS determined a tax deficiency of \$948 for her failure to include her gambling winnings in her gross income and for not including the required amount of Social Security benefits in her gross income. She contested the tax deficiency in the U. S. Tax Court.

The Courts Ruling. The court ruled that Andrea McQuarrie had to include her \$2,800 in gambling winnings in her gross income even though her gambling losses exceeded her gambling winnings. Because her \$2,800 in gambling

winnings increased her gross income, she also had to include \$914 of her \$10,312 Social Security disability benefits in her gross income. Because Andrea McQuarrie was not a professional gambler, her gambling losses were deductible only as an itemized deduction on Schedule A of Form 1040. She did not present any evidence at trial that she had any itemized deductions other than her allowed losses from gambling of \$2,800.

The court entered its decision under Tax Court Rule 155, which requires the taxpayer and the IRS to calculate the correct tax based on the courts ruling. The court noted that the amount of the child tax credit, additional child tax credit, and the earned income credit were dependent on the courts ruling.

Tax Treatment of Gambling Gains and Losses. Under Section 61(a), a taxpayer must include income from wagering or gambling in gross income. However, Section 165(d) limits the deduction for losses from wagering to the gains from wagering. Reg. § 1.165-10 allows married couples who file a joint return to combine their gambling losses to be deducted to the extent of their combined gambling gains. Section 62 does not allow losses from wagering as deductions in calculating adjusted gross income unless the taxpayer is in the trade or business of gambling. Therefore, the allowable deduction for gambling losses for a nonprofessional gambler is an itemized deduction on Schedule A of Form 1040. However, it is not subject to a reduction for two percent of adjusted gross income as are miscellaneous itemized deductions.

Andrea McQuarrie Was Not a Professional Gambler. The tax treatment for a professional gambler is different from the treatment given to a nonprofessional gambler. In *Commissioner v. Groetzinger*, 87-1 USTC 9191, 107 S.Ct. 980, 480 U.S. 23, *affg* CA-7, 85-2 USTC 9622, 771 F.2d 269, the Supreme Court of the United States held that a full time gambling activity can be a trade or business. The deduction for gambling losses for an individual who is self-employed in the trade or business of gambling is allowed on Schedule C of Form 1040 as a deduction in calculating adjusted gross income.

However, even if the taxpayer is in the trade or business of gambling, Section 165(d) still limits the deduction for the sum of gambling losses and expenses paid or incurred in carrying on the trade or business of gambling to the gambling winnings as the U.S. Tax Court held in *Praytor v. Commissioner*, 80 TCM 332, T. C. Memo 2000-282 (2000).

Andrea McQuarrie did not present any evidence at trial that she was a professional gambler. Therefore, she could not claim her gambling losses in calculating her adjusted gross income. Because she had no itemized deductions other than her allowed gambling losses, her \$7,000 standard deduction was larger than her \$2,800 itemized deductions for allowable gambling losses. Therefore, she received no tax benefit from her gambling losses.

Tax Treatment of Social Security Benefits. Section 86 requires a taxpayer to include a portion of Social Security benefits in gross income to the extent that the sum of the taxpayers modified adjusted gross income and one-half of the Social Security benefits exceed certain threshold amounts. Section 86 does not treat Social Security disability benefits any differently from Social Security retirement benefits.

In this case, Andrea McQuarrie had to include in her gross income the lesser of (1) 50 percent of the excess the sum of her modified adjusted gross income and one-half of her Social Security benefits over \$25,000; or (2) 50 percent of the Social Security benefits. Her modified adjusted gross income based on the amounts she reported on her income tax return was \$18,349 because Section 86(b)(2)(A) required her to add the \$3,000 deduction for tuition and related expenses to her adjusted gross income of \$15,349 in calculating her modified adjusted gross income. Her gambling

winnings of \$2,800 increased her modified adjusted gross income to \$21,149. The sum of her modified adjusted gross income of \$21,149 and \$5,156 for one-half of her Social Security benefits was \$26,305. Therefore, she had to include \$653 $[(\$26,305 - \$25,000) \times 50\%]$ of her Social Security benefits in her gross income. Her total increase in gross income was \$3,453 $(\$2,800 + \$653)$.

Other Tax Effects if the Taxpayer is Not a Professional Gambler. The tax treatment of gambling winnings and gambling losses for a nonprofessional gambler can have additional adverse tax consequences. For example, a taxpayer must reduce the deductions for medical expenses under Section 213, casualty and theft losses under Section 165, and miscellaneous itemized deductions under Section 67 by 7.5 percent, 10 percent, and 2 percent of adjusted gross income, respectively. Modified adjusted gross income also affects the calculation of the ceilings for various kinds of charitable contributions under Section 170. If a taxpayer or the taxpayers spouse is an active participant in a qualified pension plan, the taxpayers deduction for contributions to an IRA is limited by the taxpayers modified adjusted gross income under Section 219(g). If a taxpayer is receiving Social Security benefits, the amount of the taxpayers modified adjusted gross income can affect the amount of Social Security benefits included in gross income under Section 86. The phaseout of certain itemized deductions under Section 68 is based on adjusted gross income as is the phaseout for personal and dependency exemptions under Section 151.

The amount of a taxpayers adjusted gross income can also affect the amount of the following tax credits:

- . Child care credit (Section 21)
- . Credit for the elderly and totally and permanently disabled (Section 22)
- . Adoption expenses credit (Section 23)
- . Child tax credit and additional child credit (Section 24)
- . Hope and lifetime learning credits (Section 25A)
- . Earned income credit (Section 32)

What Practitioners Should Do. In light of the courts holding, a practitioner should remember to include gambling winnings in a taxpayers gross income even though the taxpayers gambling losses exceed the taxpayers gambling winnings. If the taxpayer is not in the trade or business of gambling, a practitioner should deduct the gambling losses, up to the amount of the gambling winnings, as itemized deductions.

A practitioner should advise clients about the adverse effects of gambling winnings on the clients tax liability even if the taxpayer has losses that exceed the amount of the winnings. Taxpayers may not understand the proper tax treatment of gambling winnings and gambling losses and the adverse tax effects that gambling winnings can have on other parts of their income tax returns.

Caution for Practitioners. The practitioner must be cautioned about reporting a taxpayers gambling winnings and gambling losses properly. Section 6694 provides for a penalty equal to the greater of \$1,000 or 50 percent of the income earned from preparing the return for practitioners who take a position on a return prepared after May 25, 2007, that is not more likely than not to be sustained on its merits.

Best Practice. Best practice dictates that a practitioner inquire about a taxpayers gambling activities in the

questionnaire the practitioner requires the taxpayer to complete before preparing the taxpayers return. If the answers on the questionnaire indicate that the client has engaged in gambling activities, the practitioner should inquire of the client about the extent of the gambling activities. The practitioner must determine if the client is a recreational gambler or is in the trade or business of gambling. Best practice also means advising clients about the tax effects of gambling during tax planning engagements.

Adequate Documentation for Gambling Losses. The practitioner should explain to the client the necessity of having adequate documentation to support the deduction for any gambling losses. *Rev. Proc 77-29, 1977-2 CB 538* states that a diary maintained by the taxpayer will usually be considered as evidence of gambling gains and losses provided that the taxpayer has verifiable documentation to support the entries in the diary. The diary should contain the date and type of gambling activity, the name and address of the gambling establishment, the names of any other individual who were with the taxpayer at the time of the gambling activity, and the amount won or lost. According to *Rev. Proc. 77-29*, verifiable documentation includes Forms W-2G; Forms 5754, Statement by Person Receiving Gambling Winnings; wagering tickets, cancelled checks, credit records, bank withdrawals, and statements of actual winnings or payment slips provided to the taxpayer by the gambling establishment. Taxpayers who buy lottery tickets should keep the losing tickets to document the amount of gambling losses from playing the lottery.

Conclusion. The lessons to be learned from this case are that a practitioner must be careful to report gambling winnings and gambling losses properly. If a taxpayer is not a professional gambler, gambling winnings are included in gross income and gambling losses are an itemized deduction limited to the amount of the gambling winnings. The increase in gross income from the gambling winnings can have other adverse tax consequences.

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IRC Sec. 529 plan allows savings to accumulate for beneficiary higher education

2008 Emerging Issues 1914

An IRC Section 529 plan allows savings to be accumulated for a designated beneficiary's higher education.

By Dorinda D. DeScherer

February 13, 2008

SUMMARY: A Section 529 cannot be set up directly for an unborn child. However, there are no age restrictions on who may be the beneficiary of a Section 529 plan. Consequently, a prospective parent--or even a prospective grandparent--can set up a Section 529 plan in his or her own name, and then change the beneficiary when the child is born.

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ARTICLE: An *IRC Section 529* plan (also known as a qualified tuition program, or 529 plan) allows savings to be accumulated for a designated beneficiary's higher education on a tax-favored basis.

Significantly, contributions can be made to a Section 529 plan with an eye to a child's college education even before the child is born. In fact, the earlier contributions are made, the more savings can be accumulated through tax-free compounding.

A Section 529 plan cannot be set up directly for an unborn child because the account beneficiary must have a Social Security number. However, there are no age restrictions on who may be the beneficiary of a Section 529 plan. Consequently, a prospective parent, or even a prospective grandparent, can set up a Section 529 plan in his or her own name, and then change the beneficiary when the child is born. In an advance notice of proposed rulemaking, the IRS said that forthcoming regulations will specifically authorize contributions to Section 529 plans by individuals for their own benefit [Reg-127127-05].

Income Taxes. A Section 529 plan allows an individual to prepay a designated beneficiary's higher education expenses or contribute to an account for paying such expenses. Section 529 plans are maintained either by states or by eligible educational institutions. In many cases, employees can contribute to state-sponsored plans on a payroll deduction basis.

Contributions to a Section 529 plan are not deductible. However, earnings are not taxable while they remain in the account. In addition, amounts withdrawn from the account (including earnings) are not taxable to the extent that they are used to pay qualifying higher education expenses of the designated beneficiary.

There are no set dollar limits on contributions. Contributions may not, however, exceed the amount necessary to provide for the qualified education expenses of the designated beneficiary [IRC Section 529(b)(6)].

In the case of a cash distribution, the portion representing amounts contributed to the plan is not included in the designated beneficiary's income. That amount represents a return of the investment in the plan. In addition, the designated beneficiary generally does not have to include distributed earnings in income if the total distribution is less than or equal to qualified higher education expenses for the year of the distribution. If the distribution exceeds qualified higher education expenses, a proportionate part of the earnings will be subject to tax [IRC Section 529(c)(3)(B)(ii)].

A distribution will not be taxable if, within 60 days, that amount is rolled over to the credit of another designated Section 529 beneficiary who is a member of the same family as the designated beneficiary for whom the distribution was made. Any change in the designated Section 529 beneficiary will not be treated as a taxable distribution if the new beneficiary is a member of the same family as the old beneficiary [IRC Section 529(c)(3)(C)].

Gift Taxes. A contribution to a Section 529 plan is treated as a taxable gift of a present interest at the time of the contribution [IRC Section 529(c)(2)(A)]. A rollover or change in the designated beneficiary, on the other hand, is a taxable gift only if the new beneficiary is in a generation below the generation of the old beneficiary [IRC Section 529(c)(5)]. A change to a beneficiary in the same or a higher generation is not subject to gift tax.

Contributions to a Section 529 plan as well as taxable rollovers or beneficiary changes qualify for the annual gift-tax exclusion [IRC § 2503(b)]. If the taxable amount exceeds the annual gift-tax exclusion (\$12,000 for 2008, or \$24,000 if spouses join in the gift), the donor may elect to take the amount into account ratably over five years [IRC Section 529(c)(2)(B)]. (Note: Contributions to a Section 529 plan do *not* qualify for the gift tax exclusion for education expenses under IRC Section 2503(e).)

Section 529 Plan for a Future Child. If future parents or grandparents make contributions to a Section 529 plan set up for themselves, there is no taxable gift because an individual cannot make a gift to himself or herself. When the child is born, the redesignation of the plan beneficiary will be treated as a taxable gift. However, most or all of this gift can be sheltered from gift tax by the annual exclusion and the five-year spread for the gift. So, for example, an individual can shift as much as \$60,000 to a new beneficiary in 2008 without triggering a gift tax; and that amount is doubled to \$120,000 if spouses join in the gift.

A reverse twist is to set up the initial Section 529 plan in the name of a member of the family in the same generation as the prospective child--a sibling or cousin, for example. In this case, the contributions to the account will be taxable gifts, but can be sheltered by the annual exclusion and five-year spread. And when a change in beneficiary is made, no gift tax will be triggered.

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Dorinda D. DeScherer, J.D., is a graduate of Barnard College of Columbia University and an honors graduate of the University of Maryland School of Law. She is currently a principal of Editorial Resource Group, Inc., which develops and creates tax and professional publications. ERG's clients have included Matthew Bender and Intuit. The Internal Revenue Service has used CPE materials prepared by ERG for in-house staff training.

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Campbell on Green v. Commissioner

2008 Emerging Issues 1890

Campbell on Green v. Commissioner

By Alan D. Campbell

February 11, 2008

SUMMARY: Alan D. Campbell comments on the U. S. Tax Courts treatment of Social Security disability benefits received on account of a work-related injury and on the tax treatment of a net operating loss carryforward. This Emerging Issue Analysis, discusses how practitioners can apply this important decision in preparing tax returns, avoid preparer penalties, and advise clients properly.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Facts of the Case. From 1985 through 2002, Theodore Major Green worked as a tax auditor for the IRS. On November 12, 1989, his wife Jacqueline Green sustained injuries when she was struck by a shopping cart at a grocery store. Jacqueline Green filed a lawsuit against Rachel Perez, the woman allegedly responsible for Jacqueline Greens injuries. On August 27, 1991, Jacqueline Green sustained additional injuries in the course of her employment with General Motors. These injuries caused her to have surgeries and left her unable to work.

Jacqueline filed a claim for Social Security disability benefits in 1992, and she began receiving such benefits in 1993 for the injuries she sustained as an employee. She had also filed a claim against General Motors for workmens compensation benefits with the State of California Workers Compensation Appeals Board. At the time of trial, she had not received any workmens compensation benefits.

On November 12, 1996, Jacqueline Green obtained a default judgment in the amount of \$166,013 in her lawsuit against Rachel Perez. Rachel Perez filed a Chapter 7 bankruptcy petition in 1997. Jacqueline Green filed a claim with the U. S. Bankruptcy Court, but she did not receive any distribution from the U. S. Bankruptcy Court.

On their income tax return for 1997, the Mr. and Mrs. Green claimed a casualty loss of \$166,013, the amount of the uncollectible default judgment. Mr. and Mrs. Green made the election on their 1997 income tax return to forgo the carryback of this loss and stated that they intended to deduct \$11,068 of the loss each year from 1997 through 2011 as a net operating loss (NOL) carryforward. For the 2000 and 2001 income tax returns at issue in this case, Mr. and Mrs. Green deducted \$11,068 of this NOL carryforward for each of the two years.

On their income tax returns for 2000 and 2001, they reported the receipt of Social Security benefits in the amount of \$12,258 and \$12,708, respectively. However, they did not include any of the Social Security benefits in their gross

income because they believed that Jacqueline Green received the Social Security disability benefits in lieu of workmens compensation benefits, which are generally excluded from gross income under *IRC Sec. 104(a)(1)*.

The IRS issued Mr. and Mrs. Green a notice of deficiency for their 2000 return on November 10, 2003, and for their 2001 return on January 26, 2005. The IRS determined that the Social Security disability benefits were taxable as determined under *IRC Sec. 86* and that the taxpayers were not allowed any deduction for their NOL carryforward. The taxpayers contested the tax deficiency in the U. S. Tax Court.

The Courts Ruling. The court ruled that Social Security disability benefits paid under Title II of the Social Security Act were not in the nature of a workmens compensation act. The court cited its previous decision in *Norris v. Commissioner*, 81 TCM 1816, TC Memo 2001-152, *affd* 2002-2 USTC 50,684 (CA-9, 2002) in which the court held that a statute is not in the nature of a workmens compensation act if it allows for disability payments for any reason other than on-the-job-injuries. Therefore, Mr. and Mrs. Green could not exclude their Social Security disability benefits from gross income under *IRC Sec. 104*. Rather, they had to include in their gross income the amount of the Social Security disability benefits determined under *IRC Sec. 86*. Under *IRC Sec. 86*, a taxpayer may have to include up to 85 percent of Social Security benefits received in gross income depending upon the amount of the taxpayers modified adjusted gross income.

The court also rejected Mr. and Mrs. Greens deduction for a net operating loss carryforward. The court noted that under *IRC Sec. 165(c)*, an individual may generally deduct losses only if they are incurred in a trade or business, for a transaction entered into for profit, or a casualty or theft loss. The court noted that grocery shopping was not a trade or business or an activity entered into for profit. The court did not analyze their claim that the loss was due to a casualty. The court did not need to do so because Jacqueline Green had no basis in the judgment.

IRC Sec. 165(b) allows a taxpayer to deduct a loss only to the extent of the taxpayers adjusted basis in property. Therefore, a taxpayer may claim a casualty loss deduction only to the extent of the adjusted basis of property damaged or destroyed in a casualty. Because the taxpayers had no basis in the judgment, they were likewise not entitled to a bad debt deduction under *IRC Sec. 166*. *IRC Sec. 166(b)* allows a bad debt deduction only to the extent of the adjusted basis in the debt.

Mr. and Mrs. Green appealed the decision of the U. S. Tax Court to the U. S. Court of Appeals for the Ninth Circuit. The U. S. Court of Appeals for the Ninth Circuit made a *de novo* review of the interpretation of the Internal Revenue Code by the U. S. Tax Court. After having made such a review, the U. S. Court of Appeals for the Ninth Circuit affirmed the decision of the U. S. Tax Court in all respects.

Tax Treatment of Workers Compensation Benefits. A taxpayer may generally exclude workmens compensation benefits for personal injuries or sickness from gross income under *IRC Sec. 104(a)(1)*. Reg. § 1.104-1(b) states that workmens compensation benefits are the benefits received by an employee under a workmens compensation act or under a similar statute.

However, if the Social Security Administration reduces a taxpayers Social Security benefits because of the receipt of workmens compensation benefits, *IRC Sec. 86(d)(3)* treats the workmens compensation benefits as Social Security benefits for federal income tax purposes. Therefore, such workmens compensation benefits are potentially taxable as Social Security benefits under *IRC Sec. 86*. Thus, under certain circumstances the law treats workmens compensation benefits as Social Security benefits, but the law never treats Social Security disability benefits as workmens compensation benefits.

Tax Treatment of Social Security Benefits. *IRC Sec. 86* requires a taxpayer to include up to 85 percent of Social Security benefits in gross income to the extent that the sum of the taxpayers modified adjusted gross income and one-half of the Social Security benefits exceed certain threshold amounts. *IRC Sec. 86* does not treat Social Security disability benefits any differently from Social Security retirement benefits.

Tax Treatment of Net Operating Losses. An individual may incur a net operating loss (NOL) from a trade or business, an activity engaged in for profit, or from a casualty or theft. *IRC Sec. 172(b)(1)(A)* allows a taxpayer to carry an NOL back two years and forward for 20 years. *IRC Sec. 172(b)(2)* requires that a net operating loss be absorbed to the extent possible in the tax year to which the taxpayer carried it. *IRC Sec. 172(b)(2)* also requires a taxpayer to carry back the loss to the earliest year allowable. Therefore, a taxpayer carries the loss back to the second previous tax year, and the taxpayer must use as much of the loss as possible for that tax year. Any remaining loss is carried to the tax year immediately before the tax year in which the taxpayer carried the loss. Then, the taxpayer may carry any remaining loss forward until the taxpayer's income fully absorbs the loss. *IRC Sec. 172(b)(3)* allows a taxpayer to waive the carryback period and carry the NOL forward only. Such an election is irrevocable.

If the Mr. and Mrs. Green had a bona fide NOL, they could make the election to forego the carryback of the NOL as allowed by *IRC Sec. 172(b)(3)*. However, *IRC Sec. 172(b)(3)* would not allow them to claim an equal amount of the loss for each year of the carryforward period.

What Practitioners Should Do. In light of the courts holding, a practitioner should remember that Social Security disability benefits are taxable in the same way that Social Security retirement benefits are taxable. A practitioner should deduct a loss for an individual only if the individual has a basis in the property for which the taxpayer claims the loss. In addition, taxpayer must have incurred the loss in a trade or business, an activity engaged in for profit, or in a casualty or theft. A practitioner should deduct a bad debt loss for a taxpayer only to the extent that the taxpayer has an adjusted basis in the debt.

Best Practice. Best practice dictates that a practitioner review *IRC Sec. 86* if the taxpayer received Social Security benefits under any unusual circumstances. *IRC Sec. 86* does contain a few exceptions to the general rules, such as the special election available for the receipt of lump-sum Social Security benefits under *IRC Sec. 86(e)*. If a taxpayer wants to deduct a casualty loss or claim a deduction for a bad debt, the practitioner must be sure that the taxpayer has adjusted basis in the loss to deduct it.

Conclusion. One lesson to be learned from this case is that an IRS tax auditor with years of experience may still not understand some of the basic aspects of the tax law. If a practitioner needs guidance in understanding a part of the tax law, the practitioner should not rely on IRS employees. Rather, the practitioner should rely upon the guidance of experienced practitioners and other authorities, such as these commentaries. Another lesson is that a taxpayer may not exclude Social Security disability benefits from gross income as though they were workmen's compensation benefits even if the taxpayer received the Social Security disability benefits for a work-related injury.

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Campbell on Robert D. Mueller v. Commissioner

2008 Emerging Issues 1891

Campbell on Robert D. Mueller v. Commissioner

By Alan D. Campbell

February 11, 2008

SUMMARY: Alan D. Campbell comments on whether a taxpayer may file a joint return with an economic partner of the same sex and on how to avoid the penalty for underpayment of estimated tax. Alan D. Campbell, co-author of the book *Tax Strategies for the Self-Employed*, discusses how practitioners can apply this important decision in determining a taxpayers filing status and in avoiding the penalty for underpayment of estimated tax.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Facts of the Case. Robert D. Mueller did not file income tax returns for the years 1986 through 1995. He worked as a computer programmer or consultant for various companies during these tax years. He also had some interest income and capital gain income in 1987. He made no estimated income tax payments during the years 1986 through 1995, but his employers withheld income tax from his wages for tax years 1987, 1993, 1994, and 1995.

Robert D. Mueller is a homosexual. In 1989, he began to have a relationship with another man whom he described as his roommate and partner. From 1989 through 1995, Robert D. Muller and his roommate/partner lived together and shared income and assets. Robert D. Mueller was not married to anyone at the end of the years 1986 through 1995.

The IRS issued Robert D. Mueller a notice of deficiency for the years 1986 through 1995. The IRS calculated the amount of the deficiency using the tax rates for unmarried individuals (other than surviving spouses and heads of households) in *IRC Sec. 1(c)*.

Constitutional Arguments. Robert D. Mueller did not dispute the basic facts on which the IRS based its notice of deficiency for the years 1986 through 1995. However, he claimed that the IRS should have based its calculation of the amount of the deficiency for the years 1989 through 1995 using the rates applicable to married couples.

Robert D. Mueller never claimed to have been married, but he argued that the prohibition on filing a joint return with his economic partner was unconstitutional because it violated his due process rights under the Fifth Amendment to the U. S. Constitution. The Due Process Clause provides that no person shall be deprived of life, liberty, or property without due process of law.

Robert D. Mueller also claimed that not being allowed to use the joint return rates violated his right to equal

protection under the law under the 14th Amendment to the U. S. Constitution. The Equal Protection Clause of the 14th Amendment provides that no state shall deny to any person within its jurisdiction the equal protection of the laws.

The Courts Analysis of Constitutional Arguments. The U. S. Tax Court noted that the 14th Amendment is incorporated into the Fifth Amendment to the U. S. Constitution as the Supreme Court of the United States held in *Weinberger v. Wiesenfeld*, 420 U.S. 636 (1975) and as the U. S. Tax Court held in *Hamilton v. Commissioner*, 68 TC 603 (1977). In *Hamilton*, the U. S. Tax Court ruled that the 14th Amendment does not apply to federal tax statutes.

However, the U. S. Tax Court stated that the Fifth Amendment is a limitation on the ability of the federal government to impose a tax. Thus, federal tax laws are not valid if they classify taxpayers in an arbitrary and capricious manner. The court noted that it had consistently denied challenges to marital classifications in the Internal Revenue Code on constitutional grounds as have other federal courts.

The Courts Ruling. The court rejected Robert D. Muellers arguments that the IRS should allow him to use the joint return rates for the years in which he lived with his economic partner of the same sex. The court ruled that the deficiency for each of the years of issue was correct.

The court also ruled that Robert D. Muller was liable for the additions to tax for the penalty for failure to file under *IRC Sec. 6651(a)(1)* the penalty for underpayment of estimated tax under *IRC Sec. 6654*. The court rejected his argument that his failure to file was due reasonable cause because he failed to file as an act of civil disobedience on a human rights issue. The court also rejected Robert D. Muellers argument that he was not liable for the penalty for underpayment of estimated tax because of reasonable cause. The court stated that a reasonable cause exception does not apply to the penalty for underpayment of estimated tax. To avoid the penalty, a taxpayer must meet one of the statutory exceptions in *IRC Sec. 6654*.

Rational Basis Standard. The court stated that it applies a rational basis standard to determine whether a statute violates a taxpayers right to equal protection under the law. The rational basis standard provides that a classification is valid if it serves a legitimate governmental interest. The court cited the decision of the Supreme Court of the United States in *Regan v. Taxation With Representation*, 83-1 USTC 9365, 461 U.S. 540 (1983) as precedent for using that standard. However, the court noted that it would use a higher standard of review if the statute (1) impermissibly interferes with the exercise of a fundamental right or (2) employs a suspect classification, such as race. The court found that neither of these exceptions applied to this case.

Defense of Marriage Act. Although Congress did not pass the Defense of Marriage Act (P. L. 104-199, 110 Stat. 2419 (1996), 1 U.S.C. § 7, and 28 U.S.C. § 1738C) until 1996, which is later than the years at issue in this case, the court noted that the Defense of Marriage Act defines marriage in any act of Congress, including the Internal Revenue Code, as a legal union between one man and one woman as husband and wife. The court noted further that the Defense of Marriage Act defines spouse to mean only a person of the opposite sex who is a husband or wife. The court explained that it did not rule on the constitutionality of the Defense of Marriage Act because Congress did not enact it until 1996, which is later than the years at issue.

Tax Return Required to Use the Joint Return Rates. The court also noted that even if Robert D. Mueller had been legally married at the end of the years at issue the court would not allow him to use the joint return rates because he did not file any federal income tax returns for any of these years. A married couple must file a joint return to use the

benefit of the joint return rates and other tax benefits of filing a joint return as the U. S. Tax Court had previously held in numerous cases, including *Martinez v. Commissioner*, 75 TCM 2394, TC Memo 1998-199, *affd* in unpublished opinion (CA-5, 1998).

Decision Affirmed on Appeal. Robert D. Mueller appealed the decision of the U.S. Tax Court to the U. S. Court of Appeals for the Seventh Circuit, which affirmed the decision of the U. S. Tax Court in an unpublished opinion. The U. S. Court of Appeals for the Seventh Circuit noted that it had previously ruled in *Barter v. United States*, 77-1 USTC 9460, 5 F.2d 1239 (CA-7, 1977) and the U. S. Court of Appeals for the Second Circuit had likewise ruled in *Druker v. Commissioner*, 83-1 USTC 9116, 697 F.2d 46 (CA-2, 1982) that treating married couples and single individuals differently for tax purposes does not violate the U. S. Constitution. The U. S. Court of Appeals for the Seventh Circuit stated that Robert D. Mueller had used a large portion of his brief arguing against the constitutionality of the Defense of Marriage Act, which was not in effect for the years at issue. In addition, the court found that he had not provided any evidence to rebut the presumption that a notice of deficiency is correct.

What Practitioners Should Do. Practitioners should remember that taxpayers must be legally married to a person of the opposite sex and not legally separated at the end of the tax year in order to file a joint return. *IRC Sec. 6013* provides special rules regarding a joint return in the year a spouse dies or if the taxpayer is married to a nonresident alien.

State law usually defines marital status. However, even if a state recognizes a marriage between individuals of the same sex, the Defense of Marriage Act prohibits the IRS from recognizing such a marriage for federal tax purposes. Unless, the Defense of Marriage Act is held to be unconstitutional, taxpayers of the same sex who are legally married under state law may never file a joint federal income tax return. In addition, couples who live together and share income and assets, but who are not legally married at the end of the year under state law, may not file a joint return whether they are of the same sex or are of the opposite sex. Practitioners should also remember that a married couple must file a joint return to use the benefit of the joint return rates and other tax benefits from filing a joint return.

Caution for Practitioners. Practitioners must be careful to determine the correct filing status for taxpayers. For example, some states recognize common law marriage, and Texas recognizes informal marriage under the Texas Family Code. A taxpayer who lives together with someone of the opposite sex in such a state, but who is not formally married, may be legally married under state law. Once a couple of opposite sexes is legally married, the couple is still considered married for federal tax purposes even if they move to a state that does not recognize common law marriage or informal marriage. If a couple of opposite sexes is legally married under state law, neither spouse may file a federal income tax return using the filing status of single or head of household unless the spouse meets the criteria for an abandoned spouse. A taxpayer who is legally married under state law at the end of the year to an individual of the opposite sex must file as married filing a joint return or married filing a separate return.

Best Practice. Best practice dictates that a practitioner should provide guidance to a couple who lives together that they must be legally married at the end of the year to a person of the opposite sex in order to file a joint return. *IRC Sec. 6013* provides for an exception to the rule that a taxpayer must be married at the end of the year if the taxpayers spouse died during the tax year, the taxpayer has not remarried, and the executor or personal representative does not choose to file a separate return for the decedent.

Best practice is also providing guidance to a taxpayer on how to avoid the penalty for underpayment of estimated tax. To avoid this penalty, a taxpayer must qualify for one of the exceptions listed in *IRC Sec. 6654*.

How to Avoid the Penalty for Underpayment of Estimated Tax. The most common way that a taxpayer can avoid the penalty for underpayment of estimated tax under *IRC Sec. 6654(d)(1)* is to make estimated payments greater than or equal to 100 percent of the tax shown on the return for the previous year. Because a taxpayer must make four estimated tax payments, the taxpayer should pay an amount greater than or equal to 25 percent ($100\% / 4$) of the tax shown on the return for the previous year on each of the four estimated payment due dates.

However, *IRC Sec. 6654(d)(1)(C)* provides if the taxpayers adjusted gross income shown on the return for the previous year is greater than \$150,000 (\$75,000 on a married filing separate return), then the taxpayer must make estimated tax payments greater than or equal to 110 percent of the tax shown on the return for the previous year to be assured of avoiding the penalty for underpayment of estimated tax. Thus, a taxpayer who had an adjusted gross income of more than \$150,000 for the previous year should make estimated payments greater than or equal to 27.5 percent ($110\% / 4$) of the tax shown on the return for the previous year on each of the four estimated tax payment due dates.

IRC Sec. 6654(g) provides that income tax withheld is treated as though the taxpayer made an estimated tax payment on each of the four estimated payment due dates equal to 25 percent of the income tax withheld. *IRC Sec. 6654(e)(1)* provides that if the gross tax liability minus the amount of income tax withheld is less than \$1,000, the penalty does not apply. Thus, taxpayers may be able to reduce or avoid the penalty for underpayment of estimated tax by having a sufficient additional amount of income tax withheld late in the tax year.

Conclusion. The main lesson to be learned from this case is that a couple must be legally married to a person of the opposite sex at the end of the tax year in order to file a joint return. Living together and sharing income and assets without benefit of a legal marriage to a person of the opposite sex are not sufficient for the filing of a joint return.

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Alan D. Campbell on Max G. Newberry and Tina F. Newberry v. Commissioner

2008 Emerging Issues 1892

Alan D. Campbell on Max G. Newberry and Tina F. Newberry v. Commissioner

By Alan D. Campbell

February 11, 2008

SUMMARY: Alan D. Campbell comments on the tax treatment of business interruption insurance proceeds received by a self-employed individual. This commentary, written by Alan D. Campbell, co-author of the book *Tax Strategies for the Self-Employed*, discusses how practitioners can apply this important decision in calculating the taxpayers self-employment tax liability.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Facts of the Case. Max Newberry operated a Piggly Wiggly grocery store as a sole proprietor. A fire destroyed his grocery store on November 10, 1974. He was not able to operate the grocery store until June 1975. In 1975, Max Newberry received business interruption insurance proceeds in the amount of \$11,000 to replace the net profit he lost from being unable to operate the grocery store.

Max Newberry included the business interruption insurance proceeds in his gross income, but he did not include them in his net earnings from self-employment. He believed that the business interruption insurance proceeds were not subject to self-employment tax because they were not income from the carrying on of a trade or business as required by Section 1402(a).

The IRS did not agree and issued the taxpayers with a notice of deficiency in the amount of \$810 for tax year 1975. According to the IRS, business interruption insurance proceeds received by a taxpayer who is self-employed are included in gross income and in net earnings from self-employment.

Max Newberry and his wife Tina Newberry filed a petition with the U. S. Tax Court and contested the proposed assessment. This key issue in this case was whether business interruption insurance proceeds are subject to self-employment tax.

The Arguments. Max Newberry argued that the business interruption insurance proceeds were not income from the carrying on of a trade or business as required by Section 1402(a). The Commissioner argued that the business interruption insurance proceeds were a substitute for the loss of profits the taxpayer would have realized from operating

his grocery business and therefore were income from the carrying on of a trade or business.

The Courts Ruling. In a case of first impression, the U. S. Tax Court agreed with Newberry that business interruption insurance proceeds were not income from the carrying on of a trade or business. The court stated there must be a nexus between the income received and a trade or business that is, or was, actually carried on.

The court noted that non-wage income of employees is not subject to FICA taxes. The court also noted that the IRS ruled in *Rev. Rul. 56-110, 1956-1 CB 488* and in *Rev. Rul. 60-330, 1960-2 CB 46* that unemployment benefits provided by an employer in addition to state unemployment benefits were not wages subject to FICA taxes even though taxpayers must include such payments in gross income.

The court stated that Max Newberrys business interruption insurance proceeds were the counterpart to the supplemental unemployment benefits received by employees. The court also noted that the IRS ruled in *Rev. Rul. 58-139, 1958-1 CB 14* and in *Rev. Rul. 68-424, 1968-2 CB 419* that strike benefits were not wages subject to FICA taxes because such payments were not for the performance of services even though such benefits were included in gross income.

What Practitioners Should Do. In light of the courts holding, practitioners should report business interruption insurance proceeds received by a self-employed individual as other income on page one of Form 1040 and not on Schedule C of Form 1040. The practitioner should report the nature of the income as business interruption insurance proceeds. By reporting the business interruption proceeds in this manner, the taxpayer will pay income taxes on the business interruption insurance proceeds, but the taxpayer will not pay self-employment tax on such income.

Caution for Practitioners. The IRS did not acquiesce to the *Newberry* decision. In Cumulative Bulletin Notice 87-26, 1987-1 CB 470, the IRS stated that Dairy Termination Payments made by the Commodity Credit Corporation to dairy farmers to compensate them for lost income from milk production were to be reported on Schedule F of Form 1040. Income reported on Schedule F of Form 1040 is subject to self-employment tax.

In *Rev. Rul. 91-19, 1991-1 CB 186*, the IRS ruled that fishing boat operators, owners, and crew members had to include payments received for not being able to fish due to the negligence of a corporation in their net earnings from self-employment. The IRS stated that taxpayers can be in a trade or business even though taxpayers are not able to operate the business temporarily.

In addition, in *Rev. Rul. 91-19*, the IRS clearly stated that it did not agree with the U. S. Tax Courts ruling in *Newberry* that a nexus between a payment received by the taxpayer and the taxpayers trade or business cannot exist if the individual is not currently engaged in daily business activities. The practitioner should remember that revenue rulings are not law, but represent the IRSs opinion of the law. The IRS stated that the payments made to Max Newberry were not in liquidation of his business but were in connection with his continuing the business even though he was temporarily unable to operate it during the reconstruction of the business premises after the fire. The IRS stated clearly that it will not follow the decision in the *Newberry* case.

Other Tax Effects. By excluding business interruption proceeds from the taxpayers net earnings from self-employment, the self-employment tax will be lower. The lower self-employment tax liability will result in a lower deduction for one-half of the self-employment tax. The lower deduction for one-half of the self-employment tax will

cause adjusted gross income to be higher, which could reduce the itemized deductions limited by percentages of adjusted gross income including medical expenses, casualty and theft losses, and miscellaneous itemized deductions.

The lower net earnings from self-employment will reduce the amount that a self-employed individual may contribute to the individual's own account in a qualified pension plan or SEP-IRA. The limit for such contributions is based on net earnings from self-employment minus the sum of one-half of the self-employment tax and the contribution itself. The lower self-employment tax paid may also result in lower Social Security benefits upon retirement.

Best Practice. Best practice is providing guidance to the taxpayer that the U. S. Tax Court has ruled that business interruption insurance proceeds are not subject to self-employment tax, but that the IRS is still willing to challenge the taxpayer on this issue. If the taxpayer chooses not to include business interruption insurance proceeds in net earnings from self-employment, the IRS might examine the taxpayer's return and propose an assessment of additional tax. If the practitioner cannot resolve the issue at the IRS Appeals Office, the taxpayer will receive a notice of deficiency from the IRS.

A practitioner who is admitted to practice before the U. S. Tax Court can then file a petition in the U. S. Tax Court on behalf of the taxpayer. If the only issue is the inclusion of business interruption insurance proceeds in net earnings from self-employment, the taxpayer and the Commissioner should be able to stipulate to the facts of the case.

The taxpayer should win on a motion for summary judgment if the taxpayer cites the *Newberry* decision. Taxpayers should expect the U. S. Tax Court to abide by its previous decisions absent any contrary subsequent decision by a higher court. The taxpayer has to consider whether the Commissioner would appeal a decision by the U. S. Tax Court favorable to the taxpayer.

Substantial Authority. Under Reg. § 1.6694-2(b)(1), a tax preparer is to use the analysis of Reg. § 1.6662-4(d)(3)(ii) to determine whether a position taken by the tax preparer is more likely than not to be sustained on its merits. This analysis involves looking at the relevance and persuasiveness of the authority in determining the weight given to it. Under Reg. § 1.6694-2(b)(2), the authorities a tax preparer is to use to determine whether a position on a tax return is more likely than not to be sustained on its merits are the authorities provided in Reg. § 1.6662-4(d)(3)(iii).

Court cases are among the substantial authorities listed there. Therefore, the *Newberry* decision gives practitioners substantial authority to exclude business interruption insurance proceeds from a taxpayer's net earnings from self-employment.

However, a court case may no longer be substantial authority if a higher court has overruled it. An opinion of a U. S. District court is no longer substantial authority if the U. S. Court of Appeals for that district has reversed it. The IRS will not treat an opinion of the U. S. Tax Court as overruled by an opinion of the U. S. Court of Appeals for a circuit for which the taxpayer does not have a right of appeal unless the U. S. Tax Court adopts the holding of the U. S. Court of Appeals. Clearly, a decision of the U. S. Tax Court that has not been reversed by any higher court is substantial authority.

Conclusion. The main lesson to be learned from this case is that substantial authority exists to exclude business interruption insurance proceeds from net earnings from self-employment. Sometimes the income received by a self-employed individual is not subject to self-employment tax even though it is subject to income tax. Section 1402 lists several items of income that are not subject to self-employment tax. In addition, the *Newberry* decision shows that sometimes taxpayers may properly exclude other items of income from net earnings from self-employment. Another

lesson is that even though the IRS does not appeal a case it loses in the U. S. Tax Court, it still may be willing to challenge other taxpayers on the same issue. Practitioners need to be prepared to respond to such challenges on behalf of their clients.

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Campbell on Randon J. Scholet v. Commissioner

2008 Emerging Issues 1898

Campbell on Randon J. Scholet v. Commissioner

By Alan D. Campbell

February 11, 2008

SUMMARY: Alan D. Campbell comments on the U. S. Tax Courts decision about whether a married taxpayer who did not file an income tax return may use the filing status of married filing jointly. This Emerging Issue Analysis , written by Alan D. Campbell, co-author of the book *Tax Strategies for the Self-Employed*, discusses how practitioners can apply this important decision to ensure the best tax results for their clients.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Facts of the Case. The case of *Randon J. Scholet v. Commissioner*, *TC Memo 2005-140*, *89 TCM 1434* (2005) addresses the issue of whether a married taxpayer who did not file an income tax return may use the filing status of married filing jointly in the calculation of his income tax deficiency. In addition, this case shows the right of the IRS to file a substitute for return (SFR) for the taxpayer and assess income tax and penalties if the taxpayer does not file an income tax return. Further, this case serves as a reminder that taxpayers must retain supporting documents to sustain deductions.

Randon J. Scholet was married for all of 1998, and he lived in Clearwater, Florida. He filed income tax returns for the years 1979 through 1997, but he did not file an income tax return for 1998. Instead on April 15, 1999, he mailed a letter to the IRS and asked the IRS for legal advice as to whether he and his wife had to file an income tax return for 1998. On May 25, 1999, he again wrote to the IRS and informed them that he and his wife were not filing an income tax return for 1998 because they believed that they were not persons liable for tax or required to file an income tax return for 1998.

Because Randon J. Scholet did not file an income tax return for 1998, the IRS determined a deficiency against him for 1998 based on the information in its possession. The deficiency was based on the filing status of married filing separately. The amount of the deficiency was \$463,386 for unpaid income tax plus penalties for underpayment of estimated tax of \$20,449.58 and for late filing of \$112,138 for a total deficiency of \$595,973.58.

Randon J. Scholet had purchased and sold numerous shares of stock during 1998. His stock sales were reported to the IRS on Forms 1099-B, Proceeds from Broker and Barter Exchange Transactions that showed net sales of

\$1,100,526. In its calculation, the IRS did not reduce the net sales for any basis the taxpayer might have had in the shares he sold. Rather, the IRS treated the net sales proceeds as the taxpayers capital gain. Randon J. Scholet also received wages of \$99,739, and he had received interest income of \$149 and dividend income of \$6,632.

At trial, Randon J. Scholet argued that the IRS determination was arbitrary. He also argued that the court should allow him to use the tax rates for a joint return. He provided evidence of his bases in some of the stocks he had sold. He also argued that he should be able to deduct a net operating loss carryover of \$15,547 from the previous tax year (1997), but he did not identify the tax year in which he incurred the loss. He argued that he should also be allowed a deduction for charitable contributions of \$2,141 for contributions that he made to a church each week of \$20, the same \$20 contributions made by his wife, and contributions made by their children of \$2 each week.

At trial, Randon J. Scholet proved that had \$14,833 of federal income tax withheld from his pay in 1998. He also proved that he was allowed deductions for home mortgage interest of \$9342.20, real estate taxes of \$4,168.74, and investment interest of \$25,582.

The Courts Ruling. The court found that the notice of deficiency for which the IRS used the sales proceeds from Randon J. Scholets stock sales as reported on Forms 1099-B was not arbitrary under the circumstances. At trial, the court allowed him to reduce the gain by his basis in the stocks he had sold for which he provided proof. The court did not allow him any basis for some stock sales for which he did not provide any proof of his basis. The court did not allow him any deduction for charitable contributions he claimed to have made because the taxpayer did not provide any proof of such contributions.

The court ruled that his filing status was married filing separately because he had not filed an income tax return. The court cited its previous decision in *Thompson v. Commissioner*, 78 TC 558 (1982) as support for its decision that a married couple must file a joint return to use the joint return rates.

The court denied any net operating loss carryforward that Randon J. Scholet claimed because he did not prove the amount of his loss he wanted to carry from 1997 and he did not identify the year in which he incurred the loss. The court found that he was liable for the failure to file penalty. The court rejected his argument that the statement he sent the IRS satisfied his obligation to file an income tax return. The court denied his deduction for charitable contributions because he did not substantiate the deduction. The court also noted that he could not deduct the charitable contributions made by family members even if he substantiated them. The court also found him liable for the penalty for underpayment of estimated tax.

What Practitioners Should Do. In light of the courts holding, the practitioner should make clients aware that commonly used arguments by tax protesters have no validity and that failure to file required income tax returns can subject individuals to civil and criminal penalties. The practitioner should also remind married couples that they must file a joint return to take advantage of the joint return rates. The practitioner should also advise clients who have transactions reported on Forms 1099-B that they may need to file income tax returns to prove their bases in the assets sold even if their gross income does not meet the level of gross income required to file an income tax return. If such a taxpayer does not file an income tax return, the IRS may treat the sales proceeds reported on Forms 1099-B as capital gains even if the taxpayer has sufficient basis to have realized a capital loss on such sales. Practitioners should remind clients to retain records to prove that they are allowed the deductions claimed on their income tax returns.

Caution for Practitioners. If a taxpayer does not file an income tax return or files a false or fraudulent return, Section 6020(b) allows the IRS to file a substitute for return (SFR) based on the information the IRS has in its possession. A substitute for return is valid for all legal purposes, but Section 6501(b)(3) provides that it does not start the running of the statute of limitations on assessment. However, the IRS does not have to prepare an SFR to assess a deficiency (*Irwin A. Schiff v. United States*, 90-2 USTC 50,591, 919 F.2d 830, (CA-2, 1990) *affg* 89-2 USTC 9551 (DC

Conn., 1989), *cert. denied*, 501 U.S. 1238, 111 S.Ct. 2871 (1991)). If the taxpayer does not file a return, Reg. § 301.6211-1(a), deems the taxpayer to have shown zero for the amount of tax on the return.

The practitioner must be also cautioned about how the IRS views transactions reported to it by brokers on Form 1099-B, Proceeds from Broker and Barter Exchange Transactions. Under Reg. § 1.61-6(a), the gain on the sale of property, rather than its sales price, is what is included in gross income. The taxpayer's gains on the sale of property and other items of gross income might not be large enough to require the taxpayer to file an income tax return. Under Section 6012(a)(1), an individual is generally not required to file an income tax return if the individual's gross income is less than the sum of the individual's personal exemption amount and basic standard deduction. However, Section 6017 requires an individual who has net earnings from self-employment of \$400 or more to file a return even if the individual's gross income would not otherwise require the individual to file an income tax return.

If the taxpayer does not file an income tax return, the IRS may treat the sales price as reported by the brokers as gross income. The IRS may proceed to file a substitute for return (SFR) for the taxpayer and assess the taxpayer with income tax and penalties based on the reported sales proceeds and other information the IRS has received from other sources regarding the taxpayer's income. However, the filing of the SFR will not start the running of the statute of limitation on assessment.

The taxpayer may not realize what the IRS has done until the taxpayer receives a notice from the IRS. The practitioner can file an original tax return for the taxpayer that shows the bases in the securities or other assets sold. The original income tax return will replace the SFR and begin the running of the statute of limitations on assessment.

Other Tax Effects if the Taxpayer is Married Filing Separately. If the taxpayer files a return as married filing separately or if the IRS files an SFR or otherwise determines a deficiency using the filing status of married filing separately, the taxpayer will not be entitled to certain tax benefits. For example, the taxpayer must generally file a joint return to claim the following tax credits:

- . Child care credit (Section 21(e)(2))
- . Credit for the elderly and totally and permanently disabled (Section 22(e)(1))
- . Credit for adoption expenses (Section 23(f)(1))
- . Hope and lifetime learning credits (Section 25A(g)(6))
- . Earned income credit (Section 32(d))

In addition, Section 1211(b) provides that the maximum deductible net capital loss is \$1,500 per year on a married filing separately return rather than the \$3,000 maximum net capital loss deduction allowed on a joint return. The thresholds for the phase-outs of certain itemized deductions under Section 68 and for personal and dependency exemptions under Section 151 are lower on a married filing separately return than they are on a joint return.

Best Practice. Best practice dictates that a practitioner should not seek legal advice from the IRS. If a practitioner or client needs legal advice, he or she should contact a competent attorney. Best practice is usually filing a joint return for a married couple unless there is serious marital discord, a large balance due is attributable to the income of only one spouse, or a careful analysis proves that the couple would save more tax by filing separate returns.

Conclusion. One lesson to be learned from this case is that a practitioner should advise clients that arguments of tax protesters are frivolous. If any doubt exists about whether the taxpayer's gross income is large enough to require the taxpayer to file an income tax return, the taxpayer should file a return or a request for an automatic extension of time to file the return by its due date rather than sending a statement asking the IRS for advice. A practitioner should be aware that if a taxpayer does not file an income tax return, the IRS may nevertheless assess a deficiency and proceed to

collection efforts.

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Levinson on deductibility of capital expenditures as qualified medical expenses

2008 Emerging Issues 1866

Levinson on deductibility of capital expenditures as qualified medical expenses

By Gerald M. Levinson

February 6, 2008

SUMMARY: Certain personal capital expenditures may be wholly or partially deductible as medical expenses if theyre incurred primarily for the prevention or treatment of a specific illness or defect.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Under *IRC Section 213(a)*, taxpayers are allowed to deduct the amount of unreimbursed expenses paid during the taxable year for medical care for themselves, their spouses, or dependents to the extent that such expenses exceed 7.5 percent of the taxpayers adjusted gross income (AGI). (For alternative minimum tax purposes, however, unreimbursed medical and dental expenses are deductible only to the extent that they exceed 10 percent of AGI. See *IRC Section 56(b)(1)(B)*).

"Medical care" is given its usual meaning by the tax code and is defined as amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. Essential transportation for medical treatment, long-term care, health insurance premiums, drug and doctor fees, and even non-lavish lodging necessitated by medical treatment are also included in this definition [*IRC Section 213(d)*].

In addition to the types of medical expenses mentioned, personal capital expenditures may be wholly or partially deductible as medical expenses if theyre incurred primarily for the prevention or treatment of a specific illness or defect. Therefore, certain durable equipment, home renovations and improvements, and even a pool, spa, or whirlpool bath thats also used for recreation, may be totally or partially deductible as medical expenses if theyre used mainly to treat or prevent a disease or medical condition. But taxpayers must practice due diligence in deducting such expenses. The devil may be in the details.

Medically Necessary Capital Improvements. Although generally not deductible for federal tax purposes under *IRC Section 263*, an expenditure that otherwise qualifies as a medical expense under *IRC Section 213* wont be disqualified merely because its a capital expenditure. Accordingly, under the tax regulations [*Treas. Reg. Section 1.213-1(e)(1)(iii)*], a capital expenditure which is related only to the person with an illness, and is not related to permanent improvement or betterment of property, is deductible if it otherwise qualifies as an expenditure for medical care.

Example. An expenditure for eye glasses, a seeing eye dog, artificial teeth and limbs, a wheel chair, crutches, an inclinator or an air conditioner which is detachable from the property and purchased only for the use of a sick person is a deductible medical expense.

A capital expenditure for the permanent improvement or betterment of property-- which would not ordinarily be for the purpose of medical care--may, nevertheless, qualify as a medical expense to the extent that the expenditure exceeds the increase in the value of the related property, and if the particular expenditure is related directly to medical care.

Example. A taxpayer is advised by a doctor to install an elevator in his residence so that the taxpayer's wife, who has heart disease, will not be required to climb stairs. If the cost of installing the elevator is \$ 10,000 and the increase in the value of the residence is determined to be only \$ 3,000, the difference of \$ 7,000, which is the amount in excess of the value enhancement, is deductible as a medical expense. However, if it is determined that the elevator has not increased the value of the residence, the entire cost of installing the elevator would qualify as a medical expense, subject to the 7.5% floor.

Practice Tip. In situations such as the above, where the value of real property is in issue, a taxpayer would be wise to (1) ask the physician for a written prescription for the installation of the elevator or, at the very least, the doctor's written recommendation, and (2) obtain an independent appraisal of the value of the residence both before and after the elevator is installed. The taxpayer should attach a copy of both the prescription/recommendation and appraisal to his Form 1040 Schedule A (Itemized Deductions).

Expenditures made for the operation or maintenance of a capital asset are likewise deductible medical expenses if they have as their primary purpose the medical care of the taxpayer, a spouse, or a dependent. Normally, if a capital expenditure qualifies as a medical expense, expenditures for the operation or maintenance of the capital asset would also qualify provided that the medical reason for the capital expenditure still exists. The entire amount of such operation and maintenance expenditures qualifies, even if none or only a portion of the original cost of the capital asset itself qualified [*Treas Reg Section 1.213-1(e)(1)(iii)*].

Swimming Pools. Numerous court cases have dealt with the deductibility as medical expenses of the cost of installing, operating, and maintaining swimming pools. The majority of these opinions have been decided against the taxpayer/claimants on the grounds that the therapy provided by a pool was readily available to the taxpayer elsewhere at a fraction of the cost, the need for therapy persisted for a short time only, or that the pool was used primarily for recreational purposes.

A deduction will not be allowed, if a pool would have been installed regardless of the specific medical treatment purpose. Concerning the deductibility as a medical expense of the cost of installing a swimming pool, the connection between medical treatment and the expenditure must be substantiated through written documentation from a physician. The burden is on the taxpayer in these cases to show absolute medical necessity for a documented disease or condition and the absence of any reasonable and less costly alternative.

The bottom line in such cases is that for costs associated with the pool to be deductible medical expenses, the primary purpose of the pool must be the cure or mitigation of a disease or physical defect, and there must be no adequate less expensive alternative available.

Practice Tip. There is a hard-to-find link on the IRS's website that provides a way to pose a tax question to the Service and receive a written reply via email. This writer, who uses a wheelchair due to a chronic medical condition (MS), had occasion to do so when he moved into a new home in 1998. The shower was renovated so that it was a roll-in shower accessible by wheelchair. This was accomplished by the destruction of a number of existing walls and the erection of new ones, as well as the installation of a number of grab bars. In my email to IRS, I described my medical situation, the work done to the bath, and the cost of the work. In a few days I received a reply stating that the Service considered the costs that I incurred to be deductible medical expenses.

While the IRS stated its response could not be used or cited as precedent, its email did indicate the position the IRS took in my personal situation. I of course attached a copy of all the emails to the return on which I deducted the costs of the renovation.

The IRS link is irs.gov.website.helpdesk@speedymail.com

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Obama Tax Policy: Meeting Economic Crisis Challenges

2009 Emerging Issues 3346

Obama Tax Policy: Meeting Economic Crisis Challenges With IRS Funding, Foreign Tax Credit Reform, Simplification and Other Action Plans

By H. David Rosenbloom Esq.

February 5, 2008

SUMMARY: If there is one word that has characterized the campaign of President Obama that word is "change." So it seems a fair question to ask what the new Administration might, could, or should have in mind, by way of change to our tax system. That system stands much in need of change. The Obama Administration starts with two key advantages: A fundamentally tax compliant country and the superior tax administration of the Internal Revenue Service.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: If there is one word that has characterized the campaign of President Obama that word is "change." So it seems a fair question to ask what the new Administration might have in mind, or could have in mind, or should have in mind, by way of change to the United States tax system. After all, that system is the very lifeblood of the country and yet it is a system that -- alas -- stands much in need of change.

The Obama Administration would approach that task with two enormous advantages: First, ours is fundamentally a tax compliant country. Americans generally understand the need for taxes and, by and large, voluntarily comply with the tax rules. That is far more unusual and important than most people realize. There are many countries in the world where taxes are viewed either with suspicion or as some sort of national game. We exhibit those tendencies as well, but for the most part at the margin. The fact that Americans can be counted upon to pay attention and attempt to follow the rules represents an invaluable "natural resource."

Second, we have the best tax administration in the world, bar none. The Internal Revenue Service is a fantastic agency, which regularly collects the enormous sums needed for our government to function, with a minimum of corruption and error. This much under-appreciated arm of government is a treasure, an international rarity, and one that the Obama Administration would be well advised to support and encourage. I return on that theme below.

Currents Against Change: Political Posturing and Unreasonable Demands

On the other hand, the United States has a few serious handicaps to overcome in approaching change in the tax area. Our politicians have found it expedient at least since the Reagan Administration to take aim at the tax system as a means of achieving short-term gains and currying political favor. No one enjoys paying taxes, and for thirty years or so

the politically ambitious have translated that fact into attacks on both the tax system and the agency that administers that system. Morale at IRS noticeably suffered and has never recovered, which is, to put it mildly, a shame. Attacks on an agency of government that undergirds our way of life were, are, and forever will be very foolish. How will a country survive, much less flourish, when it not only fails to acknowledge one of its main national assets, but actually mistreats it for the pleasure of the crowd?

Unfortunately, it has also become commonplace to ask the tax system to do a great deal more than serve its basic purpose, which is to raise taxes to fund government expenditures. Along with the opprobrium that has been hurled at the U.S. tax system have come mandates to manage credits and deductions, and to apply other rules, which are for the most part beyond the range of the typical tax administrator's expertise. The first notes sounded by the Obama Administration on this front have not been encouraging. It may have caught the Clinton Administration disease of attempting to use tax credits as remedies for everything and anything, making an already intolerably complex set of laws even harder to understand and administer.

Obama Support is Expected, Albeit Qualified

The political situation, insofar as tax change is concerned, is perhaps not as clear as some observers may think. Although President Obama enjoys substantial majority support in both the House and the Senate, he does not necessarily have the 60 votes needed in the Senate to close off a filibuster. It all depends on whether the fifty-eight or fifty-nine Democrats can be counted upon to step forth in support of what he proposes and on whether he can entice a couple of Republicans to do the same. More importantly, the Executive never obtains exactly what it wants when it submits tax proposals to Congress. Even within his own party, the President will be dealing with members who have been in the tax business for decades, and it is not clear that they will inevitably agree to his suggestions. In fact, it is almost a sure thing that there will be a variety of amendments, refinements, changes, and additions, and that what emerges from the legislative process will only faintly resemble what was brought to it for consideration.

Recipe for Change Combines Measures, Large and Small

So what are the prospects for tax change in the new Administration? This question can be discussed at the "retail" level by reciting a variety of relatively confined changes that seem worth making; and it can be approached by identifying some larger and more risky moves that an administration seriously bent on change might contemplate.

Top Marginal Tax Rate and AMT Require Attention

First, the small stuff: For individuals it seems inevitable that the top marginal rate of 35 percent will need to be raised. We have glided into both the habit of thinking we can have everything we want without paying for it and the belief that increased taxes invariably translate into reduced economic activity. The latter was certainly not the case in the Clinton Administration, when a top marginal rate of around forty-one or forty-two percent (taking into account the thoroughly non-transparent phasing out of deductions at higher income brackets) was obviously not inconsistent with national prosperity. We are going to have to move back to something like the nominal top rate of 39.6 percent that prevailed then, though one might hope that the sleight-of-hand deduction phase-out has been cast aside for good.

We obviously also need to have the estate tax maintained, something President Obama has unequivocally endorsed. That tax falls on a narrow group of extremely wealthy families, and it would be foolhardy in the extreme to concede the revenue it raises much less to repudiate the modest redistributive effects that the tax produces.

We probably have to deal, as well, with the alternative minimum tax. The AMT has been another utterly non-transparent way for Congress to deal with raising taxes, but has become something of an albatross because its non-indexed rates and exemptions make it apply increasingly to the middle class. Repealing the AMT will be expensive, but something has to be done to replace the present dual system of income taxation, nearly incomprehensible to the average person, with a single income tax that is clearer and more understandable.

Key Priorities: Adequate IRS Funding, Corporate Tax Reform

Now for a BOLD MOVE: If the Obama Administration really wants change in the tax area, what it should do, in addition to the relatively small-bore items just mentioned, is to move aggressively to fund the Internal Revenue Service so that it can do its job. The agency has been starved for resources for years, as the economic world in which it operates has grown increasingly more sophisticated. If the Administration wants to do something dramatic, it should prod Congress for sufficient funding for IRS so that it can cope with the enormous task of tax administration entrusted to it. (It might also not be a bad idea for President Obama to appear personally at the Internal Revenue Service for the purpose of making it indisputably clear that the service of its employees is appreciated; the only President ever to do that previously was John F. Kennedy.)

On the business front, what change is in store? It would appear that the top corporate tax rate will have to be reduced. The United States currently has one of the highest corporate tax rates in the developed world. But this change should be accompanied by repeal of the silly deduction for domestic production activities that was introduced in 2004, and perhaps by other efforts to rid the Internal Revenue Code of needless and complex deductions. The formula is really simple: Reduce the top rate, remove the special deductions. Congress once understood that (in enacting the Tax Reform Act of 1986). But no sooner had it acted upon that understanding than it set about to undo its own good deeds.

Resurrecting Rangel's H.R. 3970 Favored Over Attempting Deferral Repeal

As far as U.S. taxation of cross-border investment is concerned, there is surely a need to take a close look at the foreign tax credit, a little understood but highly intricate set of rules that could be vastly simplified and tightened. It would seem that this area, which Congressman Rangel proposed to reform in a Bill introduced in October 2007, would be far more fruitful than another attempt to repeal "deferral," the non-taxation of the active foreign income of controlled foreign corporations. Deferral was an issue in the Kennedy and Carter Administrations, and many people probably think the Obama team will have it in their sights. The problem is that yet another national debate about deferral would require a great deal of political capital: The issue has been contested for nearly fifty years, and much of the real tax revenue is attributable to the foreign tax credit in any case (or at least can be raised by adjustments to the foreign tax credit rules).

Review Earnings Stripping and Treaty Shopping, Simplify, and Exercise STATESMANSHIP

For inbound taxation, involving investments by foreign persons in the United States, the Obama Administration should take a careful look at earnings stripping, the practice whereby deductible interest payments "strip" income from the U.S. tax base and thus preclude substantial tax. The current rules are both inordinately complex and ineffective, an unappealing combination. In addition, serious attention needs to be paid to the issue of treaty shopping. The United States has no fewer than four separate legal doctrines aimed at this practice of "borrowing" treaties not intended to be thus used, but there are gaping holes in the coverage. For one thing, the treaties with Hungary and Poland, which do not contain so-called Limitation on Benefit articles, need immediate review.

More BOLD MOVES? But, of course: How about a serious effort to achieve radical simplification in our tax laws? As the saying goes, yes, we can. All we have to do is accept "rough justice" tax rules that are fair in general but that do not attempt to be "fair" to each and every taxpayer individually. Also, insofar as inbound taxation is concerned, it would be a BOLD MOVE indeed to undertake a complete revision of rules that were drafted in the much simpler world of 1966. Those rules have not received sufficient attention over the years. But guess what: The United States is now (but was not in 1966) a country that imports a lot of capital investment.

Finally, for the tax treaties, a BOLD MOVE would be to attempt to integrate these agreements more closely into the process of tax policy decision-making. For many years there has been a sort of turf-induced jealousy between the Executive and Legislative branches, with the latter only grudgingly acknowledging the usefulness and legitimacy of the treaties in establishing U.S. international tax law. A bit of statesmanship could go a long way toward bringing the treaties more closely into alignment with overall U.S. international tax policy. Such alignment could be of great utility,

both in helping US industry in its foreign investment and in more carefully applying the tax laws to the investments that we welcome from abroad.

RELATED LINKS: For additional discussion and analysis of federal tax issues, see Rabkin & Johnson,
 ■ Federal Tax Guidebook

ABOUT THE AUTHOR(S):

H. David Rosenbloom is an attorney specializing in international tax matters. He is a member of Caplin & Drysdale, Chartered, a law firm in Washington, DC, and the James S. Eustice Visiting Professor of Taxation and Director of the International Tax Program at New York University School of Law. Born in New York, NY in 1941, Mr. Rosenbloom attended Princeton University, the University of Florence in Florence, Italy, and Harvard Law School. He served as President of the Harvard Law Review, assistant to Ambassador Arthur Goldberg at the U.S. Mission to the United States, and clerk to Justice Abe Fortas at the United States Supreme Court.

Mr. Rosenbloom was International Tax Counsel and Director of the Office of International Tax Affairs in the United States Treasury Department from January 1978 through January 1981. A frequent speaker and author on tax subjects, he has taught international taxation and related subjects at Stanford, Columbia, the University of Pennsylvania, Harvard, and New York University Law Schools, and at educational institutions in Taipei, Mexico City, Milan, Sydney, and Pretoria. He has also served as a Tax Policy Advisor for the U.S. Treasury, the OECD, AID, and the World Bank in Eastern Europe, the Former Soviet Union, Senegal, Malawi, and South Africa.

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Philip R. Fink on Knight v. Commissioner (U.S. Supreme Court)

2008 Emerging Issues 1827

Philip R. Fink on Knight v. Commissioner (U.S. Supreme Court)

By Philip R. Fink

January 28, 2008

SUMMARY: This landmark Supreme Court case attempts to resolve a conflict among the Circuit Courts of Appeal on the interpretation of IRC Section 67(e)(1). It is hoped that the ruling in this case will provide a uniform standard for determining when investment advisory fees are subject to the 2% limitation of IRC Section 67(e)(1).

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ARTICLE: This landmark Supreme Court case attempts to resolve a conflict among the Circuit Courts of Appeal on the interpretation of *IRC Section 67(e)(1)*. It is hoped that the ruling in this case will provide a uniform standard for determining when investment advisory fees are subject to the 2% rule of *IRC Section 67(e)(1)*. (*Knight v. Commissioner, U.S. Supreme Court, Number 06-1286, January 16, 2008*).

Background. In general, the tax laws state that the taxable income for an estate or trust will be computed in the same manner as for an individual unless otherwise stated. However, *IRC Section 67(e)(1)* differentiates the tax treatment for miscellaneous expenses of individuals on the one hand, and estates and trusts on the other. Miscellaneous itemized deductions are generally allowed only to the extent that they exceed 2% of adjusted gross income. *IRC Section 67(e)(1)* allows a full deduction for estates and trusts if two requirements are met. First, expenses must be paid or incurred in connection with the administration of an estate or trust. Second, such costs would not have been incurred if the property were not held in an estate or trust. In other words, the expense in question would not have been incurred had the property been owned outright by an individual.

Facts of the case. The trust in the *Knight* case was established in 1967. For the year in question, 2000, the trust reported total income of \$624,816, and paid investment advisory fees of \$22,241. It should be noted that *IRC Section 67(e)(1)* was added to the Internal Revenue Code as part of the Tax Reform Act of 1986. One can speculate that the trustee deducted the full amount of investment advisory fees because it had always done so since the trust was established in 1967, not addressing the change in 1986 with respect to such fees.

Issue. The controversy among the various Circuits had been the interpretation of the second requirement. That is, what is the meaning of, such costs would not have been incurred if the property were not held in an estate or trust.

Trustees argument. The trustee argued that its fiduciary duties required it to hire an investment adviser. In other words, had it not been for the trust and the fiduciary duties that come along with it, the fees would have never been incurred.

Courts ruling. The court ruled that in order for an expense not to be subject to the 2% rule, it must be an expense that is unique to the administration of an estate or trust. In other words, an expense incurred by an estate or trust is not subject to the 2% rule if it would not be commonly or customarily incurred by individuals. Thus, in asking whether a particular type of cost would *not* have been incurred if the property were held by an individual, *IRC Section 67(e)(1)* excepts from the 2% rule only those costs that would be uncommon (or unusual, or unlikely) for such a hypothetical individual to incur. Since many individuals do incur the expense of an investment adviser, this type of an expense is not unique to a trust; and therefore, is subject to the 2% rule.

The court indicated that the trustees argument failed for two reasons. First, if an expense of an estate or trust is automatically deductible because it was incurred to discharge a fiduciary duty, such reasoning would eliminate the need for the second phrase in *IRC Section 67(e)(1)*, . . . and which would not have been incurred if the property were not held in such trust or estate, . . . Second, the trustee never demonstrated that it is uncommon or unusual for individuals to hire an investment adviser. As a matter of fact, the court concluded that it would be quite likely that an individual investor would have hired an investment adviser.

Tax planning implications. Are there any estate or trust-related investment advice expenses that could be fully deductible? Yes, for instance, if an investment adviser were to impose a special, additional charge applicable only to fiduciary accounts, such an expense would be fully deductible. Also, a trust may have an unusual investment objective, or may require a specialized balancing of the interests of various beneficiaries. In such cases, the incremental cost of expert advice beyond what would normally be required for an individual would not be subject to the 2% rule.

Practice Tip. Attorneys, accountants, trust administrators, fiduciaries, or anyone else involved with estate and trust administration, or concerned about the tax aspects of an estate or trust, need to devise an accounting system to segregate expenses that are subject to the 2% rule from those that are not subject to the 2% rule. Further, trust administrators should request a billing from an investment adviser that itemizes those fees that are unique to the trust.

Prop Treas Reg Sec 1.67-4(b) can give some insight as to which category fiduciary expenses fall into. Its approach is essentially the approach taken in the *Knight* case. That is, if a cost is unique to an estate or trust (i.e., not commonly or usually incurred by an individual), it is not subject to the 2% floor. A cost is unique to an estate or trust if an individual owned the property instead of the estate or trust, such cost would not have been incurred. Examples of expenses that are *not* unique and *are unique* are indicated in the table below:

Non-unique items

- . associated with custody or management of property
- . advice on investing for total return
- . gift tax returns
- . the defense of claims by creditors of the decedent or grantor
- . the purchase, sale, maintenance, repair, insurance or management of non-trade or business property

Unique items

- . fiduciary accountings
- . judicial or quasi-judicial filings required as part of the administration of the estate or trust
- . fiduciary income tax and estate tax returns
- . the division or distribution of income or corpus to or among beneficiaries
- . trust or will contest or construction
- . fiduciary bond premiums
- . communications with beneficiaries regarding estate or trust matters

Impact on tax liability. The importance of this case depends to a large extent on the amount of adjusted gross income that an estate or trust has, and the amount of expenses that are subject to the 2% rule. In most cases, the amount of the expense that is allowable as a deduction is critical since the tax rates for fiduciary returns are very progressive. In 2008, joint taxpayers do not reach the 35% federal income tax rate until they have taxable income of \$357,700. In contrast, an estate or trust reaches the 35% tax bracket after it has reached a taxable income of just \$10,700.

Example. The Anderson trust has adjusted gross income of \$7,000. It incurs \$4,000 of investment advisory fees. Accordingly, \$3,860 ($\$4,000 (\$7,000 \times 2\%)$) of the investment advisory expense is allowable as a deduction. In contrast, assume that the Anderson trust had an adjusted gross income of \$160,000 and investment advisory fees of \$4,000. Now, only \$800 ($\$4,000 (\$160,000 \times 2\%)$) of the fees is allowable as a deduction.

Caveat. If necessary, an estate or trust may decide to invest in securities that produce little or no current income, so that a larger portion of investment advisory fees are allowed as a deduction. However, prudent care must be exercised since it might be in the best interest of the income beneficiary to have current income generated from taxable sources to satisfy the requirements of the trust or estate.

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Philip Fink on who is considered a head of household.

2008 Emerging Issues 1796

Philip Fink on who is considered a head of household.

By Philip R. Fink

January 22, 2008

SUMMARY: The tax rates for a head of household are lower than those for an individual who files as a single taxpayer. The standard deduction is higher for a head of household than for a single taxpayer. Thus, the advantage of being a head of household is that an individual who would otherwise file as a single taxpayer can save a substantial amount of money.

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ARTICLE: *IRC Section 2(b)* defines who is a head of household. The tax rates for a head of household are lower than those for an individual who files as a single taxpayer. In addition, the amount of the standard deduction is higher than for a single taxpayer. Thus, the advantage of being considered a head of household is that an individual who would otherwise file as a single taxpayer can save a substantial amount of money.

Who is a head of household? In order for an individual to be a head of household, two tests must be met. First, the taxpayer must be unmarried. Second, he or she must pay more than half of the cost of maintaining a household, which is the principal abode for more than half of the year for an individual who is either a qualifying child or a qualifying relative of the taxpayer. [See *IRC Section 151(c)(1)* and (2)].

Caveat. Child for this purpose includes a stepchild, foster child, or an adopted child.

Exceptions. There are two notable exceptions to the general rule. First, a taxpayer can still qualify as a head of household if his or her dependent has a temporary absence. Second, if the dependent is a parent, the parent can live in his or her own abode as long as the taxpayer pays more than half of the cost of maintaining the parents household.

Example. Linda is a single parent. Her son, Tyler, is a qualifying child of hers. She pays all of the household costs. Tyler attends a university 200 miles away for nine months of the year, and lives with Linda for three months. Tylers absence while he is away at college is considered to be a temporary absence; and therefore, Linda qualifies as head of household

Example. Paul is single and lives alone. His widowed mother lives in her own home where she has lived for the last 50 years. His mothers only source of income is her social security benefits of \$9,600, of which she uses \$5,000 to

pay for some of her household costs and the other \$4,600 for other support items. Paul provides \$12,000 toward his mothers household costs, and \$6,000 toward her support. Since Pauls mother is considered to be a qualifying relative and he provides more than half of her household costs, he is a head of household.

Household costs. Household costs include the payment of mortgage interest, rent, utilities, upkeep and repairs, domestic help, property insurance.

Caveat. Household costs do not include the fair rental value of the property, or that part of a monthly house payment that represents principal.

Example. Steve is single. His widowed mother lives with him in his home that has a fair rental value of \$10,000. His mother is a qualifying relative. For the year, Steve made house payments of \$18,000, of which \$6,000 represents interest expense and \$12,000 represents principal payments. In addition, the following expenses were incurred for the current year: utilities, \$3,000; property insurance, \$800; and property taxes \$5,000. His mothers only income is \$8,000 of social security benefits of which she gives Steve \$6,000 to be used for household costs. Steve pays the rest of the household expenses out of his funds. In this case, the total household expenses amount to \$14,800 (\$6,000 + \$3,000 + \$800 + \$5,000). Steves mother pays \$6,000 and Steve pays the rest, \$8,800 (\$14,800 -- \$6,000). Since Steve pays more than half of the household costs, he is a head of household.

Use of a multiple support agreement. If an individual uses a multiple support agreement to consider another person as a qualifying relative in order to take a dependency exemption, he or she will not be allowed to use that person to claim head of household status.

Divorced parents. Generally, where parents are divorced, the custodial parent can claim the children as dependency exemptions. However, if a custodial parent executes a declaration waiving the right to claim the children as dependency exemptions, the noncustodial parent can claim the children as dependency exemptions. In such a case, the noncustodial parent cannot file as a head of household. However, as long as the custodian parent is providing more than half the costs of providing a household, he or she will be able to use the head of household status. Hence, such a person could be a head of household but not be able to claim the children as dependency exemptions.

Example. Fred and Sharon are divorced with two children. Sharon has custody of the children. She has properly executed a declaration waiving the right to claim the children as dependency exemptions. According to the divorce decree, Fred is to pay child support of \$2,000 a month in total for the two children. The divorce decree specifies that half (\$1,000 a month) of this amount will go toward clothing, food, education, and entertainment. The other half is to go to help pay Sharons household costs. The total annual household costs of Sharons house are \$25,000. Therefore, her share of the household costs are \$13,000 (\$25,000 -- \$12,000), which is over half of the household costs. Accordingly, she is a head of household even though Fred can claim the children as dependency exemptions.

Contrast head of household to surviving spouse filing status. A single individual can be a surviving spouse for only the two years immediately following the year in which his or her spouse died. In addition, to qualify as a surviving spouse, an individual must have a qualifying child living with him or her. In contrast, a taxpayer can be a head of household in one of two ways. First, the individual can have either a qualifying child or qualifying relative living with him or her for whom the taxpayer provides more than half of the household costs. Second, an individual can pay more than half the household expenses of his or her dependent parents house. Moreover, while surviving spouse status is only for two years, someone can be a head of household for an indefinite period.

Example. Carol and Bruce were married with two children, ages 9 and 6, when Bruce died in 2008. Carol never remarries, and pays all of the household costs and provides all of the support for her two children. In 2008, Carol can file a joint return with her deceased husband. In 2009 and 2010, she can file as a surviving spouse. In 2011 and thereafter, she can file as a head of household as long as she continues to provide more than half of the household costs,

and she has at least one qualifying child who lives with her.

Planning Tip

Tax advisers can provide a worthwhile service by helping clients determine the correct amount of withholding and estimated payments that they should be making as heads of households. For instance, if a woman is widowed and had been a surviving spouse for the last two years, becoming a head of household will increase her tax liability assuming that the other aspects of her tax situation remain the same. Increasing the amount withheld from a paycheck or an additional amount of estimated payments oftentimes will be necessary in order to avoid an underpayment penalty. Also, an individual who has been filing as a single taxpayer may become a head of household when they begin to pay more than half the cost to run a dependent parents home. In such a situation, his or her tax liability will be decrease, assuming that the other aspects of his or her tax situation remain the same. In this case, a tax adviser should instruct a client to reduce the amount withheld from a paycheck or reduce the amount of estimated payments.

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DeScherer on Situations That Can Complicate Home Sale Exclusion Calculations

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DeScherer on Situations That Can Complicate Home Sale Exclusion Calculations

By Dorinda D. DeScherer

January 15, 2008

SUMMARY: Figuring the amount of taxable gain on the sale of a home is typically a simple matter of subtracting the maximum exclusion from the realized gain on the sale. But every year tax practitioners encounter special situations where figuring the home sale exclusion is not so simple.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: Figuring the amount of taxable gain on the sale of a home is typically a simple matter of subtracting the maximum exclusion--\$250,000 for a single individual or \$500,000 for a married couple--from the realized gain on the sale. But every year tax practitioners encounter special situations where figuring the home sale exclusion is not so simple. These special situations often arise because of changes in a taxpayers personal or family situation such an unexpected move, a new marriage, divorce or death of a spouse. This commentary examines the rules that apply in such cases and tax-saving strategies that can maximize the home sale exclusion.

Figuring the amount of taxable gain on the sale of a home. This is normally a simple matter for individuals or couples who have met the basic requirements for claiming the maximum exclusion: (1) they owned and used the home as a principal residence for at least two of the five years ending on the date of the sale [*IRC Sec. 121(b)(1)*]; and (2) they did not claim the exclusion for gain from another sale or exchange during the two-year period ending on the date of the current sale or exchange [*IRC Sec. 121(b)(3)*]. The taxable gain is computed by subtracting the maximum exclusion--\$250,000 for a single individual or \$500,000 for a married couple--from the realized gain on the sale.

However, from time to time, practitioners may run up against special situations where figuring the home sale exclusion is not so simple.

The two-year rules. Perhaps the most common special situation that practitioners encounter involves clients who bump up against the two-year rules. For example, a client may be forced to sell a home unexpectedly before meeting the two-year ownership and use requirement.

Nonetheless, a reduced maximum exclusion may be available to the client [*IRC Sec. 121(b)*; Reg. Sec. 1.121-3(a)].

To qualify for a reduced maximum exclusion, the sale or exchange must have been primarily motivated by a

change in place of employment, health, or unforeseen circumstances. Whether that requirement is satisfied depends on all the facts and circumstance surrounding the sale.

IRS regulations set out safe harbors under which a sale or exchange will automatically satisfy the requirements for a reduced maximum exclusion in the case of a change of employment or health issues [Reg. Sec. 1.121-3(c),(d)]. The regulations also describe specific events that qualify as unforeseen circumstances, including involuntary conversions, disasters, death, job loss, change of employment, divorce or separation, and multiple births [Reg. Sec. 1.121-3(e)].

But, of course, not every clients situation will fall squarely within the safe harbors. According to IRS regulations, factors that may be relevant in determining the primary reason for a sale or exchange include:

The time between the taxpayers change in circumstances and the sale of the home.

Material changes in the suitability of the home as the taxpayers principal residence.

Material changes in the taxpayers financial ability to maintain the home.

Whether the circumstances precipitating the sale or exchange were foreseeable at the time the taxpayer began using the home as a principal residence.

Whether the taxpayers change in circumstances took place during the period the taxpayer owned and used the home as a principal residence [Reg. Sec. 1.121-3(b)].

Practice Tip. If a clients situation does not fit within the safe harbor but seems deserving after weighing these factors, the best course of action may be to ask the IRS for a private letter ruling. Since the home sale exclusion rules came into play, the IRS has issued scores of letter rulings approving reduced exclusions based on unforeseen circumstances. For example, in a recent ruling, the IRS approved a reduced exclusion for an individual who sold a home before passing the two-year ownership and use mark because the individual had married and the couple need a larger home to accommodate their blended family [PLR200725018].

The reduced exclusion is calculated by multiplying the applicable maximum exclusion of \$250,000 or \$500,000 by a fraction. The numerator of the fraction, which may be expressed in days or months, is the *shortest* of:

1. the time the taxpayer owned the property during the five-year period ending on the date of the sale or exchange;
2. the time the taxpayer used the property as a principal residence during the five-year period ending on the date of the sale or exchange; or
3. the period of time between the date of a prior sale or exchange on which gain was excluded and the date of the current sale or exchange.

The denominator of the fraction is either 730 days or 24 months, depending on the time measure used in the numerator.

Example. Garret Foster, a single taxpayer, bought his principal residence in January 2008. Six months later he sold the home due to a cross-country job move. Foster did not claim a home sale exclusion in the prior two years. Result: Fosters reduced maximum exclusion is \$62,500 (6 months ownership and use/ 24 months x \$250,000).

Problems can also crop up when a client sells two qualifying homes within a two-year period. Here again, a reduced maximum exclusion may apply to the second sale if it is due to a change of employment, health, or unforeseen circumstances. However, even if a reduced exclusion is not available, the client may have another ace in the hole:

Practice Tip. The home-sale exclusion is the default option. However, a taxpayer may elect not to have the

exclusion apply to an otherwise qualifying sale or exchange [IRC Sec. 121(f); Reg. Sec. 1.121-4(g)]. Thus, if a client sells two qualifying homes within a two-year period, an election out may be beneficial if the home with the smaller gain is sold first.

Example. Grace and Howard Cole are in their retirement years. A little over two years ago, the Coles moved out of their large family home and into their vacation condo, which they have since been using as their principal residence. Now, the Coles have decided to move to a retirement community. In December 2007, they sell the condo for a gain of \$100,000. Three months later in March 2008, their family home is finally sold for a gain of more than \$500,000. If the Coles take the default route, they can exclude the full \$100,000 of gain on the condo--but will not qualify for exclusion of any gain on the sale of the family home since they will have claimed the exclusion for another sale within the prior two years. By contrast, if the Coles elect to report the \$100,000 gain on the condo, they will be able to claim a full \$500,000 exclusion on the sale of the family home.

Marriage. In the typical case, married clients own their homes jointly and have lived in the home for same period of time. However, that's not always the case--especially with clients who marry later in life or who remarry. For example, a new spouse may simply move into a home that the other spouse already owns.

Practice Tip. The fact that only one spouse holds title to the home won't necessarily bar the couple from claiming a maximum \$500,000 exclusion for gain on the sale of the home.

A husband and wife who file a joint return for a year may exclude up to \$500,000 of gain on the sale of a principal residence if--

either spouse met the two-year ownership requirement,

both spouses met the two-year use requirement, and

neither spouse claimed a home sale exclusion for a sale of a principal residence within the two years prior to the current sale [Reg. Sec. 1.121-2(a)(3)].

Example. Louis Mayer bought his home in 1990 and has used it continually as a principal residence since that time. On December 1, 2005, Louis married and his new wife, Lauren, moved into his home. After the marriage, Louis remained the sole owner of the home. In 2008, the Mayers learn that they are expecting their first child. They decide to sell the home and move to a larger place. The home is sold on August 1, 2008, at a gain of \$300,000. Result: The Mayers qualify for the maximum \$500,000 exclusion. While only Louis met the ownership requirement, both spouses met the two-year use requirement, and neither of them claimed the home-sale exclusion for a prior sale. Therefore, the full \$300,000 of gain is excludable from income.

If one spouse does not qualify for the exclusion, that doesn't mean the couple is totally out of luck. The spouse who does qualify can claim the exclusion determined on a separate basis as if he or she were not married.

Example. Same facts as above, except that the Mayers married and Lauren moved into the home on December 1, 2006. Result: The Mayers do not qualify for the \$500,000 exclusion because only Tom met the two-year use requirement. Therefore, the couple's exclusion is limited to the \$250,000 that would be available to Tom as a single taxpayer. The remaining \$50,000 of gain on the sale is taxable.

This separate exclusion rule can also come into play if each spouse sells a home that he or she owned and used as a principal residence.

Example. During 2008, newlyweds Patrick and Andrea O'Malley sell the two homes that they separately owned and used as their principal residences before their marriage. Patrick and Andrea each met the ownership and use tests for their own homes, but neither met the use test for the other's home. The gain on Andrea's home is \$200,000; the gain

on Patrick's is \$300,000. Result: The OMalleys are each separately eligible to exclude up to \$250,000 of gain on the sale of their separate residences. However, Andrea cannot use her \$50,000 "leftover" exclusion to shelter the gain on Patrick's home. Instead, the OMalleys must recognize \$50,000 of gain on the sale of Peter's home.

Death of a spouse. A surviving spouse who sells the family home following the death of his or her mate also faces special tax rules. A surviving spouse can file a joint tax return for the year of the deceased spouse's death [IRC Sec. 6013(a)(2)]. Therefore, assuming the requirements are met, a surviving spouse may claim the maximum \$500,000 exclusion for joint filers if the couple's principal residence is sold in the year of death.

On the other hand, if a home is sold in a later year, the maximum \$250,000 exclusion for single taxpayers will apply to the sale. That's not necessarily bad news, however.

Practice Tip. While long-time homeowners may have a significant amount of potential gain on a home sale, some of that potential gain will disappear when one spouse dies. Under current estate tax rules, one-half the value of the home is included in the estate of the deceased spouse, although it will be sheltered from tax by the unlimited marital deduction for property passing to a surviving spouse [IRC Secs. 2040(b); 2056(a)]. Therefore, the surviving spouse takes a stepped-up basis in one-half the house equal to the fair market value at the date of death [IRC Sec. 1014(a)(1)].

Divorce. Divorced couples are also subject to special home sale exclusion rules that depend on how they deal with ownership of the home.

If ownership of the home is transferred to one spouse incident to a couple's divorce, the IRC provides that no gain or loss is recognized on the transfer. The transfer is treated as a gift and the transferee spouse takes over the transferor's basis in the home. Moreover, for purposes of the home-sale exclusion, the transferee spouse also takes over the transferor's ownership and use of the home. The period that the taxpayer owns the property will include the period that the spouse or former spouse owned the property [Reg. Sec. 1.121-4(b)(1)].

However, in some cases a divorce or separation agreement will give one spouse the right to live in the home for a period of time while the other spouse continues to have an ownership interest in the home. IRS regulations provide that a taxpayer will be treated as using a home as a principal residence for any period that the taxpayer has an ownership interest in the home and the taxpayer's spouse or former spouse is granted use of the property under a divorce or separation agreement, provided the spouse or former spouse actually uses the home as a principal residence [Reg. Sec. 1.121-4(b)(2)].

Practice Tip. In light of these rules, a divorcing couple will need to decide on the most tax-effective disposition of the family home. For example, a use arrangement may be preferable if gain on the eventual sale of the home will be substantial. If the home is transferred outright to one former spouse and he or she has not remarried when the home is sold, a maximum \$250,000 exclusion will be available to shelter the gain. By contrast, if the home is owned by both former spouses, each of them will be eligible for a maximum \$250,000 exclusion. Therefore, as much as \$500,000 of gain can be sheltered from tax. Of course, the spouse who does not reside in the home will receive a share of the gain. However, the potential tax savings may be significant enough to justify an asset allocation that maintains co-ownership of the home.

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Gary A. Zwick on Corporate Owned Life Insurance.

2008 Emerging Issues 1769

Gary A. Zwick on corporate owned life insurance.

By Gary A. Zwick

January 10, 2008

SUMMARY: IRC Section 101(j) was enacted by Congress as a reaction to the negative aspects of corporate owned life insurance. It provides a roadmap to companies wishing to continue or implement corporate owned life insurance programs, but also creates a potential pitfall to closely held companies using life insurance to fund buy/sell agreements or to buy key person insurance.

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ARTICLE: I.R.C. § 101(j) was enacted by the Pension Protection Act of 2006 as a reaction to the negative aspects of corporate owned life insurance. It provides a roadmap to companies wishing to continue or implement corporate owned life insurance programs, but also creates a potential pitfall to closely held companies using life insurance to fund buy/sell agreements or to buy key person insurance on the lives of its executives and owners. Section 101(j) is effective for life insurance contracts issued after August 17, 2006. However, if the contract is acquired after August 17, 2006 in an exchange to which Section 1035 applies and the original contract was acquired before August 17, 2006, then this section does not apply.

Exemption of certain life insurance proceeds. Generally, Section 101 allows the receipt of life insurance proceeds in excess of the basis of the policy to be tax exempt to the recipient. Two notable exceptions are proceeds of life insurance paid on a policy that was transferred for value to the owner at the time of death of the insured, and proceeds of life insurance received by a C corporation where the corporate alternative minimum tax may apply to tax book income in excess of taxable income. (The insurance proceeds create book income but not taxable income).

A third exception is Section 101(j). Section 101(j) denies tax exempt treatment of life insurance proceeds on life insurance if:

1. the contract is owned by any person or entity engaged in a trade or business or who is related to such person or entity, and the business entity or related person directly or indirectly benefits from the contract; and
2. the insured is an employee of the trade or business.

There are two exceptions where the life insurance proceeds will not be taxable even though the requirements of

Section 101(j) are met:

1. if the proceeds of the policy are paid not to the employer or related trade or business, but instead to a member of the insureds family, a trust created for one or more members of the insureds family, or any individual designated by the insured other than the business or related entity; or

2. if the proceeds of the policy are paid to the employer or a related person or entity with respect to a person that died, and at any time within the year of the employees death, she was employed by the policyholder, or the employee at the time the policy was issued was a director, a 5% or greater owner of the business, who in the year preceding the year of issuance of the policy earned an amount equal to or greater than \$95,000 as adjusted for inflation, or who was among the highest paid 35% of all employees of the policyholder.

Notification/consent. As a further requirement, if the business entity owns life insurance on employees, meets either or both of the two exceptions, and wishes to have the proceeds not be taxable when received, it must also notify the employee of the purchase of the life insurance in writing, tell the employee the maximum face value which the employer will purchase on the employees life, and that the employer or related entity or person will be the beneficiary of the death benefit. In addition, the employee must consent in writing that he/she is being insured by the employer and that the employer may continue such coverage after the employee terminates employment.

Partnerships/LLCs. Technically speaking, Section 101(j) does not apply to partners in a partnership or members of a limited liability company that is taxed as a partnership, because partners are not ordinarily employees. Where a related partnership or limited liability company is used as a vehicle to own life insurance on multiple corporate owners who are employees of the related company, Section 101(j) would apply because of the related party rules even though it covers partners.

Insurable interest. While Section 101(j) appears to limit the tax benefit of corporate owned life insurance, particularly in large companies, it also provides a roadmap to the successful implementation of such programs. Prior to the enactment of Section 101(j), some courts had held that the company did not have an insurable interest in these contracts and denied the proceeds to the company. This new provision should provide some certainty to companies that comply with the requirements of the exceptions to the rule specified above.

In closely held companies, with the exception of key person insurance, the purchase of insurance on employees is not as prevalent. But Section 101(j) is broad enough to encompass insurance funded buy/sell agreements whether they are redemption or cross purchase structures. In this situation, the notice requirements of Section 101(j) still need to be complied with in order to prevent a tax problem.

Regulations to be issued. The notice requirements have not as of this writing been detailed by the IRS, but regulations are expected in the first part of 2008. Until then, the requirements exist but a good faith attempt to comply will be sufficient until the new rules are published. The IRS in proposed regulations issued on November 9, 2007 under Section 6039I, stated that the rules when issued will not be applied retroactively to the detriment of any taxpayer which attempted in good faith to comply with the rules.

Practice Tip. In order to be as careful as possible, companies should include notice language in all employment agreements, buy/sell agreements, and other shareholder agreements to be sure that the exception to Section 101(j) is complied with. This should be done in any situation where it is possible that life insurance might be bought on the life of an employee of the company.

Sample Notice And Consent Language

Section 101(j) Notification and Consent

It is the intention of the Company to purchase life insurance on the life of the Employee. The maximum face value

of the life insurance policy will be \$_____. The actual amount purchased may be less. The Company intends this insurance to be used either as Key Person life insurance to protect the Company in case Employee dies prematurely, or as a funding vehicle to purchase the stock of the Employee in the event of death. In the case of insurance to buy the stock of the Employee, the owner of the policy may be the Company, or a related entity, or the other Shareholders of the Company. In any case, the Employer, a related entity, or the other Shareholders (in the case of buyout insurance), will be the beneficiary of the policy. This section constitutes the notice required under Code Section 101(j) to qualify for the exceptions to that section and by signing this agreement, Employee hereby consents to the purchase of the insurance and consents to allow the Employer or related person or entity to continue to own the life insurance policy after the Employee terminates employment for any reason, unless otherwise specified or provided for elsewhere in this agreement or any other agreement between the Company and the Employee.

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Myers on alternative strategies in the wake of the kiddie tax expansion

2008 Emerging Issues 1761

Myers on alternative strategies in the wake of the kiddie tax expansion

By Terence M. Myers

January 9, 2008

SUMMARY: The so-called kiddie tax, once a minor annoyance for parents who want to save taxes by shifting income to their children, has become a major headache. Because of recent tax law changes, the kiddie tax can hit families long after children have passed the kiddie stage. Recent tax law changes have impacted tax plans, and families must know what alternative strategies they can adopt to minimize that impact.

PDF LINK: [Click here for enhanced PDF of this Emerging Issues Analysis at no additional charge](#)

ARTICLE: The so-called kiddie tax, once a minor annoyance for parents who want to save taxes by shifting income to their children, has lately become a major headache. Because of recent tax law changes, the kiddie tax can hit families long after children have passed the "kiddie" stage. This commentary discusses how tax law changes impact tax plans, and what alternative strategies families can adopt to minimize that impact.

Mechanics of the Kiddie Tax. Special rules apply to the net unearned income of children. These rules are commonly referred to as the "kiddie tax." The kiddie tax was enacted in order to prevent parents, particularly upper-income parents, from shifting investment income out of their high tax brackets and into their children's lower brackets. The kiddie tax achieves this goal by basically taxing the child's investment income at the parents' marginal tax rate.

Generally, the kiddie tax applies to a child if: (1) the child has not yet reached a certain age by the close of the taxable year and either of the child's parents is alive at that time; (2) the child's unearned income exceeds a threshold amount; and (3) the child does not file a joint return [*IRC Sec. 1(g)(2)*]. The kiddie tax applies regardless of whether the child may be claimed as a dependent by either or both parents.

Under the kiddie tax rules, the net unearned income of a child subject to the tax (generally unearned income over the threshold amount) is taxed at the parents' tax rates if the parents' tax rates are higher than the tax rates of the child. The remainder of a child's taxable income (i.e., earned income, plus unearned income up to the threshold amount, less the child's standard deduction) is taxed at the child's regular rates [*IRC Sec. 1(g)(1)*]

For these purposes, "unearned income" is income other than wages, salaries, professional fees, other amounts received as compensation for personal services rendered, and distributions from qualified disability trusts. Thus,

unearned income includes taxable interest, dividends, capital gains (including capital gain distributions), and the taxable part of social security and pension payments. It also includes amounts produced by assets the child obtained with earned income (such as interest on a savings account into which the child deposited wages). Income from a gift made under the Uniform Transfers to Minors Act (UTMA) or Uniform Gifts to Minors Act (UGMA) may be subject to the kiddie tax, even though an adult custodian is given certain rights to deal with the property until the child attains majority [*Temp. Treas. Reg. 1.1(i)-1T*].

The kiddie tax is calculated by computing the "allocable parental tax" [*IRC Sec. 1(g)(3)*]. This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's "net unearned income" is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents, and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income. [*IRC Sec. 1(g)(4)*]. The minimum standard deduction allowed to dependents is \$900 for 2008 [*Rev. Proc. 2007-66, I.R.B. 2007-45*]. Thus, a child with \$1,800 or less of unearned income in 2008 will have a zero net unearned income and will not be subject to the kiddie tax.

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income. If the child has net capital gains or qualified dividends, these items are allocated to the parent's hypothetical taxable income according to the ratio of net unearned income to the child's total unearned income.

Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return [*IRC Sec. 1(g)(7)*].

Age Limit for Kiddie Tax. For tax years beginning before 2006, the kiddie tax applied to a child's unearned income only if a child had not attained age 14 before the close of the tax year. But recently enacted tax laws have expanded the reach of the kiddie tax in two steps.

1. For tax years beginning after 2005, the Tax Increase Prevention and Reconciliation Act of 2005 (P.L. 109-222) applied the kiddie tax to a child who had not attained age 18 before the close of the tax year [*IRC Sec. 1(g)(2)*], as amended by the Tax Increase Prevention and Reconciliation Act of 2005.]

2. For tax years beginning after May 25, 2007, the Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28), applies the kiddie tax to (1) a child who has not reached age 19 before the close of the tax year and (2) a child (a) who is over age 18 but not over age 24 before the close of the tax year and (b) who is a full-time student. [*IRC Sec. 1(g)(2)*], as amended by the Small Business and Work Opportunity Tax Act of 2007].

The kiddie tax, as expanded by the 2007 Act, does not apply to children whose earned income exceeds one-half of their support [*IRC Sec. 1(g)(2)(A)(ii)(II)*]. Thus, for example, college students with jobs that pay for more than one-half of their support will not be subject to the kiddie tax.

Impact of Tax Law Changes. For some families, the impact of the new law changes may be minimal. For example, suppose parents have transferred appreciating assets to a child with a long-term goal in mind, such as to help the child purchase a first home or to help the child educate his or her children. As long as the income from the assets remains below the kiddie tax threshold during the prescribed period, the expansion of the kiddie tax will have no effect. When the assets are eventually sold (beyond the kiddie tax age range), the income recognized will be taxed to the child, not the parents, regardless of the amount.

Practice Tip. However, for many other parents, transferring assets to a child may have a more immediate goal: the financing of the child's college education. For these parents, the expanded kiddie tax will require the adoption of new strategies to minimize or eliminate the effects of the kiddie tax.

Prior to the new changes, parents of college-bound children could avoid the kiddie tax by simply waiting out the

under-age-14 limitation. For example, parents could place appreciating stock in a custodial account for the child. As long as the dividend income (if any) from the stock was below the threshold amount, no kiddie tax was triggered. Then, when the child went to college, the stock investment could be liquidated to pay the child's tuition. Since the child was over 13, the capital gains tax would be calculated at the child's tax rates. Or, in the alternative, if the parents already owned an appreciated investment (e.g., stocks or real estate), they could simply transfer the investment to the child after he or she reached age 14. The investment would be sold to pay the child's college expenses and, again, the gain on the sale would be taxed at the child's rates, not the parents.

These strategies are no longer effective for parents seeking to finance their child's college costs. Sale of an investment owned by a child prior to the child reaching age 24 will trigger the kiddie tax to the extent the gain exceeds the threshold amount. In other words, merely deferring income recognition until the child reaches college age will not avoid the kiddie tax. Parents have to look for other ways to provide for their child's education and still sidestep the kiddie tax. Let's examine some of the alternatives.

Section 529 Plans. *Section 529 of the Internal Revenue Code* provides favorable tax treatment to qualified tuition programs (QTPs). There are two types of Section 529 programs:

1. the prepaid tuition plan, established and maintained by a state, state agency, or eligible education institution, that permits contributors (e.g., parents, grandparents) to purchase tuition credits or certificates on behalf of a child which entitle the child to the waiver of payment of qualified higher education expenses; and
2. the college savings plan, established and maintained by a state or state agency that permits account holders to make contributions to an account set up for the purpose of meeting a child's qualified higher education expenses.

All states and the District of Columbia sponsor at least one type of Section 529 program.

Contributions to Section 529 programs are not deductible. Federal income tax on earnings that accumulate in the plans is deferred until funds are withdrawn from the account [*IRC Sec. 529(a)*]. In addition, the earnings that have built up inside the program are excludible from gross income if they are withdrawn to pay qualified higher education expenses [*IRC Sec. 529(c)*]. So there is no kiddie tax with Section 529 programs as long as withdrawals are not used for non-educational purposes.

There are no limits on the amount that may be contribution to a Section 529 program (and there is no income limit on the contributor). However, distributions of earnings in excess of qualified higher education expenses are includible in the gross income of the distributee and subject to an additional 10% tax, absent certain circumstances [*IRC Sec. 529(c)(6)*].

Coverdell Education Savings Accounts. Formerly known as Education Individual Retirement Accounts, Coverdell Education Savings Accounts (ESAs) are trust or custodial accounts created for the purpose of paying qualified education expenses of the designated beneficiary of the account [*IRC Sec. 530(b)(1)*]. Like Section 529 programs, contributions to ESAs are not tax-deductible, but the earnings on the account are tax-free as long as the funds are withdrawn to pay qualified education expenses [*IRC Sec. 530(d)(2)(A)*]. (Unlike Section 529 programs, amounts can be withdrawn tax-free not only to pay college expenses, but also elementary and secondary education.) So a withdrawal from an ESA does not trigger the kiddie tax unless the withdrawal exceeds qualified education expenses.

ESAs are subject to restrictions on how much can be contributed and who can contribute.

Contributions may not exceed \$2,000 annually per beneficiary through December 31, 2010 [*IRC Sec. 530(b)(1)(A)*]. The annual contribution limit is not adjusted for inflation and will be reduced to \$500 in 2011, absent Congressional action.

The modified adjusted gross income of an individual ESA contributor cannot exceed \$110,000 (\$220,000 for joint

return filers). The annual limit on contributions is gradually lowered for individuals with incomes of more than \$95,000 but less than \$110,000 (more than \$190,000 but less than \$220,000 for joint return filers) [IRC Sec. 530(c)(1)].

Practice Tip. Parents whose incomes are above the income thresholds can make a gift of up to \$2,000 to their child who could deposit the entire amount in his or her ESA.

The income ceilings are not adjusted for inflation and will be reduced to \$95,000 \$150,000 for joint filers) after December 31, 2010.

Employment of Child. Since the kiddie tax applies only to unearned income, owners of family businesses may want to consider hiring their children to work in the business and paying them regular wages. The wages will be a deductible business expenses as long as they are reasonable in amount and based on services actually rendered [Treas. Reg. 1.162-7].

Not only are the wages exempt from the kiddie tax, they may also be partially or fully exempt from any income tax. A child who can be claimed as a dependent but who has earned income is entitled to a relatively generous standard deduction that can offset the wages. For 2008, the standard deduction for a dependent child is the greater of:

- . \$900, or

- . the child's earned income for the year plus \$300 (but not more than the regular standard deduction of \$ 5,450) *Rev Proc 2007-66, 2007-45 IRB*].

Thus, for example, if child has wages of \$4,000 and investment income of \$600, the 2008 standard deduction is \$4,300. If the child has wages of \$5,200 and investment income of \$600, the standard deduction is \$5,450.

Roth IRAs. If a child has earnings from employment (whether or not in a family business), contributions can be made to a Roth IRA by the child or on his or her behalf. While generally thought of as a retirement savings vehicle, Roth IRAs can be utilized for more immediate savings goals without kiddie tax consequences.

Qualified distributions from a Roth IRA are excludable from gross income. A "qualified distribution" is a distribution-

- . which is made-

- o on or after the IRA owner becomes 59-1/2,

- o to a beneficiary or the estate of the IRA owner, on or after the owner's death;

- o on account of the IRA owner becoming disabled, or

- o for a qualified first-time home buyer expense; and

- . which is made after the expiration of the five-tax-year period beginning with the first tax year for which a contribution to the Roth IRA was made. [Treas. Reg 1.408A-6].

Thus, distributions from a child's Roth IRA will present no kiddie tax problems if used to make a qualified first-time home purchase, even if the child is still a student and under age 24.

More importantly, however, for purposes of kiddie tax avoidance is another Roth IRA rule dealing with the ordering of distributions. A nonqualifying distribution from a Roth IRA is only includible in the owner's gross income to the extent that it represents a distribution of earnings and not contributions. And a distribution is treated as a distribution of earnings only to the extent that: (1) the amount of the distribution (plus all previous distributions, if any

and minus previous distributions includible in income) exceeds (2) the amount of contributions made to the Roth IRAs [*Treas. Reg 1.408A-6*]. In other words, distributions are not treated as a pro rata distribution of earnings and contributions; instead, contributions "come of the top."

Practice Tip. Because of the distribution ordering rule, Roth IRA distributions made for college expenses are not taxable unless they exceed the sum of contributions. A distribution for college expenses will be treated as coming out of earnings, thus triggering the kiddie tax only if the distribution (plus prior distributions) exceeds cumulative contributions. If so desired, undistributed earnings can be paid out tax-free when the child acquires his or her first-time home.

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Gerald M. Levinson on charitable remainder and special needs trusts.

2008 Emerging Issues 1746

Gerald M. Levinson on charitable remainder and special needs trusts.

By Gerald M. Levinson

January 4, 2008

SUMMARY: A charitable remainder trust in combination with a special needs trust can provide the parent of a child with a disability or other special needs with a financial planning device that can also result in tax savings. If the legal protocols are followed, the combination of the two trusts can entitle the parents to a charitable contribution deduction and a reduced income and/or estate tax bill, while providing continuous funding for the SNT set up for the child's benefit.

PDF LINK: [Click Here for Enhanced PDF of Commentary](#)

ARTICLE: A charitable remainder trust (CRT) in combination with a special needs trust (SNT) can provide the parent of a child with a serious disability or other special needs with a valuable financial planning device that can also result in significant tax savings. If the requisite legal protocols are followed, the combination of the two trusts can entitle the parents to a charitable contribution deduction and a reduced income and/or estate tax bill, while at the same time providing continuous funding for the SNT set up for the child's benefit.

Benefits of Combination Trusts. Upon the child's death, the amount remaining in the CRT is donated to the charity or charities of the parent's choice, and any amounts remaining in the SNT will be paid to the child's estate or to charity [Source: *IRS; Compendium of Studies of Tax-Exempt Organizations, 1989-1998; Volume 3, Publication 1416; August 2002*].

Trust Qualification Requirements. Charitable remainder trusts were created under, and are authorized by *IRC Section 664*. To qualify under Section 664, the CRT must be designed and set up as either a charitable remainder annuity trust or as a charitable remainder unitrust. If the annuity format is selected, a fixed dollar amount-- specified when the trust is established and equal to a percentage of the initial trust contribution-- is paid annually to the income beneficiary (in this case, the SNT for the disabled child) [*IRC Section 664(d)(1)(A)*]. Payments from a unitrust, on the other hand, equal a fixed percentage of the fair market value of the trust's assets, determined annually [*IRC Section 664(d)(2)(A)*]. In either case, the percentage selected cannot be less than 5%, nor more than 50%, of the contributed assets (in the case of the annuity trust) or of the fair market value of the trust (in the case of the unitrust).

A CRT is a split interest trust, meaning it has both charitable and non-charitable beneficiaries. Because a CRT must have at least one non-charitable beneficiary--a beneficiary that is not an IRS-qualified charitable organization under *IRC Section 170(c)*--the investment of trust assets can provide a steady stream of payments to a Special Needs Trust established for the child. However, the tax law [*IRC Sections 664(d)(1)(A), (d)(2)(A)*] also provides that, if payments from the CRT are made to a person other than an individual, they must be made for a term not in excess of 20 years. This restriction often presented an obstacle to parents who wanted the CRT to make continuing payouts to a SNT over the life of their child, a period that could easily extend beyond 20 years, especially where the combination trust arrangement was established when the child was young.

IRS Ruling Eases Restriction. In 2002, the IRS eliminated the obstacle posed by the 20-year requirement by issuing *Revenue Ruling 2002-20, 2002-1 CB 794*. The Ruling holds that a charitable remainder annuity trust or unitrust may pay amounts to a SNT for the life of an individual if (1) the individual is financially disabled (defined below) and (2) the CRT and SNT combination conforms to one of the following three situations (where Trust A is the Charitable Remainder trust, Trust B is the Special Needs Trust, and C is the individual with a disability or other special needs):

1. **Situation 1.** Under the governing instrument of Trust B, a designated portion of the amount it receives from Trust A will be paid to C each month. If, at any time in the sole judgment of the trustee, the monthly payment to C is insufficient to provide adequately for the care, support, and maintenance of C, or is insufficient for the needs of C for any reason, additional amounts will be paid as needed to or on behalf of C from Trust B. Upon C's death, the balance remaining in Trust B will be distributed to C's estate.

2. **Situation 2.** Under the governing instrument of Trust B, the trustee may make distributions of income and principal, as determined in the trustee's sole and absolute discretion, for the financial aid and best interests of C in a manner that supplements but does not supplant any governmental benefits otherwise available to C. Upon C's death, the balance remaining in Trust B will be distributed to C's estate.

3. **Situation 3.** Under the governing instrument of Trust B, the trustee may make distributions of income and principal, as determined in the trustee's sole and absolute discretion, for the financial aid and best interests of C in a manner that supplements but does not supplant any governmental benefits otherwise available to C. Upon C's death, the governing instrument requires the trustee to reimburse the state for the total costs of medical assistance provided to C under the state's Medicaid plan. C is given a testamentary general power of appointment over the balance remaining in Trust B. If C fails to exercise the power, the balance will be distributed, in equal shares, to C's sister and to X, a charitable organization.

In Situations 1, 2, and 3, the CRT amounts are payable to the SNT (Trust B) for the life of the disabled child (C) and not for a term of years. However, in each of these situations, the sole function of the SNT is to receive and administer the CRT amounts for the benefit of the child, who is financially disabled and unable to manage his own financial affairs. Upon the child's death, the assets remaining in the SNT will be distributed either to the child's estate or, after reimbursing the state for any Medicaid benefits provided to the child, will be subject to his or her general power of appointment. In these situations, the use of the assets in the SNT during the child's life and at his death is consistent with the manner in which his own assets would be used. The disabled child, therefore, is considered to have received the annuity or unitrust amounts directly from the CRT for purposes of *IRC Section 664(d)(2)(A)*. Accordingly, the term of the charitable remainder trust may be for the life of the child and is not limited to a term of years.

Financially Disabled Defined. Under *IRC Section 6511(h)(2)(A)*, an individual is financially disabled if he or she is unable to manage their financial affairs by reason of a medically determinable physical or mental impairment that can be expected to result in death or which has lasted or can be expected to last for a continuous period of at least 12 months. An individual will not be considered to have such an impairment unless satisfactory proof of its existence is furnished in such form and manner as the IRS may require.

The Special Needs Trust. The SNT that is named as the CRT's non-charitable beneficiary must be set up as an

irrevocable trust by someone other than the income beneficiary (the beneficiary is the child with a disability or other special needs) and should be funded with assets belonging to an individual other than the beneficiary. (If the SNT is funded with the beneficiary's assets, it would be considered self-settled and would have to contain a pay back provision requiring that, upon the beneficiary's death, trust assets be used to repay Medicare benefits paid to the beneficiary during his or her life. If a self-settled trust lacks a pay back clause, it's deemed a countable resource and may kill the beneficiary's eligibility for SSI and Medicare).

Additionally, the SNT trustee must have sole and absolute discretion over trust distributions, and the trust must limit such distributions to expenses that supplement, and do not supplant SSI benefits for food and shelter and Medicaid health benefits. The SNT beneficiary cannot be the trustee of the SNT nor have the ability to compel a distribution. And it's best that the beneficiary not have the ability to change the SNT trustee, since such ability could arguably be interpreted as a round-about way for the beneficiary to require a distribution (the power to change the trustee is best given to a third party, such as the beneficiary's relative).

If these guidelines are followed, the SNT assets will remain a non-countable resource, SNT payouts won't generate countable income, and therefore the beneficiary's eligibility for public benefits won't be jeopardized. (Under the Social Security Administration's rules, the disabled child could lose his or her SSI and Medicare benefits if the value of his or her assets top \$2,000).

Conclusion. If the charitable remainder and special needs trusts are designed as indicated in this article, and the disabled adult child is financially disabled as required by the IRS, the CRT will be able to provide a steady stream of income to the special needs trust for the child's life. The payments from the SNT to the child will supplement and not replace his or her SSI or Medicare benefits, and so will not jeopardize the child's eligibility for such benefits. And the child's parents, or other trust settlor, will receive not only an immediate income tax deduction for the initial contribution to the CRT but, because appreciable assets are removed from their estate, may enjoy a lower estate tax bill. What's more, there will be no capital gains tax on the sale of the assets. Finally, the parents' favorite charity--oftentimes the charity that's helped the child--will receive a gift of the remainder interest in the CRT and perhaps in the SNT.

For More Information

The IRS has provided sample "forms" for both charitable remainder annuity trusts and unitrusts in Rev. Procs. 89-20 [1989-1 C.B. 841]; 89-21 [1989-1 C.B. 842]; 90-30 [1990-1 C.B. 534]; 90-31 [1990-1 C.B. 539]; 90-32 [1990-1 C.B. 546]; and 90-33 [1990-1 C.B. 551]. And while there are no federal guidelines* on Special Needs Trusts (which are defined and regulated, if at all, by the states), additional information on SNTs can be obtained at the following websites:

For a national treatise and reference, see *Third Party and Self-Created Trusts*, 3d edition, by Clifton B. Kruse, published by the ABA Section of Real Property, Probate and Trust Law. (Go to www.ABAnet.org and select Product Code 5430436.)

See www.SpecialNeedsTrusts.com and www.Special-Needs-Trusts.org for links to websites that provide state-specific information about SNTs

See also www.nami.org--the website of The National Alliance for the Mentally Ill--for another state-specific database of SNT information. Place Special Needs Estate Planning Guidance System (in quotes) in the search box following the word Look at the top of the page

A type of payback special needs trust is referred to cryptically at 42 U.S.C. § 1396(p)(d)(4)(A)

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Gerald M. Levinson is a tax attorney and founder of Benefits Research & Communications in Escondido, California. He has practiced tax law for many years, and is a frequent tax commentator. He specializes in pension and trust law.

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Rhodes on Competent Authority to Resolve Conflicting Claims for the Same Tax

2008 Emerging Issues 1262

Rhodes on Competent Authority to Resolve Conflicting Claims for the Same Tax

By Rufus v. Rhodes

December 3, 2007

SUMMARY: Rufus v. Rhodes, Esq., co-author of the treatise Rhodes & Langer, U.S. International Taxation and Tax Treaties, reviews the steps a taxpayer who is faced with double taxation on the same item of income should take to resolve the issue, including a form of request for assistance.

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ARTICLE: The Problem. After having already paid tax to the Internal Revenue Service on a particular item of income, your client is somewhat surprised to hear that Germany is claiming tax on that same item. The setting for a claim for a second tax (that is, a tax on income that has already been subjected to tax by another country's tax collection agency) will vary from case to case, but the issue remains the same: your client is facing paying tax twice on the same item of income.

Possible Solution. You may have an answer to your client's problem but only if the other country imposing tax on the item of income is one that has an income tax treaty with the United States. Many countries, like Brazil, do not, in which case your solution (if there is one) will be found in the treaty article dealing with the competent authority. [See *Rhodes & Langer, U.S. International Taxation and Tax Treaties, Chapter 59*, which deals with the subject of the competent authority at some length.]

The purpose of the competent authority is to work with his counterpart in the treaty country to resolve a double taxation dispute if they can. Every U.S. income tax treaty has some competent authority provision to which one would turn when faced with this problem.

Example: George Raynor, a Swiss resident and citizen, is an inventor and has made his living inventing drugs that are widely used in the medical field. During 2007, George spent about five months in Los Angeles working with your client, Verner, Inc., a small domestic specialty drug company, perfecting a drug for anemia. At the end of that five months, George entered into a license agreement for the drug with Verner, Inc. pursuant to which the latter agreed to pay George a royalty on the drug based on sales.

George gave Verner, Inc. the required IRS Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding) and claimed exemption from withholding pursuant to Article 12 (the royalty article) of

the Swiss-U.S. income tax treaty. Verner, Inc. accepted the W-8 form and began paying the royalties, free of withholding. In 2008, as the outgrowth of an ongoing audit, the Internal Revenue Service looked at the arrangement with George and concluded that the payments were not royalties but rather deferred compensation paid for the rendition of personal services by George. Switzerland had already taken the position that the payments were royalties. Furthermore, when informed of the United States' position, the Swiss tax authorities told George that he would not be entitled to a foreign tax credit on any tax that he might pay the United States on those payments being made by Verner, Inc. George and Verner, Inc. were facing a garden-variety double taxation problem.

Getting the Competent Authority Involved. Your bible for requesting competent authority help is *Revenue Procedure 2006-54, 2006-49 I.R.B. 1035*, which walks you through the steps to request such help. This commentary reviews those various steps, expanding on them, as appropriate.

Step One. You must determine whether or not the other country claiming tax from your client has an income tax treaty with the United States. [*Rhoades & Langer, U.S. International Taxation and Tax Treaties (LexisNexis Matthew Bender)* contains reprints of all current U.S. income tax treaties]. If that country does not (none of the countries in Central America or south of Venezuela have income tax treaties with the United States, for example), then competent authority relief is simply not available.

Step Two. Once you have determined that an income tax treaty between the two countries is in place, look for the article dealing with the competent authority. The Swiss income tax treaty, for example, contains the competent authority provisions in Article 25, which instructs the competent authorities of the two countries to endeavor to resolve any difficulties or doubts arising as to the interpretation of application of the treaty.

Step Three. The U.S. based taxpayer may make a competent authority request as soon as the taxpayer receives a written notice from the Internal Revenue Service that it is proposing an adjustment that will create the double taxation. The taxpayer need not file the request at that time, but excess delay is probably not wise.

Thus, returning to the example, Verner, Inc. would be able to file a competent authority request only after the Internal Revenue Service has issued to Verner, Inc. a written notice that the latter had not withheld tax from payments made to George that the Service determined should have been withheld. That notice will normally be in the form of a Notice of Proposed Adjustment.

Step Four. Once having determined that competent authority assistance is appropriate, the taxpayer needs to prepare the request for assistance. The request should be in letter form, and contain the items of information described in Section 4.05 of *Revenue Procedure 2006-54, 2006-49 I.R.B. 1035*. A form of the letter might look like this:

December ____, 2007

Deputy Commissioner (International)

Large and Mid-Size Business Division

1111 Constitution Avenue NW

Routing MA3-322A

Washington D.C. 20024

Attn: Office of the Tax Treaty

Re: Verner, Inc. Request for Competent Authority Assistance

Dear Sir:

This letter requesting Competent Authority assistance is issued pursuant to the provisions of revenue procedure 2006-54. The contents hereof are organized according to the subsections of section 4.05 of that procedure.

a. Specific Treaty Under Which Request is Made: Convention Between the United States and the Switzerland effective for years beginning in 1998.

b. Data Concerning Person Involved:

Verner, Inc.

1900 South Ocean Lane #1609

Los Angeles, California 90061

95-4562333 (Federal ID number)

c. Relationship With Related Person: Not applicable.

d. Discussion of the Issue: The issue *[here, describe the background, with particular focus on what the foreign country's position is and how it results in double or otherwise inappropriate taxation under the treaty. This section is the make or break portion of the letter, so needs to be both thorough and clear.]*.

e. Year and Amounts Involved

Year Amount in Swiss Francs Amount is U.S. \$

2007 N/A 167,243

Later years N/A Unknown

(f) District Office Proposing Assessment Los Angeles District.

(g) Nature of the Relief Sought *[In this section, you tell the competent authority what you are requesting that he do. As to Verner and George, for example, you are requesting that the U.S. competent authority meet with the Swiss competent authority and agree whether the amounts being paid to George are compensation or are royalties.]* The taxpayer does not intend to seek relief under Rev. Proc. 99-32 [if the issue arose from an allocation of income under IRC section 482 (transfer pricing), you would probably seek 99-32 treatment].

(h) Statute of Limitations The statute of limitations has not expired in either the United States or in Switzerland with respect to the issue for which relief is sought.

(i) Domestic and Swiss Proceedings The only administrative or judicial proceedings involving the taxpayer are those related to the audit currently being conducted by the Los Angeles District. The taxpayer understands that Mr. Raynor is seeking assistance from the Swiss competent authority.

(j) Other Proceedings on the Same Issue The taxpayer is unaware of any relevant foreign judicial or public administrative proceedings that do not involve the taxpayer but involve the same issue.

(k) APA Proceeding The subject of this request has not been addressed in any APA proceeding in any country.

(l) Power of Attorney A Power of Attorney on behalf of the undersigned is attached.

(k) Simultaneous Appeals Request The taxpayer is not requesting involvement of Appeals with respect to this Request.

(l) Amended Return An amended return is not required.

(m) Taxpayers Disclosure Consent A consent by the taxpayer to disclose information as required by section 4.05(15) of *Rev Proc 2006-54* is attached.

(n) Penalty of Perjury Statement A statement signed by the taxpayer under penalty of perjury is attached.

After the request is filed, the competent authority may well request additional documents or data. You are also required to keep the competent authority apprised of any changes in circumstances and supply any new documents that become relevant.

Small Case Procedure. The revenue procedure anticipates that a U.S. taxpayer may need competent authority help even though the amount involved is not a large amount. So, if the amount at issue is no more than \$1 million for a corporation or \$200,000 for anyone else, then abbreviated and streamlined procedures are available. The letter need not be as extensive as the model set forth just above, although the letter needs to have certain basic information included. The description of what you should include is found in *Revenue Procedure 2006-54*, § 5, *2006-49 I.R.B. 1035*.

After the Request is Filed. You have filed the competent authority request -- now what? The first thing you will hear from the competent authority's office is whether or not competent authority assistance is available. Even if the competent authority accepts the request originally, the competent authority may decline to pursue the matter if the taxpayer does not accept whatever conditions the competent authority may later impose. For example, a taxpayer who demands to be involved in the discussions or negotiations between the two competent authorities will run a significant risk that the U.S. competent authority will simply terminate the proceedings. Additionally, a taxpayer who refuses to sign an extension of the statute of limitations will also run a significant risk that the proceedings will be terminated.

The competent authority's action -- either declining the request for assistance or, later, terminating the proceedings -- is not subject to review; it is final.

Assuming that the taxpayer's request is accepted, the taxpayer's role is to answer questions or supply further data in the form of a written statement or documents. At some point, the two competent authorities confer and attempt to reach an agreement. The taxpayer, however, has the final say on whether he will accept whatever agreement the two competent authorities may reach. If the taxpayer accepts the agreement, it will be final and binding on both countries. That acceptance will probably result in a closing agreement between the taxpayer and the Service.

The taxpayer who does not like the agreement reached (or if the competent authorities simply cannot reach an agreement) may withdraw his request for competent authority assistance, in which event he will be back to where he was when he made the request. In a few cases, the taxpayer may be able to request arbitration, although such a request, under current circumstances, will very likely go nowhere.

Competent Authority Agreements. The U.S. competent authority has entered into what are generally referred to as competent authority agreements with the competent authorities of 12 countries, from Austria to the United Kingdom. Each of those agreements deals with specific issues that the competent authorities thought should be reduced to written form. For example, the United States and the Netherlands entered into such an agreement in March 2003 relating to pensions invested through hybrid entities.

A current list of competent authority agreements may be obtained from the following Internal Revenue Service website: www.irs.gov/businesses/small/international/article/0,,id=137376,00.html.

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Philip Fink On Limitation on Investment Interest

2008 Emerging Issues 1224

Philip Fink On Limitation on Investment Interest

By Philip R. Fink

November 30, 2007

SUMMARY: This section [IRC Section 163(d)] limits the amount of investment interest expense that a noncorporate taxpayer can deduct. Specifically, noncorporate taxpayers can deduct only investment interest expense to the extent of net investment income. Any excess can be carried forward for an indefinite period.

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ARTICLE: This section [*IRC Section 163(d)*] limits the amount of investment interest expense that a noncorporate taxpayer can deduct. Specifically, noncorporate taxpayers can deduct investment interest expense only to the extent of net investment income. Any excess amount can be carried forward for an indefinite period. Accordingly, whenever an individual has an excess amount of investment interest, it should not be forgotten in future years.

Net investment income is the amount by which an individual's investment income exceeds his or her investment expenses.

Investment income is the gross income (other than gain) from property held for investment. Such items include interest, annuities, royalties, and dividends, with the exception that qualified dividend income is included in investment income only to the extent that a taxpayer so elects. In addition, gains from the sale of property may be considered to be investment income. That is, *IRC Section 163(d)* classifies gains as investment income to the extent of the sum of:

(1) the excess of any (a) net gain attributable to the disposition of property held for investment over (b) any net capital gain, determined by taking into account gains and losses from dispositions of property held for investment.

(2) so much of the taxpayer's net capital gain on the disposition of property held for investment (or, if less, his or her net gain on the disposition of such property) as the taxpayer elects to include in investment income.

Net gain is the excess of total gains over total losses.

Net capital gains is the excess of net long-term capital gains over net short-term capital losses.

Example: Alex has investment interest expense this year of \$25,000. During the year, he sold three blocks of stocks that resulted in a \$50,000 long-term capital gain; a \$15,000 short-term capital gain; and a \$10,000 short-term capital loss. As a result, Alex has a net gain of \$55,000 (\$50,000 + 15,000 - 10,000). His net capital gain is \$50,000 (net long-term capital gain of \$50,000 less a net short-term capital loss of \$0). Since his short-term capital gain exceeds his short-term capital loss, he has no net short-term capital loss. Accordingly, Alex can deduct only \$5,000 of his investment interest expense for the current year as shown below:

Net gain

Less: net capital gain

Excess

\$55,000

(50,000)

\$ 5,000

Election to treat net capital gain as investment income. *IRC Section 163(d)* allows a taxpayer to elect to include net capital gain as part of his or her investment income. Although making this election will allow a taxpayer to increase the amount of his or her investment interest expense deduction, the net capital gain must be taxed at the ordinary tax rate rather than the lower rate that normally applies to net capital gains. Making the election depends on the amount of investment income that is expected in the future and the time value of money.

Example: Mary has a large amount of excess investment interest and net capital gains this year. If she is expecting a large amount of investment income in the next year or two, it would be better for her *not* to make the election. This way, not only can Mary take advantage of the special tax rate on her net capital gain, but she will be able to offset her future investment income with her excess investment interest expense in a short period of time so that the time value of the tax benefit of the deduction will be relatively substantial. On the other hand, if she is not expecting to generate much investment income in future years, she should make the election to treat her net capital gains as ordinary income so that she can use up her investment interest expense. If she is expecting to receive investment income many years in the future, it would be better for her to make the election since the time value of waiting to deduct the investment interest will be diminished.

Election to treat qualified dividends as investment income. Another election provided by *IRC Section 163(d)* is to treat qualified dividend income as ordinary income. Although this election will allow a taxpayer to deduct a larger amount of investment interest expense, the dividends will be taxed at the ordinary rates. If a taxpayer expects that he or she will have a substantial amount of investment income in the near future, making the election would be a bad strategy, since he or she would have to give up the opportunity of qualified dividends being taxed at a lower rate. On the other hand, if the receipt of investment income is many years away, the time value of the tax benefit of the investment interest deduction will be so diminished that treating qualified dividends as ordinary income is the better strategy.

Tax planning timing capital gains. If a taxpayer has an excess amount of investment interest expense, he or she may want to look at his or her taxable portfolio of investments to determine if a short-term capital gain can be generated. Unlike long-term capital gains, short-term capital gains are considered to be investment income. As such, if an individual who has excess investment interest also has unrealized short-term capital gains, he or she could sell such investments generating a short-term capital gain that would be offset by excess investment interest that otherwise would

have to be deducted in future years.

Example: Harold has \$20,000 of excess investment interest expense. In addition, he has owned ABC stock for seven months and it has appreciated by \$20,000. If he sells the stock, he will have a \$20,000 short-term capital gain which is considered to be investment income that will be offset by his excess investment interest expense. However, if he does make the sale, he will forego the opportunity of having the short-term capital gain mature into a long-term capital gain. If he does not plan to have any investment income in the near future, then selling the stock is a wise move. After all, waiting for the gain to mature into a long-term capital gain may back-fire, and the stock value could decrease, resulting in no gain, long-term or short-term. Even if he did generate investment income several years later, the time value of the tax benefit of deducting the excess investment interest expense against that investment income will be greatly diminished.

Danger of accelerating investment income state income taxation. Although from a federal income taxation standpoint, it might be advantageous to accelerate investment income, the impact to state income taxation can't be forgotten. That is, many states base their income tax on an individual's federal adjusted gross income. By accelerating investment income on the federal income tax return, an individual may very well be increasing the income being reported on his or her state income tax return. However, unlike the federal return, there is typically no offsetting deduction for the additional investment interest expense on a state income tax return.

Tracking excess investment interest expense. It is important for the practitioner to keep track of excess investment interest expense. Sophisticated software can help in this regard. Nonetheless, it is important to be aware of opportunities for clients to effectively use this carryover.

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Philip Fink on Reporting Interest Income From US Savings Bonds

2008 Emerging Issues 1225

Philip Fink on Reporting Interest Income From US Savings Bonds

By Philip R. Fink

November 30, 2007

SUMMARY: This section [IRC Section 454] establishes the rules for reporting interest income for Series E, EE and I savings bonds. In general, interest from savings bonds is reported at the time the bonds are redeemed or when they reach their final maturity. Alternatively, individuals can elect to report interest each year as it accrues.

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ARTICLE: *IRC Section 454* establishes the rules for reporting interest income for Series E, EE and I savings bonds (savings bonds). In general, interest from savings bonds is reported at the time the bonds are redeemed or when they reach their final maturity. Alternatively, individuals can elect to report interest each year as it accrues.

As such, savings bonds are an excellent investment vehicle from a tax standpoint, because they provide the investor with flexibility in terms of when to report interest income.

Regardless of the election made for federal income tax purposes, this interest income is exempt for state and local income taxes.

Tax planning deferring the reporting of interest income. Most individuals will defer reporting of interest earned on savings bonds because there is no Form 1099 issued to them as there is for most forms of interest income, and there are no quarterly statements provided. For those individuals who have chosen to defer reporting interest, there is a strong likelihood that many of them may redeem these bonds in a year when they have a lesser amount of income. For instance, this could occur when an individual retires, or has lost his or her job. Consequently, he or she will have a financial need to redeem these bonds, and most likely will be in a lower tax bracket. Thus, the tax burden should be minimal. This is important because the accrued interest earned up until the time of redemption could represent many years of accrual. If a taxpayer were to be in a higher tax bracket than usual in the year that savings bonds are redeemed, the tax burden could be very substantial.

Tax planning reporting each years accrued interest. In some instances, reporting each years accrued interest is the preferred strategy. For instance, children who are given savings bonds as gifts should consider reporting each years accrued interest on their tax returns. If the total of their accrued interest plus other unearned income is less than \$1,700, the interest from the savings bonds will be taxed at a rate of no more than 10%. On the other hand, if a child will have

more than \$1,700 of unearned income, the kiddie tax will apply. As such, any unearned income in excess of \$1,700 will be taxed at his or her parents top tax rate. Therefore, if a child will have less than \$1,700 of unearned income taking into account interest from savings bonds, the interest should be reported annually. Then, in the year that he or she redeems the bonds, the only interest to be reported will be the interest that accrued in the year of the redemption. Presumably, the child will then be an adult in a higher tax bracket than he or she was as a child. Since this election requires only that the current years interest be reported, rather than all of the accrued interest over the length of time that the bond was held, the tax under this election will be much less than if all the accrued interest over the entire holding period was required to be reported in the year of redemption.

Election to switch reporting methods. *IRC Section 454(a)* provides that an individual who has elected to defer reporting interest may elect to report all of the accrued interest on bonds through the end of the year in which the election to switch was made. Then, in succeeding years, the individual must report the accrued interest for each year. It should be pointed out if this election is made, it applies to all savings bonds that an individual owns. Thus, an individual who owns many savings bonds cannot pick-and-choose which bonds he or she would like the election to apply to.

This election is advantageous for an individual who owns savings bonds and will be in a much higher income tax bracket in the year that he or she plans to redeem these bonds.

Example: Melissa is a resident at a local hospital. She has been given substantial amounts of savings bonds as gifts for various occasions. In two years, she will join a medical practice where her income will increase fivefold. After joining the medical practice, she plans to redeem her savings bonds, and use the proceeds as a down payment on a house. By making the switch while she is still a resident, the tax burden will be substantially less than waiting to report all of the interest in the year of redemption, when she will be in a substantially higher tax bracket. Of course, the interest earned in the year of redemption will be taxed at her rate for that particular year. However, she can still time the switch so that most of the interest earned over the life of the bond will be taxed at a lower rate while she is still a resident.

The election to switch reporting is also advantageous when an individual has excess investment interest expense. That is, *IRC Section 163(d)* limits the deduction for investment interest expense to the amount of an individuals investment interest income. Although any excess amount can be carried forward for an indefinite period of time, making this election has two advantages. First, the accrued savings bond interest reported in the year of the switch will be offset by the investment interest expense that would have been carried forward. Second, in the year the bonds are redeemed, only the amount of interest earned in the year of the redemption needs to be reported.

Electing to report interest on decedents final tax return. There is a special election for a decedent who elected to defer the reporting of accrued interest on savings bonds. The personal representative of an estate can elect to report all of the accrued interest up to the date of death on the decedents final income tax return. Then, when an heir eventually redeems the bonds, the only interest that the heir will be required to report will be the interest that has accrued from the date of the decedents death [see *Rev. Rul. 68-145, 1968-1 CB 203*].

Example: Raymond has invested a substantial amount of money in savings bonds over a long period of time. He died early in the current year and will be in the 15% income tax bracket. His only heir is Jason who is in the 35% income tax bracket. Assume that the personal representative of Raymonds estate elects to report all of the accrued savings bonds interest up to the date of Raymonds death. Accordingly, the interest will be taxed at just the 15% income tax bracket. A couple of years later, Jason redeems these bonds. Since the election was made to report all of the accrued interest up to the date of Raymonds death, Jason has to only report the interest that accrued after Raymond died. Since Jason is in a higher bracket than Raymond, the election minimized the total income tax burden on the interest by including more of the interest in Raymonds lower bracket, and a lesser amount of interest income in Jasons higher bracket.

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Rhoades on Tax Treatment of Stock Options Granted to Executives Who are Abroad

2008 Emerging Issues 1220

Rhoades on Tax Treatment of Stock Options Granted to Executives Who are Abroad

By Rufus V. Rhoades

November 29, 2007

SUMMARY: Rufus v. Rhoades, Esq., co-author of Rhoades & Langer, U.S. International Taxation and Tax Treaties, discusses both qualified and non-qualified stock options given to a peripatetic executive. He focuses on the foreign and domestic tax impact on the executive when he receives those options while stationed in both a treaty and a non-treaty country.

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ARTICLE: The Problem. Peripatetic executives are finding that stock options are income in most countries of the world. How and when, not to mention at what rate, they are taxed varies from country to country.

Example: Susan Peterson works for Microsoft, Inc., a Delaware corporation, in its Human Resources department. She was hired in late 2005 and, in early 2007, was posted to Brazil. While a resident of Brazil, she was given a qualified stock option by Microsoft. She stayed in Brazil until late 2009, when she returned to the home office. She exercised her option in 2010.

Lets assume that Brazil treats the actual grant of the option as an income item so Susan was taxed by Brazil on the value of the option when it was granted. That tax is, in effect, not creditable, because Brazil is taxing an item that is not income for U.S. purposes, so Susan does not have any foreign source income against which to claim a credit.

Variations on that theme would include issuance of nonqualified options and posting the executive to a treaty country.

Qualified Stock Options. A qualified option (that is, one issued pursuant to IRC §§ 421-423) is not taxable to the employee under U.S. rules until the employee disposes of the stock. Under foreign rules, a country may tax the benefits arising from an employee receiving a stock option upon the occurrence of one or, perhaps, more of the following events:

- (1) When the option is granted;
- (2) When the option vests (generally, the passage of time);
- (3) When any restrictions to the sale of the underlying stock are removed; or

- (4) When the underlying shares are sold.

Non-Treaty Country. The employee who is posted to a non-treaty country will receive her qualified option in one of three timeframes: before being posted, during posting, and after returning home. In each case, the compensation portion of the option will relate to services rendered both in the United States and in the foreign country where the employee is/was posted.

An additional complicating factor arises when the employee moves from one foreign country to another, carrying her options with her.

The question that the employer and the employee/optionee face is how to handle the foreign tax. The reason that the question is addressed to those two is that the employer is unlikely to obtain any relief from the foreign taxing agency if the agency already has a policy in place regarding stock options.

So, let's look at some alternatives.

(1) Both the employer and the employee could time the option so that the issue simply does not arise. That requires both of them (but, more particularly, the employer) to be aware of what the rules are concerning stock options in the jurisdiction to which the employee is posted. Understanding those rules also includes being aware of the rules relating to deductibility of the option as compensation.

(2) The employer and the employee could agree to ignore the local rule as to stock options and simply not disclose to the local taxing agency that the employee has a stock option. The drawback to that plan is rather obvious. If the agreement is discovered, the foreign country could take any number of harsh steps as to both the employee and the employer.

(3) The employer could modify its tax equalization plan to include increasing the employee's compensation to pick up the additional tax arising from the employee receiving, holding, or exercising the option.

(4) The employer could attempt to enter into a special agreement with the foreign taxing agency to specifically treat the options issued to the employer's employees in a manner that is more beneficial to the employee. For example, since a major issue relates to timing (the foreign tax is paid in one year and the U.S. tax on that income in a later year), perhaps the foreign tax agency might agree to assess the tax in the same year that the United States does. That won't fully resolve the issue, but it would be a start.

Treaty Country. Most income tax treaties have an article dealing with income from employment. Those articles, however, are silent on the subject of stock options. Indeed, Treasury has only recently turned to the issue of stock options in the treaty context. In its explanation of Article 14 (Income from Employment) of the 2006 U.S. Model Income Tax Treaty, Treasury states that the provisions of that article apply to the exercise of an employee stock option, even if the employee has left the source country. [See *Rhoades & Langer, U.S. International Taxation and Tax Treaties*, paragraph 1 of Article 14, at MOD-2 § 1.14.]

Similarly, to avoid double taxation on the exercise of an employee stock option, Notes to the United Kingdom-United States Income Tax Convention provide that the contracting state of which the employee is not a resident when the option is exercised will tax only that proportion of the gain that relates to the period of employment as to which the option was in effect and that the employee was employed in that country. [See *Rhoades & Langer, U.S. International Taxation and Tax Treaties*, Notes with reference to Article 14 (Income From Employment) at UNIK § 1.31[10].] Treasury's technical explanation of the Belgium treaty is similar in approach. Presumably, its technical explanation of the recent Iceland income tax treaty will follow suit.

The Organisation for Economic Co-operation and Development (OECD) suggests another approach to the problem of identifying and allocating income related to stock options: that treaty partners should separate the compensation portion of the option from the investment portion and let the host country tax only the compensation portion. [See OECD, Cross-Border Income Tax Issues Arising from Employee Stock-Option Plans, Paragraph 17 (2002).]

None of those approaches completely solves the tax credit problem, however. Even under the United Kingdom-United States income tax treaty approach, Susan Peterson (from the example above) could have received her qualified option prior to being posted to the United Kingdom, spent three of the necessary five years (before vesting) in the United Kingdom, and then, after returning to the United States, exercise the option. If the United Kingdom takes the position that some of Susans gain is taxable in the United Kingdom, she will not receive any form of foreign tax credit for that tax since the exercise of the option was not a tax recognition event as to her in the United States.

Nonqualified Stock Options. A nonqualified option is an option to purchase stock granted in connection with the optionees performance of services. That option will be treated as compensation when received if the option has a readily ascertainable fair market value under *Treas. Reg. § 1.83-7(a)* -- a condition rarely, if ever, met. Far more commonly, the employee only realizes income when he exercises the option, the amount of income being the fair market value of the stock received as a result of the exercise, less what he paid for the stock upon exercise.

In what seems, at least initially, counterintuitive, the foreign tax credit rules are more beneficial to the peripatetic executive who has received a nonqualified option than they are to one who has received a qualified option. The reason is that the amount treated as income by the foreign country will frequently coincide with when those amounts are income under U.S. rules.

Example: Susan Peterson is given a nonqualified stock option one year before she is posted to France. After three years in France, she exercises the option, thereby generating gain to herself not only for U.S. purposes, but also for French tax purposes. Assuming that her income is \$100,000 from the exercise of the option, she will be able to treat \$75,000 as foreign source income (the other \$25,000 is U.S. source, since she will allocate the income for source purposes on a pro rata basis). Susan will be entitled to a full foreign tax credit if France follows suit and only treats \$75,000 as income; if, however, France treats the full amount of the gain as taxable income, at least Susan will be entitled to a partial foreign tax credit, which is a whole lot better than if the option were qualified.

Alternative Minimum Tax. A taxpayer who exercises a qualified stock option is subject to the alternative minimum tax (AMT) under *IRC § 56(b)(3)*. The taxpayer may, however, claim the full foreign tax credit against his AMT to the extent that the taxpayer is otherwise entitled to the credit. Nevertheless, the AMT is still a potential hazard for employees who exercise qualified stock options issued by corporations that have volatile stock.

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Rhoades on IRS Summonses Issued to Third Parties per a Treaty Partners Request

2008 Emerging Issues 1222

Rhoades on IRS Summonses Issued to Third Parties per a Treaty Partners Request

By Rufus v. Rhoades

November 29, 2007

SUMMARY: Rufus v. Rhoades, Esq., co-author of the treatise *Rhoades & Langer, U.S. International Taxation and Tax Treaties*, discusses the law supporting a request for documents from a third party (usually a bank) in response to a request by a treaty country partner, such as France or Canada. He reviews how one can defeat such a request and the likelihood of success, in the face of *United States v. Hiley* and the cases that preceded it.

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ARTICLE: The Case. *United States v. Hiley*, No. 07cv1353-IEG (LSP), 2007 U.S. Dist. LEXIS 73542 (S.D. Cal. Oct. 2, 2007), deals with whether a summons issued by the Internal Revenue Service at the request of the Canada Revenue Agency (CRA) was enforceable. The CRA was investigating the Banyan Tree Foundation, a Canadian charity and some of its donors. The taxpayer was connected to the Foundation through loans that PNH Financial, Inc. (PNH) had assertedly made to the Foundations donors. The Service issued a summons to PNH (defendant Hiley was PNHs sole shareholder) at the CRAs request which the CRA made as a step in its investigation of the Foundation. The request was made under Article 27 of the United States-Canada Income Tax Convention. (That treaty and all U.S. income tax conventions are included in *Rhoades & Langer, U.S. International Taxation and Tax Treaties* (LexisNexis Matthew Bender.)

Hiley and PNH objected to the summons on the ground that since the Foundation was a charity it could not possibly have a tax liability. The court found that argument to be irrelevant because the only question before the court was whether or not the Service had issued the summons in good faith, citing *United States v. Powell*, 379 U.S. 48 (1964). (*Powell* did not involve a tax treaty.)

The *Hiley* decision is not, in and of itself, particularly noteworthy. Summonses issued by the Service pursuant to treaty obligations have been enforced before. See *United States v. Stuart*, 489 U.S. 353 (1989) (Canadian income tax treaty); *Lidas, Inc. v. United States*, 238 F.3d 1076 (9th Cir. 2001) (French income tax treaty); *Mazurek v. United States*, 271 F.3d 226 (5th Cir. 2001) (French income tax treaty). What prompts this commentary is the increasing frequency with which the Service is issuing summonses at the request of our treaty partners. That activity, in turn, raises some questions about scope and consistency.

Background of Treaty Provisions. Virtually every income tax treaty between the United States and its treaty

partners has an exchange of information clause. For example, one of our oldest treaties, the United States-Egypt income tax treaty, contains such a clause. [See *Rhoades & Langer, U.S. International Taxation and Tax Treaties*, Article 28, at EGPT § 1.28.] Some are broader than others. For example, the Canada income tax treaty requires an exchange of information about local taxes, as well as federal taxes. [See *Rhoades & Langer, U.S. International Taxation and Tax Treaties*, paragraph 1 of Article XXVII, at CANA § 1.27.]

The coverage of the typical exchange of information clause will include all taxes imposed by one of the contracting states, even though the treaty will otherwise be limited only to a certain few taxes (such as income taxes and, perhaps, excise taxes). For example, the United States-France income tax treaty is limited to federal income taxes on the U.S. side (excluding social security taxes) and excise taxes imposed on insurance premiums. [See *Rhoades & Langer, U.S. International Taxation and Tax Treaties*, paragraph 1(a) of Article 2, at FRAN § 1.02.] The exchange of information clause, however, would encompass other federal taxes, such as social security taxes, stamp taxes, and excise taxes.

Challenge to the Services Subpoena. A challenge to a subpoena issued by the Internal Revenue Service in response to a treaty countrys request for information is most likely not going to succeed. Although we have not looked at every case, the dozen or so that we did review were all decided in the Services favor. The courts clearly read the provisions of the income tax treaty on the question very broadly. The reason that the person served with the subpoena has such a heavy burden to carry, should he elect to fight it, is that the respondent to the subpoena must demonstrate that the Service did not issue the subpoena in good faith, as that concept is set forth in *Powell*.

Under *Powell*, the Service may establish its case by affidavit of Service personnel, the fundamental thrust of which is that (a) the subpoena is the result of a legitimate request by a treaty partner, (b) the requested information is not in the possession of the Service or the treaty partner, and (c) the requested information *may* be relevant to a determination of some named partys foreign tax liability.

That is not much of a burden for the Service to carry. Indeed, historically, the Service merely supplies a couple of those affidavits to the court saying all of that and the case is effectively over.

The respondent who is able to demonstrate that the subpoena was issued for an improper purpose, such as to harass the respondent or to pressure him to settle a collateral dispute (see *United States v. Powell*, 379 U.S. 48, 58 (1964)), may be successful in fighting the subpoena. The problem is that, within the context of the treaty, virtually all subpoenas are issued for a proper -- not improper -- purpose. Indeed, apparently the court will not hear an argument that the information request is improper under the requesting countrys laws. [See *Mazurek v. United States*, 271 F.3d 226 (5th Cir. 2001).] The only question that the court will address is whether the Internal Revenue Services compliance with the treaty partners request is legitimate.

Collection Assistance. The Services involvement with collection of a foreign countrys tax judgment is a totally different matter. Only five income tax treaties have comprehensive tax collection provisions: Canada, Denmark, France, the Netherlands, and Sweden. Other treaties have a limited collection provision. For example, the proposed Belgium income tax treaty provides that each party will assist the other in the collection of taxes so long as the collection efforts are undertaken to ensure that an exemption or reduced rate under the treaty would not be granted to one not entitled thereto. [See *Rhoades & Langer, U.S. International Taxation and Tax Treaties*, Article 26, at BELG § 2.26.] The 2006 U.S. Model Income Tax Treaty has a similar provision. [See *Rhoades & Langer, U.S. International Taxation and Tax Treaties*, paragraph 7 of Article 26, at MOD-1 § 1.26.]

Thus, in the collection arena, we find three possible rules. The basic non-treaty rule is that the United States still follows (although, not uniformly) what has long been known as the revenue rule, which states that a country will not enforce a tax judgment of another country. [See *Rhoades & Langer, U.S. International Taxation and Tax Treaties*, § 61.01[1].] The revenue rule is not statutory; it is old common law. [For a recent expression of the rule, see *Republic of Honduras v. Philip Morris Cos*, 341 F.3d 1253 (11th Cir. 2003).]

Two, the limited treaty rule in which enforcement of a tax by a treaty partner is required if the tax is similar to that described in the proposed Belgium income tax treaty. Some treaties have that clause (see the Japan-United States income tax treaty, *Rhoades & Langer, U.S. International Taxation and Tax Treaties*, Article 27, at JAPN § 1.27) while some do not (the United States-United Kingdom income tax treaty does not have a collection assistance clause). The clauses are brief and devoid of any procedural instructions. About 23 income tax treaties have that form of clause.

Three, the five treaties with comprehensive collection assistance provisions are: Canada, Denmark, France, the Netherlands, and Sweden. The clauses vary from one another so do not assume that by reading one, you have read them all. For example, only income taxes are covered in the Denmark, France, and Sweden treaties, while all taxes are covered by the Canada and France treaties. Also, the Canada and Denmark treaties treat the foreign tax obligation as if it were an assessment by the Internal Revenue Service, while that conclusion is not as clear under the other three treaties.

Summary. While exchange of information is fairly universal within the income tax treaty universe, tax collection assistance is generally quite restricted. Furthermore, exchange of information without a treaty's authorization is clearly prohibited.

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Chodorow -- Arizona State University College of Law on Merlo v. Commissioner

2008 Emerging Issues 875

Chodorow -- Arizona State University College of Law on Merlo v. Commissioner

By Adam Chodorow

November 5, 2007

SUMMARY: In *Merlo*, a taxpayer's exercise of incentive stock options in 2000 resulted in a huge tax bill when he was forced to recognize gain that year under the alternative minimum tax (AMT) rules. When the stock became worthless in 2001, the taxpayer tried to carry the capital loss back to 2000 and apply it against his ordinary AMT income. The U.S. Tax Court held for the IRS, saying that the AMT rules do not allow such a carry back..

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ARTICLE: Tax Court Holds that under AMT rules, Taxpayer May Not Carry Back Loss to Previous Tax Years & Apply It Against Ordinary AMT Income in Those Years

This decision offers taxpayers some valuable lessons about the dreaded alternative minimum tax (AMT) and its impact when a taxpayer exercises stock options:

Lesson #1: Recognizing gain arising from incentive stock options (ISOs) occurs at different times under federal income tax rules and the AMT rules.

For purposes of computing federal income tax, a taxpayer would not recognize gain until the year in which he or she sells the stock which resulted from exercising the ISOs. n1 By contrast, *for purposes of the alternative minimum tax*, gain is recognized in the year in which the ISOs are exercised.

In the instant case, this dual system of income recognition had disastrous effects for taxpayer Merlo:

At the time he exercised the ISOs (i.e., 2000), the stock was valued at approximately \$1 million. (Merlo had paid a mere \$10,000 for these ISOs.) Thus, for purposes of the AMT, Merlo was required to include, as ordinary income, approximately \$990,000 in income for the year 2000 (the difference between the cost of the stock and its value at the time of exercise). This caused his AMT liability to exceed his regular tax liability substantially, and obligated him to pay significantly more in taxes for 2000 than he would have otherwise. By the following year (2001), the company had gone bankrupt, rendering the stock worthless and Merlo unemployed. To add insult to injury, the worthless stock that led to the gain in 2000 was now unavailable to pay the tax owed.

Lesson #2: Under the AMT rules, a taxpayer may not carry back a loss to previous tax years, applying it against

ordinary AMT income in those years.

The taxpayer suffered a huge capital loss on the stock for the year 2001, when it became worthless. Before the Tax Court, he argued that the AMT rules allowed him to use the 2001 capital loss to offset the ordinary AMT income reported for 2000. The Tax Court wasn't buying. It rejected all of his arguments, leaving Merlo with a large tax bill for 2000 and a capital loss for 2001 that he could only carry forward to offset future capital gains. n2

Lesson #3: Whether a taxpayer receives statutory stock options (ISOs) OR non-statutory stock options, the AMT rules require the recognition of income in the year in which the options are exercised.

This case is instructive for anyone who receives stock options, regardless of whether they qualify as statutory stock options under *I.R.C. § 422*, or whether they are non-statutory options.

Lesson #4: The distinction between non-statutory stock options and statutory stock options (ISOs).

Under the regular income tax rules, employee stock options are generally not included in an employee's income at the time they are granted.

If the options are non-statutory, taxpayers must recognize gain in the year in which they exercise the options. n3 The amount of gain, in such cases, is the difference between the amount paid for the options and the value of the stock on the date of exercise. The gain on exercise is considered *ordinary* income. Many taxpayers who believe their stock will continue to rise retain the stock long after exercise. Any subsequent gain or loss upon sale is deemed to be capital.

The tax treatment for ISOs is significantly better. *I.R.C. Sections 421 and 422* allow taxpayers to exclude gains from ISOs until they sell the stock in question, assuming the taxpayer holds the stock for the requisite period. The gain is then determined based on sales price, as opposed to the stock's price at the time of exercise, and is treated as capital rather than ordinary. This rule

(1) allows for the deferral of income,

(2) allows taxpayers to pay lower capital gains rates, and

(3) prevents the liquidity problems that can rise when taxpayers retain the stock after exercise and it subsequently declines in value, since any post-exercise reduction in value will simply reduce the amount of tax owed. n4

For AMT purposes, Congress has repealed the tax preference for ISOs and mandated that ISOs will be taxed in the same manner as non-statutory stock options. Thus, taxpayers and their advisors must determine AMT income by including the difference between the exercise price and fair market value in income in the year in which the options are exercised. If a taxpayer's AMT liability exceeds his regular tax liability, the taxpayer may owe significantly more in tax than he might have expected. *Merlo* makes clear that the normal limitations regarding capital gains and net operating losses apply when determining income for AMT purposes. Thus, taxpayers may not use capital losses attributable to the sale of stock to offset the ordinary gains associated with the exercise of stock options.

Tax-Planning Tips.

To avoid the tax traps described above, tax practitioners should advise clients who receive ISOs or non-statutory stock options to sell just enough shares in the year of exercise to produce a revenue source sufficient to pay off the tax liability associated with the exercise. Alternatively, such clients should be advised to set aside other assets to do so.

In the case of ISOs, selling *all* of the stock may be prudent if the stock price falls shortly after exercise, but within the same year. Why? Because *I.R.C. § 56(b)(3)* permits taxpayers to calculate gain for AMT purposes using the sales price, as opposed to the exercise price, where the sale occurs in the year of exercise. n5 True, the income would still be treated as ordinary, but there would be less of it than if the amount was calculated using the exercise price. Accordingly,

taxpayers and their advisors should carefully consider this approach when formulating a strategy for exercising ISOs and selling the resulting stock.

Conclusion.

The tax code is filled with preferences designed to accomplish policy objectives. The AMT rescinds many of these preferences in an effort to ensure that taxpayers pay at least some minimum amount of tax. Tax professionals would be well served to remember that, in *Merlo*, the Tax Court announced that, even though the AMT rules may result in outcomes that seem unfair, or run counter to the policy goals reflected in various tax preferences or other rules, any solution to such problems must come from Congress. The courts will not bend the rules to resolve apparent conflicts between the policies underlying the regular and AMT tax provisions. Nor will they attempt to fix the alleged inequities that arise as a result of the AMT.

For in-depth coverage of the interaction of the AMT and stock options, see *Tax Planning for the Alternative Minimum Tax*, Chapter 6 (LexisNexis Matthew Bender 2007).

For an overall examination of stock options, see *The LexisNexis Tax Advisor Federal Topical*, Chapters 1B:6 (Incentive Stock Options) and 1B:7 (Non-qualified Stock Options).

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n1 ISOs are stock options that qualify for special tax treatment under *I.R.C. 421* and *422* and are often referred to as statutory stock options. Stock options that fail to qualify under this section are commonly referred to as non-statutory stock options.

n2 Under *I.R.C. § 1211*, individual taxpayers may actually deduct up to \$3,000 per year in excess of their capital gains.

n3 If the stock one acquires in the exercise of an option is non-transferable or subject to substantial risk of forfeiture, income need not be recognized until the stock becomes transferable or the risk lapses. *I.R.C. § 83*.

n4 The requisite period is 2 years from the option grant and 1 year from exercise. *I.R.C. § 422(c)*. If stock is sold before the requisite period, then the taxpayer must include, as ordinary income, the difference between the price at exercise and the option price. Any gain or loss determined using the exercise price as the basis, and the sales price as the amount realized, would be treated as capital.

n5 Unfortunately for the taxpayer in *Merlo*, his stock declined in value in the year *after* he exercised his options, and this avenue was not available to him.

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Johnson of the University of Nevada Law School on Lattera v. Commissioner

2008 Emerging Issues 876

Johnson of the University of Nevada Law School on Lattera v. Commissioner

By Steve Johnson

November 5, 2007

SUMMARY: In *Lattera*, the U.S. Court of Appeals for the Third Circuit held that a lump-sum payment received by a lottery winner who sold his right to future lottery payments was ordinary income, and not capital gain. In his Emerging Issues Analysis, Professor Steve Johnson explains why *Lattera* matters to the tax community.

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ARTICLE: *Lattera v. Commissioner*, 437 F.3d 399 (3d Cir. Apr. 5, 2006), aff'g *T.C. Memo. 2004-216*, cert. petition filed, No. 06-947 (Dec. 8, 2006)

Third Circuit Weighs in on Whether Lump-Sum Payment Received by Lottery Winner who Sells Right to Future Lottery Payments Is Ordinary Income or Capital Gain

Trying to distinguish between capital and ordinary transactions has long been a "troublesome question . . . recurring, vexing and oftentimes elusive." *Biedenharn Realty Co., Inc. v. United States*, 526 F.2d at 414 (5th Cir.) (citations omitted), cert. denied, 429 U.S. 819 (1976).

One especially difficult area is the substitute-for-ordinary-income doctrine. Despite the seemingly broad definition of "capital asset" in *IRC* § 1221, cases going back many generations have stated that "capital asset" should be defined narrowly in keeping with a perceived Congressional purpose of affording preferential rates only to gains from realization in one year "of appreciation in value accrued over a substantial period of time." *Commissioner v. Gillette Motor Transportation, Inc.*, 364 U.S. at 134 (1960); see, e.g., *Hort v. Commissioner*, 313 U.S. at 31 (1941).

In 1991, the Latteras won nearly \$9.6 million from the Pennsylvania Lottery. It was payable in 26 annual installments of about \$370,000 each. After receiving nine installments, the Latteras sold the right to the remaining 17 installments to a finance company, for a single payment of about \$3.4 million. They reported this amount as long-term capital gain. The Tax Court agreed with the IRS that the amount is ordinary income, and the Third Circuit affirmed, reasoning that the installment payments from the PA Lottery would have been ordinary income. They could not be converted into capital gain, the courts held, merely by selling the future income stream for a lump sum.

Why *Lattera* Matters. There have been many lottery cases, and the IRS has won them all. *E.g.*, *Watkins v.*

Commissioner, 447 F.3d 1269 (10th Cir. 2006); *United States v. Maginnis*, 356 F.3d 1179 (9th Cir. 2004). Nonetheless, *Lattera* is important. The substitute-for-ordinary-income doctrine is badly flawed. It rests on an unsatisfactory theory which cannot yield wholly-consistent results. The *Lattera* Court recognized that fact, and it proposed a new test. If this test becomes widely accepted within other circuits, it could apply to many types of substitutes, not just substitutes for lottery payments. If the *Lattera* test is not widely accepted, then the tax community will have to continue to drive on a punctured tire while still seeking the right patch for it.

The problem with the substitute-for-ordinary-income doctrine is that it potentially swallows up the capital gains/losses regime. It cannot be that a single payment of \$3.4 million is ordinary simply because it replaces what would have been a stream of ordinary income payments. For example, sales of stocks and bonds typically are accorded capital treatment even though, unsold, the stocks and bonds would produce dividends or interest (ordinary income for most of our tax history).

The Ninth Circuit *Maginnis* case, *supra*, tried to respond to this difficulty through a caseby- case approach based on factors that it described as "crucial" in that case but not necessarily "dispositive in all cases." Specifically, "Maginnis (1) did not make any underlying investment of capital in return for the receipt of his lottery right, and (2) the sale of his right did not reflect an accretion in value over cost to any underlying asset Maginnis held." 356 F.3d at 1183.

Rightly rejecting the *Maginnis* approach because it provides insufficient guidance, *Lattera* offered its own refinement. Drawing on securities law cases, *Lattera* proposed as a starting point a "family resemblance test." Does the item in question (here, a payment of \$3.4 million) resemble items known to be capital (like stocks and other securities), or does it resemble items known to be ordinary (like rent and interest)? If the item resembles one pole or the other, it will be so classified. 437 F.3d at 405-06.

For items that fall in between the two poles like contracts and payment rights two factors would be used: (1) the type of carve-out; and (2) the character of the asset. "Horizontal" carve-outs (disposing of part of the taxpayer's interest in the property) would tend towards ordinary treatment, while "vertical" carve-outs (complete dispositions, as in this case) would be either capital or ordinary depending on the character of the asset. Assets representing a right to earn income in the future would be capital while those representing a right to receive income already earned would be ordinary. *Id.* at 406-08.

Applying this test to the *Lattera* facts, the Third Circuit concluded that:

- (1) the payment resembled neither pole;
- (2) this was a vertical carve-out; and
- (2) the payment was for income already earned (when the lottery was won).

Accordingly, ordinary treatment was appropriate. *Id.* at 409-10.

I doubt that the *Lattera* test will become settled law. The "family resemblance" portion gives an answer only in easy cases. The two factors for problematic in-between cases likely would generate considerable uncertainty in application, rather like the "fruit and tree" metaphor that has confused assignment-of-income cases and rulings. See *Lucas v. Earl*, 281 U.S. at 115 (1930). *Watkins*, *supra*, held for the IRS in a later lottery case while "declin[ing] to enter the fray" between *Maginnis* and *Lattera*. 447 F.3d at 1273. *Lattera*, I believe, has not shown us the path out of dark doctrinal woods. It should, however, stimulate debate about where the right path may be located.

For a thorough discussion of the federal income tax treatment of lottery winnings, see *LexisNexis Tax Advisor Federal Topical*, Chapter 1A:7, Prizes, Awards and Scholarships.

For a thorough discussion of capital gains and losses, see *LexisNexis Tax Advisor Federal Topical*, Chapter

1G:8, Capital Gains and Losses.

Primary source. See Internal Revenue Code, Section 1221(a), 26 USCS § 1221(a) for definition of "capital asset."

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