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CHAIR'S MESSAGE

The Tax Section has a lot going on! Thanks so much to the Officers, Council Members, and Committee Chairs and Vice-Chairs for devoting their time and using their knowledge, experience, and relationships to advance our goals – education, better laws, pro bono, enhanced profile, future leaders, outreach, and having fun!

Education

24/7 Free CLE Library. As a Tax Section member, you may access the Tax Section's 24/7 library of free CLE Webcast programs at any time through the Tax Section website. The following programs from the 14th Annual International Tax Symposium have been submitted for addition to the 24/7 library:

- International Tax Update, David L. Forst, Fenwick & West LLP
- IRS Initiatives in Compliance and Audits, Robert Morrison, Counsel with Internal Revenue Service's LB&I
- Transfer Pricing Update, Dale Bond, Nick Raby, and David Swenson, PricewaterhouseCoopers LLP
- International Tax Planning Strategies, Melinda R. Phelan and Jonathan Martin, Baker & McKenzie LLP
- Navigating the U.S. Withholding Regulations and Surviving IRS Examination, Deidra W. Hubenak, Looper Reed & McGraw, PC

The following additional programs have been submitted for inclusion in the 24/7 library:

- Stanley Johanson's Recent Developments Affecting Estate Planning
- Brian Cororve's Planning for Spouses in 2011 and 2012 – Opportunities and Pitfalls
- Stefnee Ashlock's Estate Tax Update

Thanks to Bill Elliott, you may now view videotaped interviews with Texas Tax Legends such as Buford Berry, Richard Freling, Ron Mankoff, Bob Davis, and former IRS Commissioner Larry Gibbs. If you have any questions, please contact J. Michael Threet, the head of our CLE Committee, at (214) 969-2795 or mthreet@akingump.com.

Live CLE. The Tax Section sponsors and conducts many live CLE programs.

- The Advanced Tax Law Program conducted by TexasBarCLE took place in Houston on August 17-19.
- The 14th Annual International Tax Symposium was held at The Center for American & International Law in Plano, Texas on November 4th, 2011. Many thanks to the Vice-Chair of the International Tax Committee, Deidra Hubenak for organizing another successful Symposium!
- The annual Property Tax Seminar will be held on March 26, 2012, at the Thompson Conference Center at the University of Texas. Regular registration is $60 until March 15th. You may also pay $75 at the door, but we ask that you still

RSVP by fax or by e-mail to Ashley Creighton. If you have any questions, you may call Melinda Blackwell at 972-407-6599. We are applying for 6.0 hours of CLE, with 1.0 of that being ethics.

- The Texas Federal Tax Institute will be held at the Hyatt Hill Country in San Antonio on June 7 and 8, 2012. The Outstanding Texas Tax Lawyer presentation will take place during the lunch on June 8th.

Tax App. The Tax Section is working hard with the Computer & Technology Section to develop a "Tax App" to access Federal and Texas state tax materials on your IPhone, IPad, and IPod Touch. There will also be a web-based app. The Tax App will be the first of its kind and will give you fingertip access to the Internal Revenue Code, Treasury Regulations, tax treaties, AFRs, IRS guidance, cases, Texas Tax Code, Texas Administrative Code, and much more. We hope to roll out the Tax App very soon!

Texas Tax Lawyer. Thanks to the hard work of Lisa Rossmiller and Rob Morris, the Tax Section publishes three issues of *The Texas Tax Lawyer* each year. The *Texas Tax Lawyer* is distributed to members electronically and, upon request, in hardcopy. The issues include articles on hot topics, substantive outlines from Committee Webcasts, COGS submissions, and annotated forms. We have added a "Practitioners' Corner" to our website, which includes forms and other useful information from past issues of *The Texas Tax Lawyer*. We are working towards making the past issues of *The Texas Tax Lawyer* full-text searchable and hope to roll out this benefit to you soon! Please contact Lisa at lrossmiller@fulbright.com if you would like to submit an article.

Texas Bar Journal. Check out the Year in Review, Tax Law, in the January 2012 issue of the *Texas Bar Journal*. Many thanks to Heather Panick for preparing the article.

Better Laws

COGS Projects. The Section continuously seeks to improve the substance and administration of state and federal tax laws through its Committee on Government Submissions ("COGS") process. The COGS process also enhances the profile of our members within the tax community and furthers the national reputation of the Texas tax bar. Under the leadership of our COGS Chair, Stephanie Schroepfer, we have submitted four COGS projects this year regarding (i) IRS Notice 2011-62 proposed revisions to procedures relating to *ex parte* communications between Appeals and other IRS functions; (ii) the application of section 10101(d) of the Patient Protection and Affordable Care Act, P.L. 111-148, nondiscrimination standards to insured employer group health plans; (iii) the anti-churning rules of Section 197 of the Internal Revenue Code; and (iv) the proposed new definition of "governmental plan" for purposes of Section 414(d) of the Internal Revenue Code. Many thanks to the Tax Controversy Committee and Joel Crouch, Robert Probasco, Stephanie Mongiello, and Emily Parker; the Employee Benefits Committee and Susan Wetzel, Henry Talavera, Stephanie Schroepfer, David D'Alessandro, Neal Thomas, and Felecia Finston; and the Corporate Tax Committee and Jeffrey M. Blair, Eric Larson, David S. Peck, and R. David Wheat. If you wish to get involved with on ongoing project or have ideas for leading one yourself, please contact Stephanie Schroepfer at (713) 651-5591 or sschroepfer@fulbright.com.

Pro Bono

- ***2012 Volunteer Income Tax Assistance (VITA) Program***. Become a VITA Program volunteer now! Go to the Tax Section's website for information on training and assistance locations or contact Vicki L. Rees at (512) 499-0902 or vrees@pittmanfink.com.

- ***The Tax Court Program***. The Tax Section assists pro se taxpayers during Tax Court calendar calls in Dallas, Houston, Lubbock, El Paso, and San Antonio. Check the calendar on the Tax Section's website for the next calendar call in your city and contact our Pro Bono Chair Gerald Brantley at 512 -637-1045 or gerald@geraldbrantley.com or Bob Probasco at 214-969-1503 or robert.probasco@tklaw.com to assist.

Enhanced Profile

2012 Outstanding Texas Tax Lawyer Award. Congratulations to Emily A. Parker of Thompson & Knight L.L.P. for being selected as our Outstanding Texas Tax Lawyer for 2012! This is the highest award given by the State Bar of Texas Tax Section, and Parker is the ninth recipient of the award. This award recognizes Parker for her outstanding reputation, expertise, and professionalism in the practice of tax law; her leadership in bar associations; her significant contributions to the general welfare of the community; her reputation for ethics; and her mentorship of other tax professionals.

Parker has served our profession and government and her law firm and clients with distinction through a wide variety of roles. Parker earned her law degree with honors in 1973 from the Southern Methodist University School of Law (now known as SMU Dedman School of Law) and was selected as the school's 2007-2008 Distinguished Alumni for Government Service. Parker has represented large corporate taxpayers in a number of landmark cases in the energy industry and the area of estate taxation. From 2002 to 2004, Parker served as Deputy Chief Counsel (Operations) and for almost a year served as Acting Chief Counsel of the Internal Revenue Service, where she had ultimate responsibility for all legal matters at the IRS and leadership of all of their 1,600 attorneys.

During her career Parker has been recognized in a wide range of business and legal publications, most recently being named as 2012 Dallas Litigation & Controversy-Tax Lawyer of the Year by *The Best Lawyers in America®*. She has held numerous leadership positions for local, state, and national bar organizations, including most recently serving as Vice Chair of the American Bar Association's Section of Taxation. She has also served as a community volunteer for Dallas CASA, the Child Abuse Prevention Center, and Easter Seals of Dallas.

Parker's career has been marked with a series of firsts. She was the first female attorney hired by Thompson & Knight, its first woman Partner, and its first woman Managing Partner. Please join me in congratulating Emily Parker as the first woman to be awarded the Outstanding Texas Tax Lawyer!

Future Leaders

Leadership Academy. A big thank you to all the applicants for this year's inaugural class of the Tax Section's Leadership Academy, and congratulations to the 21 participants who were selected. The Leadership Academy will allow young tax lawyers to develop their leadership skills and network with other tax lawyers throughout the state. The Criteria for Selection were as follows:

- Three to six years experience;
- Member of the State Bar of Texas in good standing;
- Member of the Tax Section of the State Bar of Texas; and
- Commitment to attend all four sessions.

The meeting dates and cities are as follows:

- March 22-23, 2012 – San Antonio, TX
- June 14-15, 2012 – Houston (in conjunction with the State Bar of Texas Annual Meeting)
- September 20-21, 2012 – Austin, TX
- January 17, 2013 – Dallas, TX

If you were not selected this year, please apply again next year. Many thanks to David Colmenero for his efforts in spearheading the Leadership Academy and to Tina Green, Alyson Outenreath, Christi Mondrik, and Ryan Gardner for their assistance. If you have any questions, please contact David at 214-744-3700 or dcolmenero@meadowscollier.com.

Outreach

Law School Outreach and Paper Competition. We hold luncheons each year with students at the SMU Dedman, University of Texas, University of Houston, and Texas Tech University Schools of Law. Every other year, we hold luncheons at Baylor, LSU, and South Texas Law Schools. St. Mary's University, Texas Southern and Texas Wesleyan and will be visited every third year. If you wish to serve as a panelist, please contact the head of our law school student outreach program, Abbey B. Garber, at (972) 308-7913 or abbey.b.garber@irscounsel.treas.gov.

Many thanks to Ron Adzgery for again running this year's paper competition. We have increased the prize money this year to $2,500 for first place. At the judges' discretion, second and third place winners may be selected and awarded prizes of $1,500 and $1,000. The deadline for submitting papers for the 2011-2012 competition is June 1, 2012. Please see the Tax Section's website for more details.

Having Fun!

Annual Meeting and Tax Legends Lunch. Mark your calendar now to attend the Tax Section's Annual Meeting on June 15, 2012, in Houston, Texas. The Annual Meeting will include CLE programs and our Tax Legends Lunch honoring Charlie Hall of Fulbright & Jaworski. The CLE programs that we have lined up for you are (a) Effective Techniques to Resolve an LB&I Audit, with Richard Husseini of Baker Botts; (b) Creative Uses of LLCs with Steve Kuntz and Robert Phillpot of Fulbright & Jaworski;

and (c) Practice Before the IRS: The Tightening Noose, with Trey Cousins of Meadows Collier. Many thanks to Matt Larsen for coordinating the Annual Meeting and to Bill Elliott for the time and energy he puts into spotlighting a Texas Tax Legend for us. Please plan on attending – the lunch is on us!

More information about all of these activities is available on our website: www.texastaxsection.org).

Nominating Committee

The Tax Section's nominating committee for 2011-2012 consists of Dan Micciche as Chair and Tyree Collier, Patrick O'Daniel, and me as an ex officio member. Nominations for Chair-Elect, Secretary, Treasurer, or an Elected Council Member position can be submitted to any member of the nominating committee or to any Officer of the Section at any time on or before March 1, 2012.

Get Involved!!

If you are not already involved in the Section's activities, please get involved. Contact one of the chairs of the above activities or join a committee. We have included the Committee Selection form in this issue of the *Texas Tax Lawyer* and have also posted it on the Tax Section's website. Mark one or more Committees that you would like to join and send the form to the Committee Chair listed on the form.

When you join a Committee, you become a member of that Committee's list serv. The list serv provides you with an email forum for sharing tips, concerns, referrals and other matters with your fellow Texas tax lawyers. If you wish to opt out of the list serv, please contact Brent Gardner at 214-999-4585 or bgardner@gardere.com.

If you are not sure who to contact and what would be the best fit for your skills, then email me at mary.mcnulty@tklaw.com. You will help us build an even stronger Tax Section and have some fun in the process!

Mary A. McNulty
2011-2012 Chair

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STATE BAR OF TEXAS
PROPERTY TAX COMMITTEE MEETING & LEGAL SEMINAR
Monday, March 26, 2012

Thompson Conference Center at the University of Texas
2405 Robert Dedman Drive
Austin, Texas

REGISTRATION

This year the State Bar's Property Tax Committee continues the tradition of offering low cost CLE in the field of property tax at our Annual Meeting and Legal Seminar on Monday, March 26, 2012 at the Thompson Conference Center at the University of Texas. This is at the northeast edge of the UT campus and is easily accessible to I-35 and the Austin Bergstrom International Airport.

To cover the cost of the facility and break refreshments, we are offering a few different registration options for you this year. **Registration *and* payment** must be received by the specified dates to take advantage of the discounted rates.

Early Bird Registration - $40

Register and send payment by January 15th to take advantage of the Early Bird Discount!

Regular Registration - $60

January 16th - March 15th
Payment must be received no later than March 17, 2012.

Pay at the Door - $75

You may pay at the door on the day of the seminar before 8:15 a.m., but you must still RSVP by fax or by e-mail to Ashley Creighton. If you have any questions, you may call Melinda Blackwell at 972-407-6599.

Please RSVP to Ashley Creighton at Brusniak | Blackwell, make your check payable to the "State Bar of Texas Section of Taxation," and send your payment to Ashley at:

Ashley Creighton
Brusniak | Blackwell PC
17855 Dallas Parkway, Ste. 300
Dallas, Texas 75287
Tel: (972) 250-6363
Fax: (972) 250-3599
E-mail: ashley@txtax.com

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We are applying for 6.0 hours of CLE, with 1.0 of that being ethics. Please make sure that your colleagues receive the information about the seminar so they can attend. We try to keep an updated e-mail list; but appreciate your help in spreading the word about the seminar. If you would like to receive notification of future events, please send us your e-mail address and we will add you to our database.

This year we will **only provide the speaker's materials to you via email upon receipt of your payment**. We anticipate to start sending the materials out around the beginning of March. Please be sure that you RSVP to Ashley and direct your payment to her so we can provide you with the materials as soon as possible.

We look forward to seeing you on March 26, 2012!

Mary A. Van Kerrebrook
Van Kerrebrook & Associates P.C.
440 Louisiana, Suite 440
Houston, Texas 77002
Phone: (713) 425-7152, ext.15
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mary@vkalawyers.com

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STATE BAR OF TEXAS
PROPERTY TAX COMMITTEE MEETING & LEGAL SEMINAR
Monday, March 26, 2012

Thompson Conference Center at the University of Texas
2405 Robert Dedman Drive
Austin, Texas

8:00 - 8:30 **REGISTRATION & WELCOME**

8:30 - 9:45 **CASE LAW PANEL**
Jason Marshall - *The Marshall Firm*
John Brusniak - *Brusniak|Blackwell PC*
Robert Mott - *Perdue, Brandon, Fielder, Collins & Mott*
Matthew Tepper - *McCreary, Veselka, Bragg & Allen*

9:45 - 10:00 **Break**

10:00 - 11:00 **E-DISCOVERY**
Ian Davidson - *The O'Quinn Law Firm*

11:00 - 11:45 **POST JUDGMENT ISSUES**
Jim Bellevue - *Law Office of James Bellevue*
Jason Bailey - *Perdue, Brandon, Fielder, Collins & Mott, LLP*
Kristen Brauchle - *Tax Master, Harris County*

11:45 - 12:45 **Lunch**

12:45 - 1:45 **BASIC TAX SUIT DEFENSES / DELINQUENT TAX ISSUES**
Anthony (Tony) Nims - *Linebarger, Heard, Goggan & Blair, LLP*

1:45 - 2:45 **CHIEF APPRAISERS PANEL**
Moderated by Windy Nash - *Dallas Central Appraisal District*
Ken Nolan - *Dallas Central Appraisal District*
Jeff Law - *Tarrant Appraisal District*
Eddie Trigg - *Wichita County Appraisal District*
Alvin Lankford - *Williamson Central Appraisal District*

2:45 - 3:00 **Break**

3:00 - 4:00 **CHDO Exemptions**
Dennis Drouillard - *Bexar Appraisal District*

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COMMITTEE SELECTION FORM
Section of Taxation
State Bar of Texas

NAME: ______________________________ DATE: ____________________

FIRM: ____

ADDRESS: ____

CITY STATE ZIP CODE

TELEPHONE NO: (_____)____________________ E-MAIL: ____________________

BAR CARD.: ______________________

PLEASE CHECK THE BOX FOR EACH COMMITTEE YOU ARE INTERESTED IN JOINING:

	COMMITTEE	CHAIR
☐	**Corporate Tax**	Jeffry M. Blair Hunton & Williams LLP 1445 Ross Avenue, Suite 3700 Dallas, Texas 75202-2799 214-468-3306 214-468-3599 (fax) jblair@hunton.com
☐	**Employee Benefits**	Susan A. Wetzel Haynes & Boone 2323 Victory Ave., Ste. 700 Dallas, Texas 75219 214-651-5389 214-200-0675 (fax) susan.wetzel@haynesboone.com
☐	**Energy and Natural Resources Tax**	Sean R. O'Brien Jackson Walker L.L.P. 1401 McKinney Street, Suite 1900 Houston, Texas 77010 713-752-4544 713-752-4221 (fax) sobrien@jw.com
☐	**Estate & Gift Tax**	Amanda M. Gyeszly Fizer, Beck, Webster, Bentley, Scroggins, P.C. 1330 Post Oak Blvd., Suite 2900 Houston, Texas 77056 713-840-7710 AGyeszly@FizerBeck.com
☐	**General Tax Issues**	Julie C. Sassenrath Winstead PC 5400 Renaissance Tower 1201 Elm Street Dallas, Texas 75270 214-745-5887 214-745-5390 (fax) jsassenrath@winstead.com
☐	**International Tax**	Melinda R. Phelan Baker & McKenzie LLP 711 Louisiana, Suite 3400 Houston, Texas 77002 713-427-5012 713-427-5099 (fax) melinda.phelan@bakermckenzie.com

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☐	**Partnership/Real Estate**	Dan G. Baucum Shackelford, Melton & McKinley, LLP 3333 Lee Parkway, Tenth Floor Dallas, Texas 75219 214-780-1470 214-889-9770 (fax) dbaucum@shacklaw.net
☐	**Property Tax**	Mary A. Van Kerrebrook Van Kerrebrook & Assoc., P.C. 1125 Lyric Centre 440 Louisiana Houston, Texas 77002 713-425-7150 713-425-7159 (fax) Mary@vkalawyers.com
☐	**Solo and Small Firm**	Catherine C. Scheid 4301 Yoakum Blvd. Houston, Texas 77006 713-840-1840 713-840-1820 (fax) ccs@scheidlaw.com
☐	**State & Local Tax**	Alyson Outenreath Texas Tech University School of Law 1802 Hartford Ave. Lubbock, Texas 79409-0004 806-742-3990 Ext. 238 806-742-1629 (fax) alyson.outenreath@ttu.edu
☐	**Tax Controversy**	David E. Colmenero Meadows, Collier, Reed, Cousins & Blau, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 214-747-3732 (fax) dcolmenero@meadowscollier.com
☐	**Tax-Exempt Finance**	Victoria Ozimek Vinson & Elkins LLP 2801 Via Fortuna, Ste. 100 Austin, Texas 78746 512-542-8856 vozimek@velaw.com
☐	**Tax-Exempt Organizations**	Terri Lynn Helge Texas Wesleyan School of Law Associate Professor of Law 1515 Commerce Street Fort Worth, Texas 76102-6509 817- 429-8050 thelge@law.txwes.edu

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PLEASE COMPLETE THIS FORM AND FORWARD IT TO THE COMMITTEE CHAIR(S) FOR EACH COMMITTEE THAT YOU ARE INTERESTED IN JOINING.

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The State Bar of Texas
Tax Section
Would Like to Congratulate

The Selected Leadership Academy Participants for 2012-2013

Douglas M. Cowan
Deloitte Tax LLP, Dallas

Christopher A. Cunningham
C.A. Cunningham, PLLC, Dallas

Shari L. Ellington
Meadows Collier, Dallas

Renesha N. Fountain
Chamberlain Hrdlicka, Houston

David, C. Gair
Looper Reed, Dallas

Brent C. Gardner
Gardere Wynne Sewell, Dallas

Meagan R. Horn
Vinson & Elkins LLP, Dallas

Matt C. Hunsaker
Baker Botts LLP, Dallas

Christian S. Kelso
Winn, Beaudry & Winn, Dallas

C. Stoddard (Todd) Lowther
Thompson & Knight, Houston

Sam L. Merrill
Thompson & Knight, Dallas

Robert C. Morris
Fulbright & Jaworski, Houston

Ryan L. Morris
Baker Botts LLP, Houston

Michelle U. Rosenblatt
Morgan Adler, Austin

Ronald J. Rucker
PWC, Houston

Jeffrey M. Slade
Baker & McKenzie, Dallas

Molly C. Sorg
Energy Future Holdings, Dallas

Michelle L. Terbay
Mondrik & Associates, Austin

Jaime J. Vasquez
Chamberlain Hrdlicka, San Antonio

Benjamin (Ben) W. Vesely
BDO USA, Dallas

Jason L. McIntosh
Vinson & Elkins, Houston

Regarding SMLLCs: When SMLLCs treated as disregarded entities for federal income tax purposes may not be disregarded

By Jeffry M. Blair*

As a result of the check-the-box regulations, many practitioners were first introduced to the concept of a limited liability company being treated as an entity under applicable state and local law but being disregarded as an entity separate from its sole owner for federal income tax purposes.[1] Whether referred to as "tax nothings," "disregarded entities," or simply DREs, disregarded entities were originally thought by many practitioners to be disregarded for all federal tax purposes. Now, more than 14 years after the initial effective date of the check-the-box regulations, there are several identified exceptions to DRE treatment. Given this growing number of exceptions, I prepared the following check-list summarizing instances when a single member LLC ("SMLLC") may not be disregarded for certain tax purposes and indicating certain things that a practitioner may want to considered when dealing with SMLLCs.

1. *SMLLCs Checking the Corporate Box*. In general, a U.S. domestic SMLLC is treated as a DRE for federal income tax purposes under the default rules of the check-the-box regulations unless it affirmatively makes an election to be treated as an association taxable as a corporation.[2] Therefore, whenever you are dealing with a SMLLC, you should first determine if the entity has filed an election to be treated as an association taxable as a corporation or will be classified under the default rules. Don't fall into the trap of assuming that a SMLLC will be treated as a DRE simply because it is an LLC with only one owner. Some investment funds even prefer check-the-box LLCs treated as associations taxable as corporations to regular state law corporations because there are fewer requirements to maintain the entity's state law status.

2. *Foreign SMLLC*. The default rules of the check-the-box regulations for a foreign eligible entity are different than the default rules for a domestic eligible entity. Under these rules, a foreign eligible entity with a single owner will be treated as a DRE only if that sole owner does not have limited liability.[3] Otherwise, the single member foreign eligible entity would be treated as a foreign corporation.[4] A member of a foreign eligible entity has limited liability if that member has no personal liability for the debts and claims against that foreign entity by reason of being a member.[5] A member does not have limited liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as a result of the member being a member. For example, if a foreign SMLLC is owned by a foreign corporation and none of the creditors of the foreign SMLLC are able to enforce their claims against that foreign corporation under applicable foreign law, then the foreign SMLLC would be treated as a foreign corporation under the default rules. For the foreign SMLLC to be treated as a disregarded entity for federal income tax purpose, a check-the-box election would need to be made with respect to the foreign eligible entity. Since these default rules work differently for foreign and domestic entities, practitioners must be careful to make sure they apply the correct default rules and make any needed check-the-box elections in order to get the intended result.

3. _Employment Taxes and Wage Reporting_. A DRE (other than a qualified subchapter S subsidiary) is treated as a corporation with respect to federal employment taxes and wage reporting.[6] Under these rules, it is the DRE and not the DRE's sole owner that is considered to be the employer of individuals performing services for the DRE.[7] Thus, for purposes of FICA, FUTA and wage withholding, a SMLLC that is a DRE is treated as if it were a corporation and is primarily liable for withholding these taxes from employees' wages and paying these taxes to the Treasury. This can be important to the acquirer of a SMLLC that has or has had employees because the acquirer could be stepping into any unpaid employment tax liabilities of that entity. Interestingly, a SMLLC continues to be disregarded for self-employment and back-up withholding tax purposes.[8]

4. _Excise Taxes_. A SMLLC that is a DRE is also treated as a corporation for excise tax reporting.[9] This includes retail excise taxes under Chapter 31, manufacturers' excise taxes under Chapter 32, facilities and services taxes under Chapter 33, foreign issuers' taxes under Chapter 34, wagering taxes under Chapter 35, excise taxes under Chapter 36 and environmental taxes under Chapter 38.

5. _Tax Liabilities of entity converted to SMLLC_. A disregarded entity is treated as a separate entity for purposes of federal tax liabilities of the entity for any tax period for which the entity wasn't disregarded.[10] Therefore, if a SMLLC was formerly a member of an affiliated group filing a consolidated federal income tax return and converted into a SMLLC, that new SMLLC would continue to remain liable for the joint and several liability imposed under Treasury Regulation section 1.1502-6, even though it was no longer a C corporation or a member of the former affiliated group. Acquirers of SMLLCs are well advised to get representations and other protections that the entity being acquired was never a member of an affiliated group filing a consolidated federal tax return and against similar state law income tax liabilities.

6. _Successor Liabilities_. Similarly, a SMLLC that is a disregarded entity is also treated as a separate entity for purposes of federal tax liabilities of any other entity for which the SMLLC is liable under state law.[11] For example, if a C corporation merged with and into a SMLLC, the SMLLC would become liable under state law for any of the existing, unpaid tax liabilities of the merged C corporation.[12] In that case, the IRS can assess any tax deficit of the former C corporation against the successor SMLLC and the SMLLC is the proper party to sign any consent to extend the statute of limitations on assessment.[13]

7. _Tax Credits and Tax Refunds_. A SMLLC is treated as a separate entity for federal tax refunds or tax credits.[14] Therefore, if a C corporation converts to a SMLLC or is merged into a SMLLC, the SMLLC, as successor of the C corporation, would own the rights to any tax refunds or the right to use tax credits of the former C corporation.

8. _Small Partnership Exception to TEFRA_. A SMLLC that is a DRE is also regarded as an entity for purposes of determining whether another partnership should be excluded from the unified audit and litigation rules for partnerships, commonly referred to as the TEFRA[15] rules. In general, the TEFRA rules apply to all partnerships required to file a partnership tax return under Code section 6031(a).[16] Partnerships with ten or fewer partners are excluded from these

TEFRA rules under Code section 6231(a)(1)(B) if each of the partners is a U.S. individual, C corporation, or an estate of a deceased partner.[17] The Internal Revenue Service has taken the position that for purposes of determining whether a partnership is excluded from the TEFRA rules under this small partnership exception, a DRE should be treated as an entity separate from its sole member.[18] Therefore, if a partnership has a SMLLC that is a DRE as a partner, the partnership will not qualify for the small partnership exception, even if the SMLLC's sole owner is an individual and the partnership would otherwise meet the requirements for the exception.[19]

9. *Allocating Liabilities under Code section 752*. A partner's tax basis in its partnership interest is increased by the amount of the partnership's liabilities that are allocated to that partner under Code section 752 and the Treasury Regulations issued thereunder. In general, a partner's share of recourse partnership liabilities equals the portion of those liabilities, if any, for which that partner or a related person bears the economic risk of loss.[20] In making this determination, all statutory and contractual obligations relating to the partnership liability are taken into account, including guarantees, indemnifications, reimbursement agreements and other obligations running directly to creditors, to other partners or to the partnership.[21] For purposes of determining whether a partner has the economic risk of loss with respect to a partnership liability, each partner is generally assumed to be able to meet its payment obligations, irrespective of the partner's actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.[22] However, if the payment obligation or guarantee is owed by a partner's SMLLC that is a DRE rather than directly by the partner, the SMLLC will only be treated as having the economic risk of loss up to the net value of the SMLLC.[23] The net value of the SMLLC is the fair market value of the assets of the SMLLC that may be subject to the creditor's claims under local law reduced by the obligations of the SMLLC.[24] Effectively, these rules limit the ability of a partner to increase its tax basis in its partnership interest where the partner's actual risk of loss is reduced through the use of guarantees by SMLLCs with small net worth.

10. *Dual Consolidated Losses*. In general, a dual consolidated loss cannot be used to reduce the taxable income of any U.S. affiliate in the taxable year in which the loss is recognized or for any other taxable year.[25] The dual consolidated loss rules were enacted to prevent a dual resident corporation from being able to take a deduction for the same loss in more than one country.[26] Prior to these rules, a U.S. corporation could set up a hybrid entity (often using some form of DRE) that was largely ignored for U.S. federal income tax purposes but was treated as an entity under the income tax laws of the foreign jurisdiction. Losses incurred by the DRE were included on both the U.S. income tax return of the parent corporation and the income tax return for the foreign country. To prevent this, the dual consolidated loss rules generally treat a SMLLC treated as a DRE as an entity separate from its sole owner and do not permit losses of the SMLLC that are included on the foreign income tax return to also be used to offset U.S. income. For this purpose, the SMLLC's income and loss is calculated on a stand alone basis and the SMLLC is not simply disregarded.[27]

11. *Tax Treaties*. Even though a SMLLC is disregarded for United States federal income tax purposes, the treatment of the entity under an applicable tax treaty may be different. In addition, the tax treatment may depend on whether the owner of the SMLLC is a foreign entity wanting the tax benefits of a United States tax treaty or the owner is a United States entity

seeking the tax benefits of a foreign tax treaty. In general, a foreign person is entitled to the benefits of a U.S. tax treaty (e.g. a reduced rate of withholding or no withholding on dividends, interest or royalties from U.S. sources) only if the foreign person is a resident of the foreign country with which the U.S. entered into the treaty.[28] However, if the foreign person derives income through an entity that is treated as a "fiscally transparent" entity (e.g. a U.S. SMLLC that is treated as a DRE for U.S. federal income tax purposes), then a question arises as to whether income, profit, or gain derived by the SMLLC should be eligible for the benefits under the tax treaty. If the applicable tax treaty is based off the 2006 U.S. Model Income Tax Treaty, then an item of income, profit or gain derived by a SMLLC that is a DRE will be considered as derived by a resident of a country only to the extent that the item of income, profit or gain is treated as income, profit, or gain of a resident of that country under the tax laws of that country.[29] For example, suppose a U.S. SMLLC that is treated as a DRE for U.S. income tax purposes was solely owned by a foreign person that is a resident of Country X. If the income tax treaty between the U.S. and Country X was based on the 2006 U.S. Model Income Tax Treaty, then the income received by that SMLLC could be eligible for treaty benefits under that income tax treaty if the foreign owner was a resident of Country X and was taxable by Country X on that income. Alternatively, if the entity was a Country X SMLLC and was directly taxable by Country X on its income, then the SMLLC should be eligible for treaty benefits because it is directly taxable on its income by Country X. In that case, a foreign SMLLC could be regarded as an entity for purposes of determining whether the income of the SMLLC was eligible for benefits under an income tax treaty.

In situations where the applicable treaty is not based off the 2006 U.S. model Income Tax Treaty, Code section 894 provides a similar limitation on the ability of a SMLLC to receive treaty benefits. Code section 894(c)(1) denies a foreign person the ability to use a U.S. income tax treaty to reduce the withholding tax with respect to an item of income derived through an entity which is treated as a partnership (or is otherwise treated as fiscally transparent for federal income tax purposes) if (i) such item of income is not treated for purposes of the taxation laws of such foreign country as an item of income of such person; (ii) the treaty does not contain a provision addressing the applicability of the treaty in the case of an item of income derived through a partnership; and (iii) the foreign country does not impose tax on a distribution of such income from such entity to such person.[30] Under these rules, a foreign SMLLC treated as a DRE would not be disregarded for purposes of the treaty benefit limitation rules of Code section 894(c)(1) if the foreign owner of the SMLLC was not taxable on the SMLLC's income. For example, suppose FCN, a Country N corporation, owned 100% of a U.S. SMLLC that was disregarded for U.S. federal income tax purpose. If Country N treated the US SMLLC as a U.S. corporation and did not tax its income, then the SMLLC would be not be disregarded for purposes of Code Section 894(c)(1) and the income would not be eligible for benefits under the tax treaty between the United States and Country N.[31]

For U.S. entities owning SMLLCs that are relying on a foreign country's tax treaty, the tax results can even be worse. Some countries, such as Canada, do not disregard SMLLCs and simply treat the SMLLCs as corporations. In addition, some foreign countries have added anti-hybrid provisions to their tax treaties that can impact the treatment of a SMLLC treated as a DRE. For example, the 2007 protocol to the U.S.-Canada treaty contained an anti-hybrid rule that indicated that a resident of the United States or Canada is not eligible for treaty benefits in the other country with respect to an income item if (1) the other country treats the person as having received the income from an entity that is a resident of that country, (2) the entity is fiscally transparent in the country of the taxpayer's residence, and (3) the tax treatment of the income in the residence country is not the same as it would be if the entity were not fiscally transparent.[32] Under this provision, if a U.S. individual is the sole owner of a Nova Scotia unlimited liability company ("NSULC") that elects to be treated as a disregarded entity for U.S. federal income tax purpose, dividends paid by the NSULC to the U.S. individual would be subject to Canadian withholding at the statutory rate and would not be eligible for the reduced treaty rate.

As the above examples illustrate, dealing with SMLLCs in connection with tax treaties presents many traps for the unwary, regardless of whether they are regarded or disregarded.

12. *Conduit Financing*. Code section 7701(l) authorizes the Treasury to prescribe regulations recharacterizing any multiple party financing transaction as a transaction directly between any two or more such parties where the IRS determines that such recharacterization is appropriate to prevent avoidance of any tax imposed under the Code.[33] Pursuant to this authority, the Treasury issued regulations in 1995 that permitted the IRS to disregarded intermediate parties to these multiple party financing transactions where the participation of the entity is part of a tax avoidance plan and if certain other conditions are met.[34] In 2008, the Treasury issued proposed regulations dealing specifically with DREs.[35] The proposed regulations clarify that the term "person" includes a business entity that is disregarded as an entity separate from its single member owner under the check-the-box regulations.[36] Under this proposed regulation, the IRS would be permitted to take into account and not simply ignore the role of a SMLLC or DRE in the financing arrangement.

13. *State and Local Tax Law*. Although SMLLCs treated as DREs may be disregarded for federal income tax purposes, they are usually not disregarded with respect to state and local taxes other than income taxes. Therefore, for purposes of sales and use taxes, property taxes, and other state or locally imposed taxes, the fact that an entity is disregarded for federal income tax purposes is irrelevant.[37] In addition, many states, including Texas, impose income and/or franchise taxes on SMLLCs treated as DREs even if they are disregarded for federal purposes.[38] Moreover, even if a SMLLC is not subject to a state income tax, it will likely be subject to some state imposed entity level tax.[39]

14. *Gift Tax Valuations*. In *Pierre*, a divided Tax Court held that a gift of an interest in a SMLLC treated as a DRE for federal income tax purposes should be valued as a gift of the membership interests in the SMLLC and not as a gift of interests in the SMLLC's assets.[40] Under the facts of the case, a donor formed a SMLLC under New York state law and did not make a check-the-box election to treat the SMLLC as an association taxable as a corporation. The donor contributed cash and publicly traded securities to fund the SMLLC. Twelve days after funding, the donor made two gifts of 9.5% interests in the SMLLC to trusts set up for the donor's son and granddaughter and sold a 40.5% interest to each trust in exchange for promissory notes. The donor took discounts of 36.55% on the value of the gifts. The IRS objected to the discounts and argued that the gifts should be valued based on the value of the underlying assets. The Tax Court held that as a matter of law the donor's gifts to the trusts

should be valued for federal gift tax purposes as transfers of an interest in the LLC. In reaching its conclusion, the Tax Court flatly rejected the government's position that the check-the-box regulations changed how the gift of a SMLLC interest should be valued and did not require the Tax Court to disregard a validly formed LLC for purposes of gift tax valuation purposes.

15. *Pro Se Representation*. A sole owner of a sole proprietorship may appear in federal court without the assistance of an attorney. The sole owner of a corporation, however, must be represented by a lawyer, even if the interests of the corporation and the sole owner are tightly intertwined. Although a SMLLC that is disregarded for federal income tax purposes seems more like the sole owner of a sole proprietorship, the Seventh Circuit has held that the SMLLC must be represented by an attorney and cannot be represented pro se by the sole owner if the sole owner is not an attorney.[41]

The above checklist does not purport to be a complete list of all of the occasions that a SMLLC treated as a DRE will not be disregarded; however, it does illustrate that there are a growing number of occasions where practitioners need to be careful in their use of SMLLCs. Moreover, since the times a SMLLC will not be disregarded seems to be growing almost as fast as the list of times that such an entity is disregarded, practitioners would be wise to not treat the terms "disregarded entity" or "tax nothing" too literally.

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1 Although this article focuses primarily on single member LLCs that are treated as disregarded entities for federal income tax purposes, it should be noted that there were other entities that beat out single member limited liability companies as being the first entities disregarded for federal income tax purposes. These entities include qualified REIT subsidiaries under section 856(i) of the Internal Revenue Code of 1986, as amended (the "Code") and qualified subchapter S subsidiaries under Code section 1361(b)(3). There is also the granddaddy of disregarded entities, the grantor trust.

2 Treas. Reg. §§301.7701-3(b)(1) & (c).

3 Treas. Reg. §301.7701-3(b)(2)(i)(C).

4 Treas. Reg. §301.7701-3(b)(2)(i)(B).

5 Treas. Reg. §301.7701-3(b)(2)(ii). The determination as to whether a member is liable for the debts of the DRE is based solely on the statutes and law of the applicable jurisdiction. *See* Preamble to T.D. 8697, 1997-1 C.B. 215 (Dec. 17, 1996).

6 Treas. Reg. §301.7701-2(c)(2)(iv)(B). DREs are treated as disregarded entities for purposes of

7 Preamble to T.D. 9554 , 2011 USTR ¶86,458 (Nov. 1, 2011).

8 *See* Treas. Reg. §301.7701-2(c)(2)(iv)(A); Treas. Reg. §301.7701-2T(c)(2)(iv)(A).

9 Treas. Reg. §301.7701-2(c)(2)(v)(B).

10 Treas. Reg. §301.7701-2(c)(2)(iii)(A)(1).

11 Treas. Reg. §301.7701-2(c)(2)(iii)(A)(2).

12 Treas. Reg. §301.7701-2(c)(2)(iii)(B) example 1.

13 *Id.*

14 Treas. Reg. §301.7701-2(c)(2)(iii)(A)(3).

15 TEFRA stands for the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. No. 97-248, 96 Stat. 324 (1982).

16 Code § 6231(a)(1)(A).

17 Code § 6231(a)(1)(B).

18 Rev. Rul. 2004-88, 2004-32 I.R.B. 165 (2004) (a limited partnership with four individuals as limited partners and a SMLLC wholly owned by another individual as the general partner did not meet the small partnership exception of Code §6231(a)(1)(B)); C.C.A. 200250012 (Dec. 12, 2002) (small partnership exception did not apply to partnership whose two members were a C corporation and a SMLLC that was wholly owned by the C corporation parent of the other member).

19 *Id.*

20 Treas. Reg. § 1.752-2(a).
21 Treas. Reg. § 1.752-2(b)(3).
22 Treas. Reg. § 1.752-2(b)(6).
23 Treas. Reg. § 1.752-2(k)(1).
24 Treas. Reg. § 1.752-2(k)(2). The fair market value of the assets of the DRE excludes the fair market value of any assets that are pledged to secure a partnership liability under Treas. Reg. § 1.752-2(h)(1).
25 Code § 1503(d)(1); Treas. Reg. § 1.1503-2(b)(1).
26 Preamble to TD 8434, 1992-2 C.B. 240, 241.
27 *See* Treas. Reg. § 1.1503(d)-5.
28 *See, e.g.*, United States Model Income Tax Convention of November 15, 2006, art. 1(1).
29 *Id.* at art. 1(6).
30 Code § 834(c)(1).
31 In enacting Code section 834, Congress intended to limit potential tax-avoidance opportunities available to foreign persons that invest in the United States through hybrid entities. In particular, the House Ways and Means Committee was concerned that if a foreign corporation invested in the U.S. through a U.S. LLC, treated as a partnership for U.S. tax purposes, and the income of the entity not being taxed by the foreign country because the entity was treated as a U.S. entity by that foreign country. If reduced withholding rates applied under the applicable tax treaty, then some of the income would escape taxation by either country. *See* H.R. Rep. No. 148, 105th Cong., 1st Sess. 550 (1997).
32 Protocol Amending the Convention between the United States of America and Canada With Respect to Taxes on Income and on Capital (Sept. 21, 2007), Article IV (7)(b).
33 Code § 7701(l).
34 Treas. Reg. § 1.881-3(a)(1).
35 Prop. Treas. Reg. § 1.881-3(a)(2)(i)(C).
36 *Id.*
37 *See, e.g.*, Texas Policy Letter Ruling No. 200307025L (July 25, 2003) (stating that the fact that a SMLLC was disregarded for federal income tax purposes and used its sole owner's federal taxpayer identification number had no bearing on the imposition of the Texas motor vehicle sales and use tax statute).
38 *See* Tex. Tax Code Ann. § 171.0002(d), Tex. Admin. Code § 3.581(e) (2008) (SMLLCs subject to Texas franchise tax).
39 *See, e.g.*, N.Y. Tax Law § 658(c)(3)(A) (annual $25 filing fee must be paid by DREs); Cal. Rev. & Tax. Cd. § 23153(d)(1) ($800 annual LLC fee); Cal. Rev. & Tax. Cd. § 17942(a) (annual fee based on California sourced income).
40 *See Pierre v. Commissioner*, 133 T.C. 24 (2009). In a separate decision involving the same taxpayer, the Tax Court held that since the gifts and the sales to the trusts all occurred on the same day, these transactions should be viewed as a sale of a 50% interest in the LLC to each trust and a gift to the trust to the extent that the value of the interest transferred was greater than the promissory note received. *Pierre v. Commissioner*, T.C. Memo 2010-106 (2010); RIA T.C. Memo ¶2010-106 (May 13, 2010).
41 *United States v. Hagerman*, 545 F.3d 579 (7th Cir. 2008) (holding that a SMLLC could not litigate in federal court unless it was represented by an attorney); *Lattanzio v. COMTA*, 481 F3d 137) (2d Cir. 2011) (same).

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CAVEAT GRANTOR: SELECTING A "DEFECT" TO OBTAIN GRANTOR TRUST STATUS

By Judith K. Tobey[*]

I. Introduction and Section 671 (Trust Income, Deductions and Credits Attributable to Grantors and Others as Substantial Owners)

Statute. Section 671[1] provides that when the grantor or another person is treated as the owner of any portion of a trust, such person shall include the items of income, deductions and credits against tax that are attributable to such portion of the trust in computing his or her own taxable income and credits. Any remaining portion of the trust will be taxed as a separate and independent taxpayer.[2]

The Treasury Regulations under Section 671 indicate that the principle underlying the grantor trust rules is "that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed…"[3] The Treasury Regulations also provide that it is generally immaterial whether the income involved constitutes income or corpus for state law trust accounting purposes. Accordingly, unless otherwise noted, references to "income" in the grantor trust rules contained in Sections 671 through 679 and the corresponding Treasury Regulations refer to income as determined for federal tax purposes and not to trust accounting income. When such rules intend to refer to trust accounting income, the phrase "ordinary income" is used.[4]

History. The principles now codified in Section 671 and the grantor trust rules that follow are often traced back to the 1940 United States Supreme Court decision in *Helvering v. Clifford*.[5] In that case, decided before the era of joint income tax returns for married couples, a wealthy grantor created a short-term trust for the benefit of his wife. The grantor retained absolute discretion with respect to distributions from the trust and a vast array of substantial powers over the management of trust property. All trust income was distributed to the grantor's wife, who reported the income on her individual income tax return, and paid income tax at a lower rate than her grantor-husband would have paid on the same income. In determining that the grantor-husband was taxable on trust income, the court stated that "the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by [the grantor] all lead irresistibly to the conclusion that [the grantor] continued to be the owner" of the trust property.[6] The court found that "so far as [the grantor's] dominion and control were concerned it seems clear that the trust did not effect any substantial change."[7]

Following the *Clifford* decision, the Treasury Department issued regulations in 1946 providing guidance to taxpayers regarding the circumstances in which a trust would be recognized as an independent taxpayer (and the circumstances in which a grantor would be deemed to retain such dominion and control over the trust property as to remain liable for the income taxes himself). The principles of these so-called "Clifford Regulations" were codified in the 1954 Internal Revenue Code as the precursor to the current grantor trust rules contained in Sections 671 through 679 of the current Code. With the advent of joint returns for married couples, the reduction of income tax rates in general, and the extreme compression of income tax brackets applicable to trusts, there is now little motivation to engage in the kind of income splitting between grantors, trusts and trust beneficiaries that Mr. Clifford attempted. The "defects" that caused a trust to be disregarded for income tax purposes (thus preventing the shifting of income from a taxpayer in a higher income tax bracket to a trust or individual in a lower income tax bracket) may now be considered desirable and are often intentionally included by estate planners as they draft new trusts for their clients. The old label ("defective") is now seen alongside the new ("intentional"), giving rise to the unusual moniker with which estate planners have become so familiar in recent years: the intentionally defective grantor trust.

Advantages and Drawbacks of Grantor Trust Status. Although grantor trust status was viewed as a "defect" in the past, there are now many reasons why estate planners and grantors intentionally seek grantor trust status. Among the most common reasons are: (1) the grantor's ability to alleviate a trust's income tax burden is an additional tax-free "gift" to the trust;[8] (2) transactions between the grantor and the trust will be ignored for income tax purposes (such as the grantor's sale of assets to the trust, the grantor's purchase or exchange of low basis assets from the trust in return for high basis assets (or cash) shortly before the grantor's death, and transactions between two grantor trusts with the same owner);[9] (3) a grantor trust is an eligible S corporation shareholder;[10] (4) the grantor may use the grantor trust's losses against his individual income; (5) the income of a grantor trust is subject to the less compressed income tax rates applicable to individuals (even if no trust property is distributed to the beneficiaries); (6) a grantor trust may take advantage of the special rule under Section 121 for the exclusion from taxable income of a portion of the proceeds from the sale of the grantor's principal residence;[11] (7) a grantor trust may qualify for certain exceptions to the transfer for value rule in connection with the transfer of a life insurance policy;[12] and (8) special varieties of grantor trusts provide unique estate planning benefits, including grantor retained annuity trusts (GRATs), qualified personal residence trusts (QPRTs) and irrevocable life insurance trusts (ILITs).

Some of the drawbacks to grantor trust status include the following: (1) a grantor may be liable for the trust's income tax burden and be without sufficient funds to cover the expense; and (2) in some situations grantor trust status may increase the amount of tax on trust income (such as where taxable income is below the threshold at which a nongrantor trust reaches the highest income tax bracket, or where a trust can be structured to avoid state or local taxes to which the grantor would be subject). In addition, in the 1990's there was some uncertainty regarding whether the Service might take the position that the grantor's payment of income taxes constituted a taxable gift to the trust beneficiaries (either as such tax was paid or upon the creation of the trust). However, this uncertainty was resolved by Revenue Ruling 2004-64, in which the Service clearly stated that the grantor's payment of income taxes attributable to trust income would not be treated as a gift for federal gift tax purposes.[13] Finally, it is important to note that although a grantor may be comforted by a trust provision requiring that he be reimbursed for income taxes paid on trust income, such a provision will likely defeat the grantor's estate planning goals. A provision requiring that the trust reimburse the grantor will result in the inclusion of the entire trust principal in the grantor's estate for federal estate tax purposes under Section 2036(a)(1) because the Service views such a provision as the grantor's retention of the right to have trust property expended to satisfy his own legal obligations.[14] A provision permitting (but not requiring) the trustee to reimburse the grantor will not, by itself, cause such inclusion.[15]

Selecting the Appropriate Defect to Obtain Grantor Trust Status. Once the grantor has decided that the benefits of grantor trust status outweigh the potential disadvantages, the drafting attorney must consider the many possible paths to grantor trust status. Each possibility should be evaluated in at least four major areas. The first, and often most critical, criterion for any potential "defect" or trigger of grantor trust status is its effect on the estate and gift tax consequences associated with the grantor's transfer to the trust. More specifically: (1) will the trigger cause the property transferred to the trust to be included in the grantor's taxable estate? (2) will the trigger cause the grantor's transfer to be treated as an incomplete gift for gift tax purposes (making the transfer subject to gift tax when it becomes complete or subject to estate tax at the grantor's earlier death)? If the answer to either of these questions is "yes," the grantor will likely dismiss the potential trigger out of hand.

Transfer Taxes. The degree to which a grantor has retained some benefit from or control over trust property will determine: (1) whether the grantor will be treated as the owner of trust property for income tax purposes; (2) whether trust property will be included in the grantor's estate for estate tax purposes; and (3) whether the grantor's gift to the trust will be deemed a completed gift for gift tax purposes. The most desirable outcome for many grantors is to retain as much benefit and control over trust property as possible without causing the trust property to be included in his or her estate for estate tax purposes (whether by reason of an incomplete gift or otherwise). This measured amount of benefit and control may or may not cause the grantor to be treated as the owner of the trust property for income tax purposes. Although the inquiry is essentially the same for income, estate and gift tax purposes, the boundaries are drawn differently in each case, and the grantor's benefit and control over trust property may push a trust over the line for purposes of one type of tax but not for the others.

A trust will generally cross the line for income tax purposes from an independent taxpayer to a grantor trust when the grantor has "retained substantial dominion or control"[16] such that the transfer of property to the trust "did not effect any substantial change" in this regard.[17] The rules set forth in Sections 671 through 679 describe the specific circumstances in which the grantor's retained dominion and control will cause grantor trust status. The test for estate tax inclusion is similarly based upon the degree to which the grantor has retained a beneficial interest or power to control the management or disposition of the trust property. Guidance regarding the kinds of retained interests and powers that will cause estate tax inclusion can be found in Section 2036 (retained life estates), Section 2037 (transfers taking effect at death), Section 2038 (revocable transfers), and other Sections of Chapter 11 of the Code. As discussed in detail below, in many circumstances, the grantor will retain sufficient dominion and control over trust property to cause grantor trust status but will avoid inclusion of the trust property in his or her estate for estate tax purposes.

The Treasury Regulations provide the following guidance regarding the determination of whether a gift is complete for federal gift tax purposes:

> "As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case."[18]

If the gift is not completed before the grantor's death, the property will be included in the grantor's estate for estate tax purposes upon his or her death. Although the Regulations under Sections 671 and 2511 seem to contain a similar "dominion and control" standard, in certain circumstances, the grantor may make a completed gift while retaining a degree of dominion and control over the gifted property that causes grantor trust status.

Provided there are no transfer tax consequences associated with a particular "defect" or grantor trust trigger, the grantor should evaluate the potential trigger in three additional areas relating to the future flexibility of the trust instrument and the ease of trust administration. These three criteria are: (1) whether the grantor can "reverse" or "undo" the grantor trust trigger to terminate grantor trust status in the future ("flexibility"); (2) whether the particular grantor trust trigger affects the income taxation of all trust property or only a portion of the trust property (the "portion rule"); and (3) whether events beyond the grantor's control (and events that may not come to the attention of tax professionals) may affect the trust's income tax status in the future ("maintenance").

Flexibility. Although there are many reasons why a grantor may choose to establish a grantor trust, circumstances may later arise that make grantor trust status undesirable (for example, the additional income tax liability becomes unduly burdensome for the grantor). If the retained right or power that initially caused grantor trust status is one that is easily reversed or relinquished, the grantor may well be very grateful for the opportunity to terminate grantor trust status. Some of the triggers discussed below lend themselves more readily to this kind of reversal than others (such as the ability to relinquish one of the administrative powers described in Section 675, the ability to relinquish the power to add trust beneficiaries under Section 674, and the ability to remove and replace one or more trustees who are related or subordinate to the grantor as discussed with regard to Section 674).

While the ability to terminate grantor trust status is certainly an attractive option, note several potential traps for the unwary in this area.

First, although the Service has not yet objected to the grantor's ability to terminate grantor trust status, "toggling" back and forth (terminating and re-establishing grantor trust status within a relatively short period of time) has been identified by the Service as a transaction of interest.[19] Notice 2007-73 described two complex transactions in which such toggling was used by taxpayers to claim losses greater than any actual economic loss sustained and to inappropriately avoid the recognition of gain. Transactions that are the same or similar to those described in that Notice must be disclosed to the Service.[20] Many estate planners have concluded that any sort of toggling (whether by the grantor or a third party, and whether similar to the transactions described in the Notice or otherwise) should be avoided. Others are comfortable with the relinquishment and subsequent reinstatement of the right or power that causes grantor trust status, so long as the grantor cannot both relinquish and reinstate the "trigger" power (and of course, assuming the transaction is not otherwise abusive). If the grantor can both terminate and re-establish grantor trust status, the Service may treat the trust as if grantor trust status were never terminated,[21] or worse yet treat the power to toggle grantor trust status on and off as a power described under Section 2036(a)(2) or a power rendering the grantor's gift to the trust incomplete.[22]

Second, when grantor trust status is terminated and the trust becomes an independent taxpayer, the Service will treat the termination as a deemed sale of all trust property from the grantor to the newly independent trust.[23]

Finally, and as discussed below, special care should be taken if the grantor intends to terminate grantor trust status by removing and replacing one or more trustees. If the grantor of a trust retains the power to remove and replace a trustee, he may be treated as possessing all of the trustee's discretionary powers of distribution (which may in turn cause the assets of the trust to be included in the grantor's estate for estate tax purposes under Section 2036 or 2038).[24] However, if the grantor's power to remove and replace a trustee is limited such that the replacement trustee must be a person who is not related or subordinate to the grantor (as such term is defined in Section 672(c), described below), then the grantor will not be treated as though he retained the trustee's discretionary control over trust income.[25]

Portion Rule. The Treasury Regulations under Section 671 set forth the so-called "portion rule." As noted above, when a grantor or another person is treated as the owner of *any portion* of a trust, he or she must include the items of income, deductions and credits from *that portion* of the trust in his or her own taxable income.[26] This means that a trust may be a grantor trust in its entirety or only in part, depending upon the reason for the trust's grantor trust status (which Section or Sections of the grantor trust rules apply and which power or interest is involved). As the Treasury Regulations note, a person may be treated as the owner of the entire trust, the owner of specific trust property and its income (in which case all items directly related to that property are attributable to that portion), or the owner of an undivided fractional interest in the trust or an interest represented by a dollar amount (in which case a pro rata share of each item of income, deduction and credit is normally allocated to that portion).[27] If a person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and income allocable to corpus.[28] When grantor trust treatment is sought, the grantor often intends that such treatment be conferred upon the entire trust and not only a portion of the trust. Thus, close attention must be paid to the portion rule as it relates to each "trigger" that causes grantor trust status under Sections 673 through 679.

Maintenance. Some of the triggers of grantor trust status described below require more effort and attention to maintain than others. For example, certain triggers require that specific language be included in the trust instrument, while others simply require the service of certain individuals as trustees of the trust. Some triggers require that a power be *exercisable* by the grantor or trustee, while others require that a power *actually be exercised*. Other triggers may be turned on or off depending on the grantor's marital status. When selecting the most desirable path to grantor trust status, many grantors will be attracted to those triggers that require little or no maintenance—in other words, a grantor trust that is not likely to become an independent taxpayer while no one is looking. As described below, this could easily happen if the grantor relies on certain provisions of Subpart E to obtain grantor trust status: the grantor may have a change in marital status (by death or divorce), there may be a change in trustees that does not require the grantor's consent (such as the resignation of a trustee and the appointment of a successor by the resigning trustee or a beneficiary), or the trustee may fail to exercise a power that was relied upon to continue grantor trust treatment (such as the payment of insurance premiums under Section 677). Thus, in selecting a "trigger" that will cause grantor trust status, the grantor must consider the degree of maintenance associated with each trigger and may often prefer to select a trigger that is "baked in" to the language of the trust instrument (and cannot be reversed, relinquished or undone without the attention of the grantor or a tax professional).

Overview of Sections 671—679. Sections 671 through 679 contain the provisions taxing income of a trust to the grantor or another person under certain circumstances even though such person is not treated as a beneficiary of the trust. Sections 671 and 672 contain general provisions and definitions, and Sections 673 through 677 describe the circumstances in which income of a trust will be taxed to the grantor. These circumstances include the following: if the grantor has retained a reversionary interest in the trust (Section 673); if the grantor or a nonadverse party has certain powers over the beneficial interests in the trust (Section 674); if the grantor can or does benefit from certain administrative powers over trust property (Section 675); if the grantor or a nonadverse party has the power to revoke the trust or otherwise return the trust corpus to the grantor (Section 676); and if the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse (Section 677). Section 678 provides that income is taxed to a person other than the grantor to the extent that such person has the sole power to vest trust income or corpus in himself, and Section 679 taxes the income of a foreign trust with one or more United States beneficiaries to the United States grantor of the trust. With the exception of Section 678, each of these Sections of the grantor trust rules is explored in more detail below.[29]

II. Section 672 (Definitions and Rules)

Section 672 contains several key definitions and general rules that apply to the remaining Sections of the Code dealing with grantor trusts. A working understanding of these terms and rules is critical to the analysis and selection of an appropriate grantor trust trigger. One definition that is noticeably absent from this collection is a definition of the "grantor" of the trust. Note that the grantor is not necessarily the person or persons identified in the trust instrument as "grantor," "settlor" or "maker." Rather, the Treasury Regulations provide that a "grantor," for purposes of determining whether such person owns any portion of the trust under the grantor trust rules, is any person who makes a gratuitous transfer to the trust.[30] For this purpose, a "gratuitous transfer" is any transfer other than one for fair market value, and a transfer may be gratuitous without regard to whether it is treated as a gift for gift tax purposes.[31] A trust may have more than one grantor, in which case each will own a share of the trust property in proportion to his or her contribution.

Adverse Party & Substantial Beneficial Interest. For purposes of the grantor trust rules, an "adverse party" is a person who has a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of a power that such person possesses with respect to the trust.[32] The Treasury Regulations provide that an interest is considered "substantial" if its value in relation to the total value of the trust property subject to the referenced power is not insignificant.[33] The beneficiary's interest need not be a present interest, and the interest of a contingent remainder beneficiary may be a substantial beneficial interest, depending on the specific facts and circumstances.[34] When a beneficiary's interest is measured by the life of another person, its substantiality can be measured using actuarial tables.[35] However, if the beneficiary's right to receive income or principal is contingent upon other events or conditions (such as college graduation, marriage or emergency medical needs) or the approval of a third party, the likelihood of occurrence and the value of the beneficiary's interest become difficult to estimate.[36] If the likelihood of the contingency or condition occurring is unascertainable, the interest is unlikely to be a "substantial beneficial interest."[37]

The Regulations also demonstrate the application of the "portion" concept described in Section 671 to the classification of adverse parties, noting that a beneficiary will ordinarily be considered an adverse party, but if his or her interest in income or corpus is limited to only a part of the trust, then he or she may be an adverse party only with respect to that part of the trust.[38] Similarly, the interest of an income beneficiary may or may not be adverse with respect to the exercise of a power over trust corpus (depending on whether the exercise of the particular power would affect the beneficiary's income interest).[39] And, the interest of a remainder beneficiary will be adverse to the exercise of any power over corpus, but not to the exercise of any power over an income interest that precedes his remainder.[40] In addition, if a beneficiary can benefit from only a fraction of the trust property (such as an income beneficiary of a trust with more than one income beneficiary), then the beneficiary will be adverse only with respect to the exercise or nonexercise of a power over that share of the trust property.[41] The Treasury Regulations also note that a trustee will not be an adverse party merely because of his interest as trustee.[42] Finally, and most conveniently, a "nonadverse party" is any person who is not an adverse party.[43] The terms "adverse party" and "nonadverse party" are used throughout Sections 674, 675, 676 and 677.

Related or Subordinate Party. For purposes of the grantor trust rules, a "related or subordinate party" is any nonadverse party who is: (1) the grantor's spouse living with the grantor, or (2) any one of the following: the grantor's father, mother, issue, brother or sister; the grantor's employee; a corporation or employee of a corporation in which the stock holdings of the grantor and the trust are significant from the standpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive.[44] Section 672(c) also provides that for purposes of Sections 674 and 675, a related or subordinate party will be presumed to be subservient to the grantor with respect to the exercise or nonexercise of powers conferred on such party unless the contrary can be shown by a preponderance of evidence.[45] It is apparently quite difficult to rebut this presumption.

Power Subject to Condition Precedent. A person will be considered to hold a power described in the grantor trust rules even though (a) he or she cannot exercise the power without first giving notice or (b) the power takes effect only upon the expiration of a certain period of time after he or she exercises the power.[46] However, the grantor will not be treated as the owner of a trust by reason of a power that affects beneficial enjoyment of the trust property only after a period of time that is so long that if the power were valued as a reversionary interest it would not have exceeded five percent of the value of trust property upon the trust's creation.[47] For example, if a grantor retains a power to revoke the trust, exercisable at any time, but he or she must give the trustee fifty years notice of the revocation, such retained power would not trigger grantor trust status because the value of a reversionary interest that becomes possessory in fifty years is less than five percent.[48]

Spousal Unity Rule. For purposes of the grantor trust rules, the grantor is treated as holding any power or interest held by (A) any individual who was the spouse of the grantor at the time of the creation of such power or interest; or (B) any individual who became the grantor's spouse after the creation of the power or interest (only with respect to periods after the marriage).[49] An individual who is legally separated from the grantor pursuant to a divorce decree or a decree of separate maintenance will not be considered the grantor's spouse.[50] It is important to note that the spousal unity rule of Section 672(e) is applicable in determining whether a grantor is treated as the owner of trust property for federal income tax purposes only; it does not apply to any determination that may be made under Sections 2036, 2038 or otherwise with regard to the inclusion of trust property in the grantor's estate for estate tax purposes. This distinction underlies many of the most common triggers of grantor trust status in which the grantor's spouse is given a power or right that causes the grantor to be treated as the owner of the trust for income tax purposes but does not cause inclusion of the trust assets in the grantor's taxable estate.

III. Section 673 (Reversionary Interests)

A. Statute. Section 673 provides that the grantor will be treated as the owner of any portion of a trust in which he has a reversionary interest in the corpus or income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds five percent of the value of such portion.[51] For this purpose, the value of the grantor's reversionary interest will be determined assuming the maximum exercise of discretion in favor of the grantor.[52] There is an exception from the general rule for reversionary interests that take effect upon the death of a lineal descendant of the grantor who dies before attaining the age of twenty-one.[53] More specifically, in the case of a beneficiary who is (1) a lineal descendant of the grantor and (2) holds all of the present interests in any portion of a trust, the grantor will not be considered the owner of that portion of the trust under Section 673(a) solely by reason of a reversionary interest in such portion that takes effect upon the death of such beneficiary before attaining the age of twenty-one.[54] Note that in accordance with Section 672(e), the grantor will be taxed as the owner of any trust in which his spouse has a significant remainder interest.

B. Comments.

History. Section 673 was initially added to the Internal Revenue Code to combat the use of income-shifting *Clifford*-type trusts. In its original form, Section 673 provided that a grantor would be treated as the owner of a trust if he retained a reversionary interest that would or was reasonably expected to take effect in possession or enjoyment within ten years of the transfer to the trust. This rule, rather than the five percent rule described above, still applies to trusts created before March 2, 1986 (for trusts created after March 1, 1986, the five percent rule applies). In addition, with respect to transfers in trust made before March 2, 1986, the provisions of Section 673 will apply and trigger grantor trust status only if the grantor retains a reversionary interest; the interest of the grantor's spouse will not be imputed to him pursuant to the current spousal unity rule of Section 672(e).

Reversionary Interest. A reversionary interest is an interest that entitles the grantor to receive a portion of the trust property at some point in the future (following the termination of the previous interest in the trust property). The most common type of reversionary interest is the grantor's retained right to receive the trust corpus (and any accumulated income) upon the termination of the trust. However, the fact that trust property may revert to the grantor under the laws of intestate succession (i.e., upon the death of a trust beneficiary who dies intestate) does not seem to create a reversionary interest causing grantor trust status under Section 673.[55]

Valuation. Since there is no guidance contained in the Code or Treasury Regulations, reversionary interests are often valued for purposes of Section 673 using the principles set forth in Sections 2037, 2031 and 7520 (and the Regulations thereunder).[56] The analogy to Section 2037 seems apt, as Section 2037(a)(2) provides for the inclusion in the grantor's gross estate of any property transferred by the grantor in which he retained a reversionary interest.[57] The Treasury Regulations under Section 2031 provide that the fair market value of a reversionary interest (for purposes of Section 2037) is the present value of such interest determined by using the actuarial principles of Section 7520.[58] Finally, Section 7520 provides that the value of a reversionary interest is determined under the tables prescribed by the Secretary and by using an interest rate equal to 120% of the federal midterm rate in effect under Section 1274(d)(1) for the month in which the valuation date falls (the "7520 rate").[59] In the case of a reversionary interest that becomes possessory after a term of years or upon the death of an individual, the applicable tables are found in Internal Revenue Service Publications 1457 and 1458 (formerly known as Book Aleph and Book Beth, and most recently updated as of May 1, 2009).

Although Section 7520 and the Service's actuarial tables are helpful in valuing reversionary interests that take effect upon the death of an individual or following a term of years, reversionary interests that take effect upon the occurrence of an uncertain event are much more difficult to value. The Treasury Regulations under Sections 2031 and 2037 provide some (although not much) guidance in this regard with respect to the valuation of reversionary interests for estate tax purposes under Section 2037. When read together, these Regulations suggest that a reversionary interest generally has some value unless the likelihood of the condition or contingency giving rise to the reversion is very remote.[60] Thus, in most cases, the value of a reversion that is not susceptible of valuation pursuant to actuarial principles is the "price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."[61]

For purposes of determining whether the value of the reversionary interest meets the five percent test of Section 673, the calculation is made based on the value of the trust property at the time of the transfer (and in the case of multiple transfers to the same trust, the five percent rule is applied independently to each transfer based on the value of the trust property as of the date of such transfer). Similarly, if the reversionary interest pertains to only a portion of the trust, the five percent test is computed based on the value of the portion of the trust to which the reversionary interest applies.

When interest rates are low, any trust in which the grantor retains a reversionary interest must be of very long duration in order to avoid grantor trust status under Section 673. Furthermore, even if the duration of the trust or the applicable interest rate is such that the value of the reversionary interest is less than five percent of the value of the portion of the trust to which the reversion applies, the grantor may still be treated as the owner of that portion of the trust under Section 677(a)(2).[62] In that case, items of income, deduction and credit that are allocable to trust corpus (such as capital gains and losses) will be included in the portion of the trust owned by the grantor.[63] Finally, note that the five percent rule contemplates a calculation based on values as of the date of transfer to the trust, and any subsequent change in the value of the trust property or applicable interest rate does not appear to affect grantor trust status.[64]

C. <u>Score</u>.

Transfer Tax. The grantor's gift to a trust in which he retains a reversionary interest will not be rendered incomplete solely by reason of such retained interest. If the grantor has parted with dominion and control over the interests granted to other beneficiaries of the trust, the gifts of those interests will be complete for gift tax purposes.[65] The value of the completed gift will depend upon the rights and benefits granted to the non-grantor beneficiaries and the length of the trust's duration. In addition, if Section 2702 applies to the transfer, and the reversionary interest retained by the grantor is not a qualified interest, then gift tax will be calculated based on the value of all property transferred to the trust (with no reduction for the value of the interest retained by the grantor). Under Section 2702, the value of a grantor's retained interest is generally disregarded in computing the gift tax value of property transferred to or for the benefit of a member of the grantor's family unless the grantor's retained interest is a qualified interest under Section 2702(b).

The value of the grantor's reversionary interest in the trust at the time of his death will be included in his estate for estate tax purposes under Section 2033 as an interest in property held by a decedent at the date of his death. If the reversionary interest terminates at the grantor's death, then the grantor's estate will include the value of interests in the trust held by successor beneficiaries under Section 2037 if such beneficiaries obtained ownership of their interests by surviving the grantor and the value of the grantor's reversionary interest was more than five percent of the value of the trust immediately before the grantor's death. The latter requirement of Section 2037 will always be met in the case of a Section 673 reversionary interest.

If the grantor grants his spouse a remainder interest in the trust rather than retaining an interest himself, the spousal unity rule of Section 672(e) will operate to bring the trust within the scope of Section 673, assuming that the value of the remainder interest exceeds five percent of the value of the trust. In that case, the property would not be included in the grantor's estate, Section 2702 would not apply if the grantor gave away his entire interest in the property, and the gift tax marital deduction should eliminate any gift tax liability with respect to the remainder interest if the grantor's spouse is a citizen of the United States. The remainder interest will be included in the spouse's estate at her death, and its actuarial value will increase over time even if the value of the trust property does not.

Flexibility. Assuming the grantor has given his spouse a remainder interest in the trust (because retaining a reversionary interest has such disastrous transfer tax consequences), there is no apparent method of terminating grantor trust status at a later date. Grantor trust status under Section 673 is determined at the time property is transferred to the trust. It is not clear whether the spouse's subsequent transfer of her remainder interest would change the grantor trust status of the trust.[66]

Portion Rule. A grantor may have a reversionary interest in only the income of a trust, only the corpus of a trust, or only a portion of either (or both). If a grantor is treated as the owner of a portion of the trust under Section 673 by reason of his reversionary interest in the trust's ordinary income (only), then the grantor will not be taxed on items of trust income allocable to corpus under Section 673.[67] Note, however, that if a grantor is treated as the owner of a portion of the trust under Section 673 by reason of his reversionary interest in the trust's corpus (only), then both ordinary income and other income allocable to corpus will be included in that portion.[68] Similarly, both ordinary income and other income allocable to corpus are taxable to the grantor if the grantor's reversionary interest applies to both income and corpus of the trust.[69] As a practical matter, a reversionary trust that meets the requirements of Section 673(a) is likely to be treated as a wholly grantor-owned trust because of the application of Section 677 to items of taxable income allocable to corpus that are accumulated and set aside for the benefit of the grantor.[70]

Maintenance. Section 673 appears to be a fairly low-maintenance path to grantor trust status, as the language of Section 673(a) directs us to examine beneficial ownership of the trust property "as of the inception" of the trust. This would seem to support a conclusion that the value of any reversionary interest is measured (for purposes of the five percent test) as of the date the trust is created (with subsequent changes in the value of trust property and applicable interest rates having no effect).[71] It would also support the notion that any subsequent change in the grantor's marital status would not affect the trust's income tax treatment.

IV. Section 674 (Power to Control Beneficial Enjoyment)

A. Statute. Section 674(a) sets out the general rule that a grantor will be treated as the owner of any portion of a trust of which the beneficial enjoyment (of the corpus or the income) is subject to a power of disposition exercisable by the grantor or a nonadverse party (or both) without the approval or consent of any adverse party.[72] That general rule is significantly eroded by the three groups of exceptions that follow in Sections 674(b), 674(c) and 674(d). Section 674(b) provides eight exceptions for powers over trust property that may be held by any person, Section 674(c) provides two additional exceptions for powers that are exercisable by an independent trustee (someone not a related or subordinate party subservient to the grantor's wishes), and Section 674(d) provides a final exception for a power exercisable by any trustee other than the grantor or the grantor's spouse. Thus grantor trust status can be obtained under Section 674 if the grantor or a nonadverse party has a power to affect the beneficial enjoyment of trust property that does not fall within any of the exceptions described below.

Section 674(b)(1) (Power to Apply Income to Support of a Dependent). Section 674(b)(1) provides that the income of a trust will not be taxable to the grantor under Section 674 by reason of any person holding an unexercised power described in Section 677(b).[73] Section 677(b) provides that the income of a trust will not be taxable to the grantor merely because such income, in the discretion of another person, the trustee or the grantor acting as trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support, *unless such income is actually so applied or distributed*.[74] The Treasury Regulations under Section 674 clarify that this exception does not extend to a power held by the grantor unless such power is held by the grantor in his or her capacity as trustee or co-trustee.[75]

Section 674(b)(2) (Power Affecting Beneficial Enjoyment Only After Occurrence of Event). Section 674(b)(2) provides that a power to affect the beneficial enjoyment of trust property held by any person will not cause grantor trust status if the power will not be effective for such a long period of time that if the power were held by the grantor it would not meet the five percent test of Section 673.[76] Once that period ends, however, and the power may be effectively exercised, the grantor may be treated as the owner of the trust unless the power is properly relinquished.[77]

Section 674(b)(3) (Power Exercisable Only by Will). Section 674(b)(3) generally provides that a testamentary power of appointment over trust property held by any person will not cause the grantor to be treated as the owner of the trust under Section 674. However, the following testamentary power of appointment will cause grantor trust status: a testamentary power of appointment over accumulated trust income that is held by the grantor, where trust income is accumulated for such disposition or may be so accumulated in the discretion of the grantor or a nonadverse party (or both) without the approval or consent of any adverse party.[78]

Section 674(b)(4) (Power to Allocate Among Charitable Beneficiaries). Section 674(b)(4) generally provides that a power held by any person to determine the beneficial enjoyment of trust property irrevocably payable for charitable purposes specified in Section 170(c) (or to an employee stock ownership plan in a qualified gratuitous transfer) will not trigger grantor trust status.

Section 674(b)(5) (Power to Distribute Corpus). Section 674(b)(5) provides that a power held by any person to distribute trust corpus will not trigger grantor trust status if such distributions are either (A) limited by a reasonably definite distribution standard set forth in the trust instrument or (B) chargeable against the proportionate share of trust property held for the benefit of the recipient beneficiary as if such corpus constituted a separate trust.[79] Note that a "reasonably definite" standard for this purpose is similar, but not identical, to an "ascertainable standard" in the context of a general power of appointment causing estate tax inclusion.[80] The Treasury Regulations provide examples of a reasonably definite standard and generally provide that a "clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonable definite standard" for purposes of Section 674(b)(5).[81] Finally, a power will not fall within this exception to Section 674(a) if any person has the power to add to the beneficiary or beneficiaries of the trust, unless such addition is to provide for after-born or after-adopted children.[82]

Section 674(b)(6) (Power to Withhold Income Temporarily). Section 674(b)(6) provides that a power held by any person to distribute or accumulate trust income to or for any current income beneficiary will not cause trust income to be owned by the grantor, provided that any accumulated income is ultimately payable: (A) to the beneficiary from whom such distribution was withheld, to his or her estate or to his or her appointees pursuant to a broad general or special power of appointment, or (B) on termination of the trust (or in conjunction with another distribution of trust corpus that includes accumulated income), to the current income beneficiaries of the trust in shares that have been irrevocably specified in the trust instrument, or (C) to the beneficiary's appointees or to one or more alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified, if the beneficiary dies before a date of distribution that he or she could reasonably be expected to survive.[83] The Treasury Regulations describe this power to accumulate income as one that "enables the holder merely to effect a postponement in the time when the ordinary income is enjoyed by a current income beneficiary."[84] The Regulations also provide that the exception in Section 674(b)(6) is generally not available for a power that permits the shifting of ordinary income from one beneficiary to another.[85] However, the exception provided in Section 674(b)(6) does encompass a limited power to shift accumulated income from one beneficiary to another.[86] Finally, note that this exception applies only to powers over trust accounting income and that a power will not fall within this exception if any person has the power to add to the beneficiary or beneficiaries of the trust, unless such addition is to provide for after-born or after-adopted children.[87]

Section 674(b)(7) (Power to Withhold Income During Disability of Beneficiary). Section 674(b)(7) provides that a power held by any person to distribute or accumulate trust income to or for the benefit of any current income beneficiary during (A) such beneficiary's legal disability, or (B) any period in which such beneficiary is under the age of twenty-one years, will not cause trust income to be taxable to the grantor of the trust.[88] This power is similar to that described in Section 674(b)(6), but there is no requirement under Section 674(b)(7) that the income withheld ultimately be subject to the beneficiary's disposition (payable to the beneficiary, his or her estate or his or her appointees). This means that income may be diverted from a minor or disabled income beneficiary, accumulated and added to corpus, and subsequently distributed to beneficiaries other than the income beneficiary without triggering grantor trust status.[89] Finally, note that the exception described in Section 674(b)(7), like that described in Section 674(b)(6), applies only to powers over trust accounting income and that a power will not fall within this exception if any person has the power to add to the beneficiary or beneficiaries of the trust, unless such addition is to provide for after-born or after-adopted children.[90]

Section 674(b)(8) (Power to Allocate Between Corpus and Income). Section 674(b)(8) provides that a power held by any person to allocate receipts and disbursements between corpus and income for trust accounting purposes, even though expressed in broad language, will not cause grantor trust status.[91] Practitioners generally presume that this exception applies only to such a power exercised in a fiduciary capacity.[92]

Section 674(c) (Exception for Certain Powers of Independent Trustees). Section 674(c) provides two additional exceptions to the general rule in Section 674(a) that the grantor will be treated as the owner of any portion of a trust of which the beneficial enjoyment (of the corpus or the income) is subject to a power of disposition exercisable by the grantor or a nonadverse party. Section 674(c) provides exceptions for powers exercisable solely by a trustee or trustees, none of whom is the grantor or the grantor's spouse and no more than half of whom are related or subordinate parties subservient to the wishes of the grantor to (A) distribute or accumulate income to or for a beneficiary or beneficiaries; or (B) pay corpus to or for a beneficiary or beneficiaries.[93] These exceptions apply only to powers that may be exercised by such independent trustees without the approval or consent of any other person and include discretionary powers to distribute trust income and corpus that are not limited by any standard.[94] As noted above, Section 672(c) creates a presumption that a related or subordinate party is subservient to the grantor's wishes. This presumption is difficult to overcome and would require a finding that the trustee is not acting in "accordance with the grantor's wishes."[95] Note that a power will not fall within this exception if any person has a power to add to the beneficiaries of the trust, unless such addition is to provide for after-born or after-adopted children.[96]

Section 674(d) (Power to Allocate Income if Limited by a Standard). Section 674(d) sets forth the final exception to the general rule contained in Section 674(a) for a power solely exercisable by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute or accumulate income for a beneficiary or beneficiaries if such power is limited by a reasonably definite external standard set forth in the trust instrument.[97] As in Section 674(c), this exception applies only to a power that may be exercised by such trustees without the approval or consent of any other person. Unlike Section 674(c), this exception seems to apply only to powers over trust income, although a dispositive power similarly subject to a reasonably definite external standard will likely fall within the exception for a power over corpus set forth in Section 674(b)(5)(A).[98] Note that a "reasonably definite external standard" under Section 674(d) is not necessarily the same as an "ascertainable standard" for purposes of identifying a general power of appointment under Sections 2041 and 2514.[99] Note also that a grantor's power to remove, replace or add trustees may prevent a trust from qualifying for the exceptions described in Section 674(c) and 674(d) (generally where the grantor has an unrestricted right to remove and replace the trustee and the grantor's imputed possession of the trustee's powers to affect beneficial enjoyment would trigger grantor trust status).[100] Finally, as with the exceptions in Sections 674(b)(5), 674(b)(6), 674(b)(7) and 674(c), this exception does not apply if any person has a power to add to the beneficiaries of the trust, unless such addition is to provide for after-born or after-adopted children.[101]

B. <u>Comments & Scores</u>.

Possible Paths to Grantor Trust Status under Section 674. In order to establish a wholly-owned grantor trust under Section 674, the grantor or a nonadverse party must have a power to affect the beneficial enjoyment of all trust income and corpus, and such power must not fall within any of the exceptions described in Sections 674(b), 674(c) or 674(d). Some of these exceptions deal with powers that would cause disastrous transfer tax consequences for the grantor regardless of by whom the power is held. For example, if any trust property were distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support, the value of all trust property would be included in the grantor's estate for estate tax purposes under Section 2036.[102] Section 2036(a) provides that the value of a decedent's gross estate includes the value of all property the decedent has transferred in which he has retained (1) the possession or enjoyment of the property or the right to income from the property, or (2) the right to designate the persons who will enjoy the property or the income therefrom.[103] The Treasury Regulations under Section 2036 provide that such possession or enjoyment of the property is considered as having been retained by the decedent when such property is to be applied toward the discharge of a legal obligation of the decedent (including the decedent's legal obligation to support a dependent).[104]

Some of these exceptions deal with powers that would cause undesirable transfer tax consequences if held by the grantor, but are transfer tax neutral if held by the grantor's spouse or another nonadverse party. For example, if the grantor holds a testamentary power of appointment over trust property, such property will be included in the grantor's estate for estate tax purposes under Section 2041 or 2038, depending upon the permissible objects of the power.[105] Section 2041 provides that the value of a decedent's gross estate includes any property over which the decedent holds a general power of appointment at his or her death,[106] and Section 2038 provides that the value of a decedent's gross estate includes any property transferred by the decedent over which he retains a power to change the beneficial enjoyment (such as a power of appointment over trust property).[107] Furthermore, the grantor's retention of any power of appointment will render at least a portion of the grantor's transfer to the trust incomplete for gift tax purposes (whether the gift is entirely or only partly incomplete depends upon the terms of the trust).[108] However, if the grantor gives his spouse a special testamentary power of appointment over both accumulated trust income and corpus, the spousal unity rule of Section 672(e) would treat the power as held by the grantor (rather than his spouse) for income tax, but not estate tax, purposes, so that the trust property would not be included in the grantor's estate and the gift to the trust would be complete. A special power of appointment (as opposed to a general power of appointment) will also avoid inclusion of the trust property in the spouse's estate. Bearing that in mind, below is an analysis of three of the most common methods for triggering an intentional grantor trust under Section 674.

Grantor's Spouse as Trustee.[109] If the grantor's spouse is serving as trustee of a trust, and she has a discretionary power to spray trust income and corpus among the trust beneficiaries (charging distributions against the trust as a whole) that is not subject to a reasonably definite standard contained in the trust instrument, then the trust will be a wholly-owned grantor trust under Section 674(a).[110] Note that the grantor's spouse should not be a beneficiary of the trust or have a legal obligation to support any beneficiary of the trust, otherwise she will be an adverse party under Section 672(a) and the general rule of Section 674(a) will not apply.[111] The trustee's discretionary power to spray trust income and corpus among the beneficiaries prevents the application of the exceptions contained in Sections 674(b)(6) (the power to withhold trust income temporarily) and 674(b)(5)(B) (the power to make distributions of trust corpus chargeable against the beneficiary's proportionate share of trust property).[112] The absence of a reasonably definite distribution standard avoids Section 674(b)(5)(A) with respect to distributions of trust corpus limited by a reasonably definite standard.[113] Finally, the exceptions contained in Section 674(c) will not apply to powers held by the grantor's spouse as trustee by reason of the spousal unity rule set forth in Section 672(e).[114]

This possible path to intentional grantor trust status can be evaluated as follows: (a) Transfer Taxes—If the grantor's spouse has not made contributions to the trust and cannot make distributions of trust property to herself or in satisfaction of her legal obligations, her service as trustee as described above should not cause inclusion of the trust property in her estate for estate tax purposes (Section 2036 or 2038 would likely operate to include the value of trust property in the estate of a grantor serving as trustee of the same trust); (b) Flexibility—In these circumstances, grantor trust status could be terminated intentionally by the resignation or removal of the grantor's spouse as trustee and the appointment of a successor trustee who is not a related or subordinate party (assuming such an arrangement is possible under the trust instrument and state law, such removal and replacement powers retained by the grantor should not cause adverse transfer tax consequences[115]). This would cause the trust to fall within the exception to grantor trust status (applicable to both income and corpus) described in Section 674(c); (c) Portion Rule—If the grantor's spouse has discretionary powers of distribution over both income and corpus, the entire trust will be treated as owned by the grantor for income tax purposes;[116] (d) Maintenance—When the grantor's spouse dies (or divorces the grantor), grantor trust status will terminate unless the successor trustee (or more than half of the successor trustees) is a related or subordinate party who is subservient to the grantor's wishes.[117] If the marriage terminates by reason of divorce, the grantor's spouse may continue serving as trustee, and the grantor and beneficiaries may not have an opportunity to substitute a related or subordinate trustee. Note, however, that the grantor's spouse may move out of the grantor's home (stopping short of divorce) without affecting the income tax status of the trust, as Section 674(c) does not require that the grantor and spouse live together (as required by Section 674(d)).

Related or Subordinate Parties as Trustees.[118] Similarly, grantor trust status could be achieved under Section 674 by appointing a trustee (or more than half of a group of co-trustees) who is a both a nonadverse party and a related or subordinate party subservient to the grantor's wishes, and granting such trustee a discretionary power to distribute trust income and corpus that is not limited by a reasonably definite external standard. A trustee who is a nonadverse party will initially cause the trust to fall within the general grantor trust rule of Section 674(a).[119] If the trustee is related or subordinate to the grantor (and presumed subservient to the grantor's wishes) under Section 672(c), then the exception provided for independent trustees under Section 674(c) will not apply.[120] Without a reasonable definite external standard, the distributions of trust income will not fall within the exception described in Section 674(d) for powers to allocate income limited by a standard, and distributions of trust corpus will not fall within the exception of Section 674(b)(5)(A) for distributions of corpus limited by a reasonably definite standard.

The trustee should have the power to spray distributions of trust corpus among the beneficiaries without charging such distributions against each beneficiary's proportionate share of the trust corpus (in order to avoid the exception for trust corpus in Section 674(b)(5)(B)) and the power to spray accumulated trust income among the beneficiaries (in order to avoid the exception for trust corpus in Section 674(b)(6)). Alternatively, the trust could provide for separate shares with respect to current and accumulated trust income, so long as the trust lasts for each beneficiary's lifetime and any accumulated income is not payable to the beneficiary's estate or appointees under a testamentary power of appointment (thus failing to qualify for the exception under Section 674(b)(6)).[121]

Using this structure to trigger grantor trust status has many of the same benefits and drawbacks described above with respect to a trust of which the grantor's spouse is serving as trustee: (a) Transfer Taxes—Powers held by a trustee who is a related or subordinate party subservient to the grantor's wishes should not cause the inclusion of trust property in the grantor's estate for estate tax purposes or render the grantor's gift to the trust incomplete. Even if the trustee is actually subservient to the grantor's wishes (as opposed to merely presumed to be subservient under Section 672(c)), the trustee's powers will apparently not be imputed to the grantor to cause inclusion in the grantor's estate under Section 2036.[122] Assuming the trustee is not a contributor to the trust and does not have any obligation to support a trust beneficiary, the trustee's discretionary powers to distribute trust property should not cause transfer tax consequences with respect to his or her own estate (a trustee who is a nonadverse party is necessarily also not a beneficiary of the trust); (b) Flexibility—As described above, a change of fiduciaries could terminate grantor trust status in these circumstances. More specifically, if the successor trustee (or half or fewer of the successor co-trustees) was not related or subordinate to the grantor, the trustee's discretionary power to distribute trust income and principal among the beneficiaries would qualify for the exception from grantor trust status provided in Section 674(c) for independent trustees; (c) Portion Rule—As noted above, if the trustee has discretionary powers of distribution over both income and corpus, the entire trust will be treated as owned by the grantor for income tax purposes;[123] (d) Maintenance—If one or more trustees die, resign or otherwise cease to serve as trustee, then the trust's continued treatment as a grantor trust will depend on the identity of the successor trustee or trustees and the identity of any remaining trustees.[124]

Power to Add Trust Beneficiaries. Several of the exceptions to grantor trust status contained in Section 674 that can be especially difficult to avoid are negated in one fell swoop if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus of a trust, except where such addition is to provide for after-born or after-adopted children. More specifically, the exceptions to grantor trust status described in Sections 674(b)(5) (relating to powers to distribute corpus), 674(b)(6) (relating to powers to withhold income temporarily), 674(b)(7) (relating to a power to withhold income during a beneficiary's disability), 674(c) (relating to certain powers held by independent trustees) and 674(d) (relating to a power to allocate income limited by a standard) are not available if any person has the power to add beneficiaries of the trust. In other words, if the grantor or a nonadverse party holds a power of disposition over trust property (a grantor trust under Section 674(a)), but one of the exceptions contained in Section 674(b)(5), 674(b)(6), 674(b)(7), 674(c) or 674(d) (preventing grantor trust status) covers such power, the trust will nevertheless be treated as a grantor trust if any party holds the power to add trust beneficiaries.

Although the Code and Treasury Regulations do not provide much guidance regarding (a) who may hold such a power and (b) which beneficiaries or class of beneficiaries may be added, the following rules of thumb have emerged with respect to the use of this "defect" as a path to grantor trust status. The person with the power to add trust beneficiaries (the "powerholder") generally should not be: (i) the grantor (because holding such a power would cause the grantor's gift to the trust to be incomplete for gift tax purposes[125] and would also likely cause inclusion of the trust property in the grantor's taxable estate under Section 2036 or 2038); (ii) an existing beneficiary of the trust (because his or her exercise of the power could be deemed a gift of a portion of his or her interest in the trust); (iii) the trustee (for several reasons, including the possibility that the added beneficiaries may be considered beneficiaries from the trust's inception and thus initial rather than additional beneficiaries, and the possible conflict of such a power with the trustee's fiduciary duty to act in the best interests of the existing beneficiaries); or (iv) anyone who has a legal obligation to support an existing trust beneficiary (because his or her exercise of the power could be deemed a gift of the property that would have otherwise been used to satisfy the obligation[126]). The grantor's spouse may hold this power, assuming that she is not a contributor to the trust.

Various guidelines have also been developed by estate planning practitioners regarding which persons (or class of persons) are permissible additional beneficiaries of a trust. In general, the beneficiaries added under Section 674 should not include: (i) the grantor (because the possibility of trust property being distributed to the grantor may cause inclusion of the trust property in the grantor's estate for estate tax purposes[127]); (ii) the person with the power to add beneficiaries or anyone such powerholder is obligated to support (because the powerholder could be treated as holding a general power of appointment causing inclusion of such property in the powerholder's taxable estate for estate tax purposes[128] or causing the exercise of such power to be a taxable gift from the powerholder[129]);[130] or (iii) an existing contingent remainder beneficiary of the trust (because such person may not be considered an additional beneficiary). Among the more common classes of additional beneficiaries are (a) charitable organizations;[131] and (b) charitable split-interest trusts of which members of the grantor's family are non-charitable beneficiaries. Finally, note that if a nonadverse party holds a lifetime power of appointment over trust property that may be exercised in favor of any person who is not a beneficiary of the trust, this power will likely be considered a power to add trust beneficiaries under Section 674.[132]

Granting a power to add trust beneficiaries under Section 674 is one of the most commonly used methods of achieving grantor trust status. Its popularity is likely due to the following features: (a) Transfer Taxes—So long as (i) the power to add trust beneficiaries is not held by the grantor, an existing beneficiary, or any person who has a legal obligation to support an existing beneficiary, and (ii) the powerholder may not add himself or herself (or someone he or she is obligated to support) as a beneficiary of the trust, the power to add trust beneficiaries should not cause adverse transfer tax consequences for the grantor or the powerholder; (b) Flexibility—The power to add trust beneficiaries is easily "reversed" and grantor trust status terminated if the powerholder has the right to release his or her right to name additional beneficiaries of the trust; (c) Portion Rule—Assuming the grantor or a nonadverse party has a power to affect the beneficial enjoyment of all trust income and corpus, then the power to add trust beneficiaries should operate to create a trust that is wholly owned by the grantor for income tax purposes; (d) Maintenance—The power to add trust beneficiaries may be included in a trust agreement in a manner that requires very little future maintenance by the trustee and others trying to preserve grantor trust status. The grantor should be sure to name successor powerholders in the event of the original powerholder's death, and the trust agreement may grant a fiduciary (such as a special trustee or trust protector) the ability to name successor powerholders (appropriately limited to exclude beneficiaries, trustees and other unsuitable persons). Because these provisions can be included in the trust agreement at the outset, and a powerholder is unlikely to effectively release his or her power without the assistance of a tax professional, there is relatively little risk of an unintentional termination of grantor trust status.

Other Powers. Other powers under Section 674 that may be used to obtain grantor trust status include: (a) giving the grantor's spouse (or a nonadverse party) a lifetime power to appoint trust property (whether there is a standard limiting trust distributions or not),[133] and (b) naming the grantor's spouse as trustee and limiting distributions from the trust with a reasonably definite external standard (although this will cause grantor trust status only with respect to the income portion of the trust and will cause such status only so long as the spouse is married to and living with the grantor).[134]

V. <u>Section 675 (Administrative Powers)</u>

A. <u>Statute</u>. Section 675 describes four categories of administrative powers that if exercised for the benefit of the grantor (rather than the trust beneficiaries) or in a non-fiduciary capacity, will trigger grantor trust status. More specifically, Section 675 provides that the grantor will be treated as the owner of any portion of a trust in respect of which: (1) the grantor or a nonadverse party has the power to allow any person to deal with the trust property for less than adequate consideration; (2) the grantor or a nonadverse party has the power to loan trust property to the grantor without requiring adequate interest or security; (3) the grantor actually borrows trust property and does not completely repay the loan before the beginning of the taxable year (unless the loan is both (a) made by a trustee who is neither the grantor nor a related or subordinate party, and (b) the loan provides for adequate interest and security)); or (4) any person may exercise any one of the following administrative powers in a non-fiduciary capacity: (A) a power to vote stock of a corporation in which the holdings of the grantor and trust are significant, (B) a power to control the investment of the trust property, to the extent such property consists of stock of corporations in which the holdings of the grantor and trust are significant, or (C) a power to reacquire trust corpus by substituting other property of equivalent value. Each of these administrative powers is described in more detail below.

Section 675(1). Section 675(1) provides that the grantor will be treated as the owner of any portion of a trust in respect of which a power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth. Although prohibited by most trust instruments, examples of such transactions would include leasing trust property to the grantor for less than fair market rent, selling trust property to the grantor for less than a fair market value price, and exchanging property with the grantor for other property that is not equivalent in value.[135] The transfer tax consequences associated with the use of such a power to trigger intentional grantor trust status are most undesirable, and therefore Section 675(1) is of little use in that regard. Notably, not only would the grantor risk inclusion of trust property in his estate if he possessed such a power to engage in self-dealing,[136] but a nonadverse third party holding a power described in Section 675(1) would also risk such inclusion.[137] In addition to the estate tax consequences, if the grantor holds this power, his gift to the trust may be considered incomplete, and any transactions that actually occur may provide evidence that he never surrendered dominion and control of the contributed property.

Section 675(2). Section 675(2) provides that the grantor will be treated as the owner of any portion of a trust in respect of which a power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security, except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security. "Indirect" borrowing would include a transaction in which a grantor purchases trust property for an unsecured promissory note.[138] Note that unlike the power described in Section 675(3), the mere existence of the power to loan trust property to the grantor is sufficient to confer grantor trust status (in other words, the power need not be exercised). In addition, grantor trust status will be triggered by inadequate interest *or* inadequate security; both are not necessary.[139] Finally, the power to make loans to the grantor without adequate interest or without adequate security will not cause grantor trust status if the trustee has a general power to loan trust property to others on the same terms.

Section 675(3). Section 675(3) provides that the grantor will be treated as the owner of any portion of a trust in respect of which the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. This rule does not apply to a loan that provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor's wishes.[140] For periods during which an individual is the spouse of the grantor (within the meaning of Section 672(e)), any reference in Section 675(3) to the grantor shall include a reference to such individual.[141]

Although there may be situations in which a trust is treated as a grantor trust under both Sections 675(2) and 675(3), Section 675(3) clearly requires that actual borrowing by the grantor occur (in contrast to Section 675(2), which requires merely the power to borrow). If such borrowing actually occurs at any time during the taxable year, then grantor trust status is conferred for that entire year (if the loan is repaid, grantor trust status will not extend into the following year).[142] For purposes of Section 675(3), indirect borrowing seems to encompass any transaction in which the grantor benefits from the loan proceeds and does not pay adequate interest or adequate security.[143] The applicable federal rate under Section 1274(d) is generally considered an adequate rate of interest, and adequate security should be determined in accordance with local fiduciary standards and comparable commercial lending practices.[144] Finally, there is some question as to how the portion rule is applied to a trust that is a grantor trust by reason of the grantor's actual borrowing. It is unclear whether the amount of trust income borrowed determines the portion of the trust that is treated as a grantor trust or whether the portion of the trust accorded grantor trust status is determined based upon the amount that could have been borrowed, if some borrowing actually occurs.[145] Some cases seem to indicate that if the grantor is serving as trustee, any actual borrowing by the grantor will confer grantor trust status to the entire trust.[146] However, as noted below, actual borrowing of all trust property is the most conservative way to achieve grantor trust status for the entire trust (as opposed to only a portion of the trust).

Section 675(4). Section 675(4) provides that the grantor will be treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a non-fiduciary capacity by any person (without the approval or consent of any person in a fiduciary capacity). For purposes of Section 675(4), the term "power of administration" means any one of the following: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.[147] Note that although Section 675 makes reference to "any person" holding one or more prohibited administrative powers, the Treasury Regulations under Section 675(4) indicate that such powers must be held by a nonadverse party in order to trigger grantor trust status.[148] In addition, whether such administrative powers are held in a non-fiduciary capacity is a question of fact that must be determined based upon all of the terms of the trust instrument and the circumstances surrounding the creation and administration of the trust, and the Service will not rule on whether such a power is held in a fiduciary or non-fiduciary capacity.[149] Furthermore, if an administrative power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries, and this presumption may be rebutted only by clear and convincing proof to the contrary.[150] Therefore, if grantor trust status is desired, a non-adverse party other than the trustee should hold one or more of the powers described in Section 675(4).[151]

Sections 675(4)(A) and (B) deal with powers to control the voting and investment of stock or securities of corporations in which the holdings of the grantor and the trust are significant. Although these powers are similar to the right to vote shares of stock in a controlled corporation described in Section 2036(b), they are not the same, and a grantor's retention of the Section 675(4) powers will not necessarily cause inclusion of the trust property in the grantor's estate (although Sections 675(4) and 2036(b) will often overlap). Section 2036(b) provides that the value of a decedent's gross estate will include the value of all shares of a controlled corporation transferred by the decedent if the decedent retains the right to vote (directly or indirectly) such shares. A controlled corporation is defined in Section 2036(b)(2) as a corporation in which the decedent owned (with the application of the attribution rules described in Section 318) or had the right to vote (either alone or in conjunction with any person) stock possessing at least twenty percent of the total combined voting power of all classes of stock.

Notably, the Code and Regulations do not provide any definition of the term "significant" with respect to Section 675(4). Although it seems that the holdings need not be dominant to fall within Sections 675(4)(A) and (B), it is not clear whether the holdings of the grantor's family or entities in which the grantor owns an interest will be attributed to the grantor for purposes of determining whether holdings are "significant." Sections 675(4)(A) and (B) apply only with respect to holdings in a corporation; voting control and investment authority with respect to interests in a partnership or limited liability company will not trigger grantor trust status under these Sections.

If the grantor holds the powers described in Section 675(4)(A) or 675(4)(B), there is a substantial risk that the trust property will be included in his estate for estate tax purposes under Sections 2036(a)(1) and 2036(b). The chances that the grantor's gift of such property will be deemed incomplete for gift tax purposes appears to be more remote. Finally, the portion rule applies to these Sections so that grantor trust status is accorded only with respect to the stock held by the trust, and grantor trust status terminates when the stock is sold or otherwise disposed.

Section 675(4)(C) refers to a power to reacquire trust property by substituting other property of an equivalent value. Although the term "reacquire" implies that such a substitution may be made only by the original contributor of the affected property, this does not seem to be the case. Private letter rulings have supported the notion that a beneficiary or third party may hold the power described in Section 675(4)(C),[152] and the sample inter vivos charitable lead trust forms provided by the Service also support the position that the substitution power may be held effectively by a third party.[153] Note that such a third party's exercise of this power to substitute assets could be a taxable exchange with respect to the grantor, the third party, or both.[154]

B. <u>Comments & Scores</u>.

Possible Paths to Grantor Trust Status under Section 675. Section 675 provides several very useful (and commonly used) methods for obtaining grantor trust status without causing undesirable transfer tax consequences. Whether the powers described in Section 675 are retained by the grantor or a third party, they are some of the most flexible and unobtrusive triggers of grantor trust status.

Independent Trustee's Power to Lend without Adequate Security. Granting certain trustees the power to loan trust property to the grantor without requiring adequate security is one of the several attractive triggers of grantor trust status contained in Section 675 for the following reasons: (a) Transfer Taxes—It seems clear that the grantor may not hold the power to make loans of trust property to himself on such favorable terms without risking inclusion of trust property in his taxable estate and rendering his gift to the trust incomplete.[155] Furthermore, the power to make loans of trust property to the grantor without requiring adequate interest, regardless of by whom the power is held, would likely cause the trust property to be included in the grantor's estate for estate tax purposes under Section 2036. However, the power to make an *unsecured* loan of trust property to the grantor, which loan *requires adequate interest*, may be held by a nonadverse party (such as the grantor's spouse or a third party) serving as trustee without negative transfer tax consequences (both interest and security need not be inadequate in order to trigger grantor trust status). In addition, some commentators have suggested that a nonadverse party serving as trustee who is not related or subordinate to the grantor might be the safest choice, as it tends to negate any appearance of an implied understanding between the grantor and trustee that could be construed as a retention of such lending power by the grantor himself;[156] (b) Flexibility—As Section 675(2) seems to contemplate a lending power held by the trustee, it is unclear whether such a power may be relinquished or reacquired were a change in the trust's income tax treatment desired; (c) Portion Rule—If the grantor may borrow the entire trust corpus without adequate interest or without adequate security, then grantor trust treatment will extend to the entire trust. However, if the grantor may borrow only a portion of the trust property on these terms, then the trust may not be a wholly-owned grantor trust;[157] (d) Maintenance—As this power need only be exercisable, it is relatively low maintenance. However, attention must be paid to the identity of successor trustees in order to avoid undesirable transfer tax consequences.

Actual Borrowing by Grantor or Grantor's Spouse. The grantor's actual borrowing of trust property without adequate interest or adequate security from a related and subordinate trustee who is subservient to the grantor's wishes is another attractive method of triggering grantor trust status without causing undesirable transfer tax consequences. More particularly, this path to grantor trust status under Section 675(3) has the following benefits and disadvantages: (a) Transfer Taxes—In order to prevent inclusion of trust property in the grantor's estate for estate tax purposes, the grantor or his spouse may borrow trust property (i) for adequate interest and adequate security from a trustee who is either the grantor or a related or subordinate party subservient to the grantor's wishes or (ii) without adequate security from a trustee who is not such a related or subordinate party. An example of the latter option might be the purchase of all trust property by the grantor for an unsecured promissory note that provides for adequate interest payments. As noted above, if the grantor is serving as trustee, he may not borrow trust property without adequate interest and adequate security without risking estate inclusion under Sections 2036 and 2038 (and even if a third party is serving as trustee, inadequate interest may cause estate inclusion as well); (b) Flexibility—Section 675(3) is an extremely flexible method of triggering grantor trust status, because the determination of the trust's income tax treatment is made on a year-by-year basis. More specifically, the grantor's (or his spouse's) repayment of trust property borrowed (and interest due) will terminate grantor trust status for the year following repayment; (c) Portion Rule—As noted above, the application of the portion rule to Section 675(3) is not entirely settled, so the grantor may prefer to borrow the entire trust corpus to ensure that the trust is treated as a wholly-owned grantor trust for any years during which the loan is outstanding; (d) Maintenance—The most significant drawback to Section 675(3) is the same feature that allows the high degree of flexibility described above. Namely, grantor trust status is determined on a year-by-year basis under Section 675(3), requiring close monitoring of borrowing and repayment (remember that if a loan is outstanding for only one day of the year, grantor trust treatment will attach for the entire year). Furthermore, in the absence of close supervision, indirect borrowings by the grantor permitted by the trust instrument may cause inadvertent income tax consequences.

Power to Substitute Assets Exercisable in Non-Fiduciary Capacity. Allowing the grantor or a third party the power to acquire the trust property by substituting other assets of equivalent value is likely the most frequently used trigger of grantor trust status. In addition to the features highlighted below, this power may be used to exchange the grantor's high-basis assets for low-basis assets held by the trust, allowing the low-basis assets to acquire a new basis at the grantor's death.[158] The power of substitution has few, if any, transfer tax consequences, provides flexibility for future planning, confers grantor trust status upon the entire trust, and is relatively low maintenance.

More specifically: (a) Transfer Taxes—Whether the power to substitute assets is held by the grantor in a fiduciary capacity or a non-fiduciary capacity, it now seems clear that the retention of such a power will not cause trust property to be included in the grantor's estate for estate tax purposes under Section 2036 or 2038[159] and will not render the grantor's gift incomplete. As the Service pointed out in Revenue Ruling 2008-22, although a grantor may exercise this power, the trustee has an independent fiduciary duty to ensure that the substituted assets are of equivalent value and to prevent the shifting of benefits among trust beneficiaries. Note that there is some question as to whether estate inclusion may occur if the grantor retains the right to acquire life insurance or stock of a controlled corporation that is held by the trust by substituting assets of equivalent value.[160] An extra-cautious drafter might exclude such assets from a substitution power held by the grantor. Alternatively, the power may be held by the grantor's spouse or another third party; (b) Flexibility—If this power is held by the grantor, it may be relinquished at any time in order to terminate grantor trust status. If held by a third party, the power might be relinquished and later reacquired, although care must be taken to avoid the type of toggling that has recently come under scrutiny as described in Notice 2007-73 and discussed above; (c) Portion Rule—A power to acquire trust corpus by substituting assets of equivalent value appears to confer grantor trust status to the entire trust under the portion rule of Section 671;[161] (d) Maintenance—The substitution power is a relatively low maintenance method for establishing a grantor trust. Like the power described in Section 675(2), the power to substitute assets must merely be exercisable (allowed by the trust agreement and possessed by a living and capable powerholder) but need not be exercised in order to trigger grantor trust status. However, care must be taken to appoint one or more successor powerholders in the event of the death or resignation of any third party serving in such capacity, and the circumstances surrounding the administration of the trust must also be monitored to ensure that the power is continually held (and exercised, if at all) in a non-fiduciary capacity.

VI. Section 676 (Power to Revoke)

A. Statute. Section 676 provides that the grantor will be treated as the owner of any portion of a trust with respect to which the grantor or a nonadverse party (without the consent of an adverse party) has the power to revest title in the grantor.[162] However, this rule does not apply to a power which may only affect the beneficial enjoyment of trust income received after the occurrence of an event that is so remote (or after such a long period of time) that the grantor would not be treated as the owner of the trust under Section 673 if such power were a reversionary interest.[163] If such an event actually occurs, the grantor may be treated as the owner unless such power to revest title in the grantor is relinquished.[164] Note that the term "revest" includes not only the power to revoke the trust, but the power to alter or amend the trust instrument, the power to appoint the trust property, and the power to reacquire trust property for less than fair market value.[165]

B. Comments & Score. Section 676 is very rarely employed for the purpose of triggering grantor trust status because it causes transfer tax consequences that are unacceptable from an estate planning perspective. This is the case whether the power to revest trust property is held by the grantor or a nonadverse third party. More specifically, if the grantor holds a power to revest title to trust property in himself, his gift to the trust will be incomplete for gift tax purposes, and the trust property will be included in his estate for estate tax purposes under Sections 2036 (transfers with retained life estate), 2038 (revocable transfers) and 2041 (powers of appointment). Notably, if the grantor's power to revest title in himself is exercisable only with the consent of an adverse party, the trust will not be a grantor trust, but the trust property will still be included in the grantor's estate for estate tax purposes (although the grantor's gift would be considered complete for gift tax purposes).[166] In addition, even the grantor's postponed power to revest title of trust property in himself under Section 676(b) will cause trust assets to be included in the grantor's estate for estate tax purposes under Section 2036, which does not distinguish between retained powers that are subject to contingencies beyond the decedent's control.[167]

Finally, if the power to revest title to trust property in the grantor is held by a nonadverse third party (or the grantor's spouse), the grantor's gift to the trust may be deemed complete for gift tax purposes assuming there is no actual or implied understanding or agreement between the grantor and the powerholder to follow the grantor's instructions.[168] Although Sections 2036 and 2038 generally apply to powers retained by the grantor, a power to revest title to trust property that is not subject to an ascertainable standard may cause inclusion of the trust property in the powerholder's estate for estate tax purposes under Section 2041 and may also subject the trust property to claims of the grantor's creditors, which may be undesirable for tax and non-tax reasons.[169] In addition, if the trust is considered a reciprocal trust or the grantor retains an unrestricted right to remove and replace trustees of the trust, the grantor may inadvertently bring the trust within the scope of Sections 2036 and 2038.[170] Given the disastrous transfer tax consequences associated with the use of a power described in Section 676, the remaining criteria for evaluating this method of triggering grantor trust status will not be discussed.

VII. Section 677 (Income for Benefit of Grantor)

A. Statute. Section 677 generally provides that the grantor will be treated as the owner of any portion of a trust the income of which may be used for the benefit of the grantor or his spouse. More specifically, the grantor will be treated as the owner of any portion of a trust the income of which: (1) may be distributed to the grantor or grantor's spouse, (2) may be held or accumulated for future distribution to the grantor or grantor's spouse, (3) may be applied to the payment of premiums on policies of insurance on the life of the grantor or grantor's spouse (other than policies irrevocably payable for charitable purposes specified in Section 170(c)), or (4) is actually distributed or applied to discharge the grantor's (or his spouse's) legal obligation to support a trust beneficiary other than his spouse.[171] However, the grantor will not be treated as the owner of any portion of a trust by reason of a power that can so affect the beneficial enjoyment of trust income only after the occurrence of an event so remote (or only after such a long period of time) that the grantor would not be treated as the owner under Section 673 if such power were a reversionary interest.[172] The grantor may be treated as the owner after the actual occurrence of the event unless the power is relinquished.[173] If the grantor and his spouse divest themselves permanently and completely of every interest in trust property described in Section 677(a), then the grantor will not be treated as the owner of any portion of the trust following such divestment.[174] Note however, that unless such divestment is a qualified disclaimer described in Section 2518, it may be treated as a taxable gift from the grantor or the grantor's spouse to the remaining trust beneficiaries.

Finally, with respect to the treatment of a grantor as the owner of a portion of a trust solely because its income may be distributed or held or accumulated for future distribution to the grantor's spouse or applied to the payment of premiums for insurance on the spouse's life, Section 677(a) applies to the income of a trust solely during the period of the grantor's marriage to his spouse (making the actual dates of marriage and divorce particularly important).[175] For purposes of Section 677(a)(2), the grantor will be taxed on trust income depending on his marital status on the date of accumulation, not the date of distribution.[176]

Section 677(a)(1). Section 677(a)(1) provides that the grantor will be treated as owning any portion of a trust the income of which may be distributed to the grantor or the grantor's spouse without the approval or consent of an adverse party, or in the discretion of the grantor, the grantor's spouse or a nonadverse party. The mere possibility of such a distribution is sufficient to trigger grantor trust status regardless of whether any such distributions are actually made.[177] In addition, Section 677(a)(1) also applies to distributions actually made to the grantor or his spouse, even if such distributions were not authorized by the terms of the trust instrument.[178] Furthermore, payments made by the grantor, grantor's spouse or a nonadverse party to discharge any legal obligation of the grantor or grantor's spouse (other than the support or maintenance of a beneficiary—other than the grantor's spouse—whom the grantor is legally obligated to support) are treated as distributions of trust income to the grantor or grantor's spouse.[179]

Section 677(a)(2). Section 677(a)(2) provides that the grantor will be treated as owning any portion of a trust the income of which may be held or accumulated for future distribution to the grantor or the grantor's spouse without the approval or consent of an adverse party, or in the discretion of the grantor, the grantor's spouse or a nonadverse party. Section 677(a)(2) applies to trusts of which the income is added to corpus pursuant to the terms of the trust, in the discretion of the trustee, or as required by local law, if (i) the trust property will revert to the grantor or a remainder interest will pass to the grantor's spouse at any time or upon the occurrence of an event, (ii) the trustee has discretion to distribute accumulated trust income to the grantor or his spouse at any time, or (iii) the grantor or his spouse has a power to reach such accumulated income at any time.[180] The grantor will be taxed on such trust income in the year it is accumulated, even if the property is not distributed to the grantor or his spouse that year and even if the grantor and his spouse have no current access to the accumulated property.[181] If the grantor retains such a reversionary interest in accumulated income or the grantor's spouse has such a remainder interest, then under Section 677(a)(2) the grantor will be treated as the owner of all items of taxable income, deduction and credit allocable to trust corpus because they are accumulated for future distribution to the grantor or his spouse (as the case may be).[182]

Section 677(a)(3). Section 677(a)(3) provides that the grantor will be treated as owning any portion of a trust the income of which may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (other than policies irrevocably payable for charitable purposes specified in Section 170(c)) without the approval or consent of an adverse party, or in the discretion of the grantor, the grantor's spouse or a nonadverse party. Although the Code seems to suggest that the mere power to apply income to the payment of such premiums is sufficient to trigger grantor trust status, several older court opinions indicate that the grantor will be taxed only on the trust income actually applied to the payment of premiums, not on all income that could have been used for such purpose.[183] The Service has also issued private letter rulings that seem to support both positions.[184] In either case, the grantor may also be taxed on trust income distributed to a beneficiary and subsequently applied to premiums on policies of insurance on the life of the grantor or the grantor's spouse if the beneficiary is acting as the grantor's agent.[185]

Section 677(b). Section 677(b) provides an exception to the general rule of Section 677(a) for trust income that may be applied or distributed for the support or maintenance of a trust beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain. The grantor will not be treated as the owner of any portion of a trust merely because trust income, in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be so applied or distributed unless such income is *actually so applied or distributed*.[186] Therefore, unlike the provisions of Section 677(a), the grantor will not be treated as the owner of any portion of a trust merely because the trustee or another person has the power to make such payments.[187] Note, however, that the general rule of Section 677(a), and not Section 677(b), will apply in the following circumstances: (i) where the grantor or a nonadverse party has discretion to apply trust income to discharge the grantor's obligations (other than the obligation of support or maintenance described in Section 677(b));[188] (ii) where the grantor (alone or in conjunction with another person) has discretion to apply or distribute trust income unless such discretion is held as trustee or co-trustee;[189] and (iii) to the extent income is required (without any discretionary determination) to be applied to the support of a beneficiary whom the grantor is legally obligated to support.[190] Finally, if any amount applied or distributed for the support of a beneficiary whom the grantor is legally obligated to support is paid out of trust corpus or accumulated income, the grantor will be treated as a beneficiary of the trust, and the amount applied or distributed will be considered to be an amount paid within the meaning of Section 661(a)(2), taxable to the grantor under Section 662.[191]

Although the grantor's legal obligation to support a trust beneficiary is not well-defined, such an obligation seems to be based upon the identity of the beneficiary and the nature of the payment. For example, the grantor will generally have a legal obligation to support his minor children, including payments for their food, shelter, clothing, medical and dental care and education.[192] It is often difficult to distinguish between expenses that fall within the grantor's legal obligation of support, and those that might be considered luxury items. Modern case law appears to consider the grantor's financial and social status in making such determinations.[193]

B. Comments & Scores.

Possible Paths to Grantor Trust Status. If the grantor retains an interest in the income of a trust, the trust property will likely be included in his estate for estate tax purposes, and his transfer of the property to the trust may not be complete for gift tax purposes. If the grantor retains an income interest and is also the trustee of the trust, the trust property will be included in his estate under Section 2036(a), and his transfer of property to the trust will be an incomplete gift under Section 2511.[194] If a third party trustee is required to make distributions to satisfy the grantor's legal obligations, then the trust property will be included in the grantor's estate under Section 2036 as well.[195] If such a trustee has discretion to use trust property to satisfy the grantor's legal obligations, and the trust property may be reached by the grantor's creditors under state law, then the trust property will be included in the grantor's estate, and the grantor's transfer to the trust will be treated as an incomplete gift for federal gift tax purposes.[196] Otherwise, the value of the grantor's completed gift to the trust will be determined by subtracting the value of the interest he retained.[197] Furthermore, actual distributions to the grantor made at the trustee's discretion may create the appearance of an implied agreement regarding distributions between the grantor and trustee.[198]

Given the transfer tax consequences of the grantor's retention of an income interest in the trust, the practical triggers of grantor trust status under Section 677 involve income interests held by the grantor's spouse and the use of trust income for payment of premiums on policies of insurance on the grantor's (or his spouse's) life. The use of trust income to pay such premiums will not, by itself, cause trust property to be included in the grantor's estate for estate tax purposes.[199] These two options are discussed in more detail below.

Grantor's Spouse as Discretionary Beneficiary. If the grantor transfers his separate property to a trust of which his spouse is a discretionary beneficiary, and a person other than the grantor, his spouse, or an adverse party who is related or subordinate to the grantor is trustee, the grantor will be treated as the owner of the trust under Section 677(a)(1). This possible path to grantor trust status has the following benefits and disadvantages: (a) Transfer Taxes—Trust property will not be included in the estate of the grantor or his spouse, and the grantor's transfer to the trust will be a completed gift for gift tax purposes (so long as the grantor and his spouse do not create reciprocal trusts with the same terms naming each other as beneficiary[200]); (b) Flexibility—This structure does not allow a simple method of terminating grantor trust status. If the grantor's spouse divests herself of her interest in the trust, grantor trust status may terminate, but such divestment will be considered a taxable gift from the spouse to the other trust beneficiaries unless it meets the requirements of a qualified disclaimer under Section 2518. A third party might be granted the right to terminate the spouse's beneficial interest in the trust, if such a provision is acceptable from a non-tax perspective;[201] (c) Portion Rule—The application of the portion rule to powers held under Section 677 is not entirely clear.[202] However, the applicable Treasury Regulations seem to indicate that the grantor is treated as owning only those items of income, deduction and credit allocable to the portion of the trust from which his spouse may benefit.[203] If income may be accumulated for later distribution to the grantor's spouse under Section 677(a)(2) (the spouse has an interest in the remainder of the trust), then the grantor will be treated as the owner of items of income allocable to trust corpus because they are accumulated for such distribution;[204] (d) Maintenance—This is a relatively low maintenance method of obtaining grantor trust status, however such status will terminate when the grantor's spouse dies or divorces the grantor.

Income Used for Payment of Life Insurance Premiums. The grantor will be treated as the owner of any portion of a trust the income of which may be applied by a nonadverse trustee to pay premiums on policies of insurance on the life of the grantor or the grantor's spouse. As discussed above, the power to so apply trust income will not cause adverse transfer tax consequences for the grantor or the grantor's spouse. However, because it is unclear whether the grantor is taxed as the owner of only that income actually applied to pay life insurance premiums or as the owner of all trust income that could have been so applied, Section 677(a)(3) should not be relied upon to confer grantor trust status.[205] This uncertainty also makes it difficult to evaluate the Section 677(a)(3) trigger in terms of flexibility, the portion rule, and maintenance requirements.

VIII. Section 679 (Foreign Trusts Having One or More United States Beneficiaries)

A. Statute. Section 679 generally provides that a United States person who directly or indirectly transfers property to a foreign trust will be treated as the owner of the portion of the trust attributable to such transfer if there is at least one United States beneficiary of any portion of the trust (determined on an annual basis).[206] However, the following transfers will not trigger grantor trust status under Section 679: (a) any transfer of property to a foreign trust by reason of the death of the transferor; (b) any transfer of property to a foreign pension, profit-sharing, or stock bonus trust under Section 402(b), 404(a)(4) or 404A; (c) any transfer of property to a foreign trust described in Section 501(c)(3) (without regard to the requirements of Section 508(a)); and (d) any transfer of property to a foreign trust to the extent the transfer is for fair market value.[207] The rules of Section 679 apply without regard to whether any United States grantor retains any of the powers or interests that would render the trust a grantor trust under Sections 673 through 677.[208]

B. Comments.

Definitions. The Treasury Regulations under Section 679 define the key terms used in determining the income tax status of a foreign trust.[209] A United States person is generally defined in Section 7701(a)(30) to include a United States citizen or resident alien, a foreign national who has a substantial presence in the United States, and any United States partnership, corporation, estate or trust. A foreign trust is defined in Section 7701(a)(31)(B) as any trust other than a United States trust.[210] A United States trust is generally defined as a trust over which a court within the United States has primary jurisdiction with respect to the trust's administration (the "court test") and with respect to which one or more United States persons has authority to control all substantial decisions (the "control test").[211]

A foreign trust is treated as having a United States beneficiary unless (A) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person, and (B) if the trust were terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of a United States person.[212] Treasury Regulations under Section 679 provide that the determination of whether a foreign trust has a United States beneficiary is made annually and without regard to whether trust income or corpus is actually distributed to a United States person during that year and without regard to whether a United States person's interest in the trust is contingent on a future event.[213] Even though a trust instrument may be drafted to preclude United States beneficiaries, the trust may be treated as having such a beneficiary based on any written or oral understandings or agreements relating to the trust and the facts and circumstances surrounding the administration of the trust.[214]

Status of Beneficiaries. As the existence of United States beneficiaries is determined on an annual basis, the death or expatriation of a beneficiary may affect the trust's status as a grantor trust. If a foreign trust acquires a United States beneficiary (and thus acquires grantor trust status), the United States grantor will be treated as having additional income (in the amount of the trust's undistributed net income at the end of the preceding year) in the first year in which the trust is treated as having a United States beneficiary.[215] If a foreign trust ceases to have a single United States beneficiary (by reason of death or the beneficiary's change in nationality), the United States grantor will cease to be treated as owner of the trust beginning in the first year following the year in which the trust ceased to have a United States beneficiary.[216] The United States grantor will also be treated as making a transfer of property to the foreign trust on the first day of the first year following the year in which the trust ceased to have a United States beneficiary.[217]

Reporting Requirements. Several special reporting requirements are imposed on the grantors and beneficiaries of foreign trusts described in Section 679.[218] The creation of such a foreign trust must be reported to the Service, the grantor must submit annual accountings to the Service, and any beneficiary who receives a distribution from a foreign trust must report such receipt to the Service. The failure to file any of these reports on a timely basis will result in harsh penalties.[219]

C. Score.

Although the creation of a foreign trust with one or more United States beneficiaries will not necessarily cause inclusion of the trust property in the grantor's estate for estate tax purposes (depending on the terms of the trust), foreign trusts are subject to many complex additional rules that do not apply to domestic trusts.[220] For this reason, grantors are unlikely to establish a foreign trust merely to obtain grantor trust status. Note with respect to both flexibility and maintenance, that the trust's income tax status is determined on an annual basis and may change based upon the status of the trust's beneficiaries (the acquisition or loss of a single United States beneficiary) and fiduciaries (the acquisition or loss of a foreign trustee with authority to make at least one substantial decision regarding the trust), which are likely to be beyond the grantor's control.

IX. Summary and Conclusions

Below is a summary of the scores assigned to each of the paths to grantor trust status described above. Unsurprisingly, the methods most commonly employed by estate planners received the most favorable scores (the power to add trust beneficiaries and the power to substitute assets exercisable in a non-fiduciary capacity). However, given that each trigger listed below may be integrated into a trust instrument without adverse transfer tax consequences, some of the less frequently used powers and provisions may be worth considering in special circumstances or where one's default or standby trigger conflicts with a particular client's (tax and non-tax) planning goals or objectives.

	Transfer Tax Neutral	Flexibility to Terminate Status	Portion Rule Easily Avoided	Low Maintenance
Grantor's Spouse as Remainderman Section 673	Yes	No	Yes	Yes
Grantor's Spouse as Trustee Section 674(a)	Yes	Yes	Yes	No
Related or Subordinate Parties as Trustees Section 674(a)	Yes	Yes	Yes	No
Power to Add Trust Beneficiaries Section 674	Yes	Yes	Yes	Yes
Independent Trustee's Power to Lend without Adequate Security Section 675(2)	Yes	No	Yes	Yes
Actual Borrowing by Grantor or Grantor's Spouse Section 675(3)	Yes	Yes	Yes	No
Power to Substitute Assets Exercisable in Non-Fiduciary Capacity Section 675(4)(C)	Yes	Yes	Yes	Yes
Grantor's Spouse as Discretionary Beneficiary Section 677(a)	Yes	No	No	Yes
Income Used for Payment of Life Insurance Premiums Section 677(a)(3)	Yes	No	No	No

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[1] All references to a "Section" contained herein refer to a Section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.
[2] Section 671.
[3] Treas. Reg. § 1.671-2(b).
[4] *Id*.
[5] *Helvering v. Clifford*, 309 U.S. 331 (1940).
[6] *Id*. at 335.
[7] *Id*.
[8] Rev. Rul. 2004-64, 2004-2 C.B. 7.
[9] Rev. Rul. 2007-1, 2007-3 I.R.B. 265; Priv. Ltr. Rul. 200606027 (Feb. 10, 2006); Priv. Ltr. Rul. 200434012 (Aug. 20, 2004); Priv. Ltr. Rul. 9535026 (May 31, 1995); Priv. Ltr. Rul. 9525032 (Mar. 22, 1995); Rev. Rul. 1985-13, 1985-1 C.B. 184.
[10] Section 1361(c)(2)(A)(i).

[11] Rev. Rul. 1985-45, 1985-1 C.B. 183.
[12] Section 101(a)(2)(B). *See also,* Rev. Rul. 2007-13, 2007-11 I.R.B. 684 (holding that the sale of a life insurance policy to grantor trust was not a transfer for value under Section 101(a)(2)); Priv. Ltr. Rul. 200606027 (Feb. 10, 2006) (stating that the exchange of insurance policies between two grantor trusts with the same owner did not trigger realization of gain or loss).
[13] Rev. Rul. 2004-64.
[14] *Id*.
[15] *Id*.
[16] Treas. Reg. § 1.671-2(b).
[17] *Helvering*, 309 U.S. at 335.
[18] Treas. Reg. § 25.2511-2(b).
[19] Notice 2007-73, 2007-36 I.R.B. 545.
[20] Treas. Reg. § 1.6011-4(a). Note that when the Service was confronted with an apparently abusive transaction involving the toggling of a grantor trust, it declined to set new rules in this area. However, the Office of Chief Counsel did encourage the examining agent to consider the step transaction and economic substance doctrines in combating the abuse. I.R.S. Off. Mem. 200923024 (Jun. 5, 2009).
[21] *See, e.g.*, Treas. Reg. § 1.675-1(a) (regarding a grantor's ability to amend the trust instrument to cause grantor trust status under Section 675).
[22] *See* Stephen R. Akers, Carlyn S. McCaffrey, and Diana S. C. Zeydel, Presented at the Fall Meeting of the American College of Trust and Estate Counsel: *Planning with Grantor Trusts - Structuring a Trust to Maximize the Benefits and Minimize the Risks* (Nov. 3, 2007).
[23] *Madorin v. Commissioner*, 84 T.C. 667 (1985).
[24] The grantor will certainly be treated as holding the trustee's power to manage or distribute trust property if he has the power to appoint himself as trustee of the trust. Treas. Reg. § 20.2036-1(b)(3).
[25] Rev. Rul. 95-58, 1995-2 C.B. 191 (1995).
[26] Section 671.
[27] Treas. Reg. § 1.671-3(a).
[28] Treas. Reg. § 1.671-3(b).
[29] Section 678 is excluded from the discussion below because it is outside the scope of this paper. The author directs readers to the following excellent analyses of Section 678: Jonathan G. Blattmachr, Mitchell M. Gans, and Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC JOURNAL 106 (2009); Laura Peebles, Presented at the American Bar Association Section of Taxation Fiduciary Income Tax Committee Meeting: *Navigating Grantor Trust Issues under Section 678 Before and After the Settlor's Death* (Sept. 26, 2009); T. Randolph Harris, Mary Ann Mancini, and Howard S. Tuthill, III, Presented at the Fall Meeting of the American College of Trust and Estate Counsel: *The Rest of the Story: Income Tax Issues Related to Transfer Tax Planning with Grantor and Non-Grantor Trusts* (Oct. 24, 2008).
[30] Treas. Reg. § 1.671-2(e)(1).
[31] Treas. Reg. § 1.671-(2)(e)(2)(i).
[32] Section 672(a). Section 672(a) also provides that a general power of appointment over trust property is a beneficial interest in the trust, although not necessarily a "substantial" beneficial interest.
[33] Treas. Reg. § 1.672(a)-1(a).
[34] Treas. Reg. § 1.672(a)-1(c).
[35] BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS § 80.1.3 (Thomson Reuters/WG&L 2d/3d ed. 1993-2003 & 2011 Cum. Supp. No. 1).
[36] *Id*. at § 80.1.3.
[37] H. ZARITSKY & N. LANE, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS § 7.06[3][a] (Thomson Reuters/WG&L 3d ed. 2001 & Supp. Nov. 2010).
[38] Treas. Reg. § 1.672(a)-1(b).
[39] Treas. Reg. § 1.672(a)-1(c).
[40] Treas. Reg. § 1.672(a)-1(d). Note, however, that if undistributed trust income is added to corpus, then a remainder beneficiary's interest may be adverse to the exercise of a power to distribute income (although not adverse to a power to allocate income among the income beneficiaries). ZARITSKY, *supra* note 37 at § 7.06[3][d].
[41] ROBERT A. ESPERTI, RENNO L. PETERSON & ROBERT S. KEEBLER, IRREVOCABLE TRUSTS: ANALYSIS WITH FORMS § 4.03[2][a][ii] (Thomson Reuters/WG&L March 2011).
[42] Treas. Reg. §1.672(a)-1(a).

43 Section 672(b).
44 Section 672(c).
45 *Id*.
46 Section 672(d).
47 Treas. Reg. § 1.672(d)-1.
48 *Id*.
49 Section 672(e)(1).
50 Section 672(e)(2).
51 Section 673(a).
52 Section 673(c).
53 Section 673(b).
54 *Id*.
55 S. Rep. No. 313, 99th Cong., 2d Sess. 871 (1986). Staff of Joint Committee on Taxation, 99th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986 at 1249 (Comm. Print 1987).
56 ZARITSKY, *supra* note 37 at § 8.03[1]; Lisa Whitcomb and Scott A. Bowman, Presented at the American Bar Association Section of Taxation Fiduciary Income Tax Committee Meeting: *What's Yours is Mine and What's Mine is Mine: Grantor Trust Sections 673 and 676* (January 22, 2011). Rev. Rul. 76-178, 1976-1 C.B. 273 also seems to lend support to the analogy to Section 2037 for valuation purposes.
57 Section 2037(a)(2).
58 Treas. Reg. § 20.2031-7T(d). Treas. Reg. § 20.2031-7T(d) is applicable to valuation dates on or after May 1, 2009.
59 Section 7520(a).
60 Treas. Reg. § 20.2037-1(c)(3); *see also* ZARITSKY, *supra* note 37 at § 8.03[1][c].
61 Treas. Reg. § 20.2031-1(b).
62 Treas. Reg. §§ 1.671-3(b)(2), 1.673(a)-1(a).
63 *Id*.
64 *See* Stephen R. Akers, Jonathan G. Blattmachr, & F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 REAL PROP., TRUST, & EST. L.J. 208 (2009).
65 Treas. Reg. § 25.2511-2(b).
66 *See* Akers, *supra* note 64.
67 Treas. Reg. § 1.671-3(b)(1).
68 Treas. Reg. § 1.671-3(b)(3). *See also* ZARITSKY, *supra* note 37 at § 8.02.
69 Treas. Reg. § 1.671-3(b)(3).
70 Section 677(a)(2).
71 Akers, *supra* note 64.
72 Section 674(a).
73 Section 674(b)(1).
74 Section 677(b).
75 Treas. Reg. § 1.674(b)-1(b)(1).
76 Section 674(b)(2).
77 *Id*.
78 Section 674(b)(3).
79 Section 674(b)(5).
80 Treas. Reg. § 20.2041-1(c)(2).
81 Treas. Reg. § 1.674(b)-1(b)(5)(i).
82 Section 674(b)(5).
83 Section 674(b)(6).
84 Treas. Reg. § 1.674(b)-1(b)(6)(i).
85 Treas. Reg. § 1.674(b)-1(b)(6)(i)(c).
86 Treas. Reg. § 1.674(b)-1(b)(6)(ii), Example 1.
87 Section 674(b)(6); Treas. Reg. § 1.674(b)-1(b)(6).
88 Section 674(b)(7).
89 ESPERTI, *supra* note 41 at § 4.03[4][a][vii].
90 Section 674(b)(7); Treas. Reg. § 1.674(b)-1(b)(7).
91 Section 674(b)(8).

[92] ESPERTI, *supra* note 41 at § 4.03[4][a][viii]; BITTKER, *supra* note 35 at § 80.6.2, citing legislative history regarding the intent of Section 674(b)(8) to permit a grantor, as trustee, to hold a "power which is normally vested in the trustee for purposes of conforming to appropriate trust accounting principles." S. Rep. No. 1622, 83d Cong., 2d Sess. 369 (1954).
[93] Sections 674(c), 672(e).
[94] Treas. Reg. §1.674(c)-1.
[95] Akers, *supra* note 64 (citing S. Rep. No. 1622, 83d Cong., 2d Sess. 87 (1954)).
[96] Section 674(c).
[97] Section 674(d).
[98] Akers, *supra* note 64.
[99] *See* Treas. Reg. § 20.2041-1(c)(2); 25.2514-1(c)(2). It may also be different from a standard that would generally prevent inclusion of trust property in a grantor's gross estate under Sections 2036 and 2038. Akers, *supra* note 64.
[100] Treas. Reg. § 1.674(d)-2(a).
[101] Section 674(d).
[102] Section 674(b)(1).
[103] Section 2036(a).
[104] Treas. Reg. § 20.2036-1(b)(2).
[105] Section 674(b)(3).
[106] Section 2041(a)(2).
[107] Section 2038(a)(1).
[108] Akers, *supra* note 64.
[109] For an excellent discussion of this technique, *see* Akers, *supra* note 22, and Akers, *supra* note 64.
[110] *See, e.g.*, Priv. Ltr. Rul. 200846001 (Nov. 14, 2008).
[111] Sections 672(a), 674(a). In addition, she may be deemed to possess a general power of appointment over trust property under Section 2041 or 2514.
[112] Sections 674(b)(6), 674(b)(5)(B).
[113] Section 674(b)(5)(A).
[114] Sections 674(c), 672(e).
[115] Rev. Rul. 95-58, 1995-2 C.B. 191 (1995).
[116] Treas. Reg. § 1.671-3(b); Sections 674(b)(5), 674(b)(6), 674(c).
[117] Section 674(c).
[118] For an excellent discussion of this technique, *see* Akers, *supra* note 22 and Akers, *supra* note 64.
[119] Section 674(a).
[120] Sections 672(c), 674(c).
[121] *See, e.g.*, Treas. Reg. § 1.674(b)-1(b)(6)(ii), Example 2.
[122] Akers, *supra* note 64 (citing *Goodwyn v. Commissioner*, 32 T.C.M. 740 (1973) for the principle that the grantor's actual control over a trustee is insufficient to cause inclusion of trust property in the grantor's estate under Section 2036).
[123] Treas. Reg. § 1.671-3(b); Sections 674(b)(5), 674(b)(6), 674(c).
[124] Section 674(c).
[125] Treas. Reg. § 25.2511-2(c).
[126] *See* Akers, *supra* note 64.
[127] Section 2037(a)(2).
[128] Section 2041.
[129] Section 2514.
[130] These transfer tax consequence will not necessarily result if the powerholder can add himself as a beneficiary but a third party has discretion regarding any distributions made to such powerholder as an additional beneficiary of the trust. *See* Akers, *supra* note 64.
[131] *See, e.g.*, *Madorin*, 84 T.C. 667.
[132] Treas. Reg. §1.674(d)-2(b).
[133] Section 674(a).
[134] Section 674(d).
[135] ZARITSKY, *supra* note 37 at § 11.02.
[136] Sections 2036(a)(2), 2038(a)(1), which would apply even if the grantor engaged in such a transaction in his capacity as trustee. Treas. Reg. §§ 20.2036-1(b)(3), 20.2038-1(a)(3).

[137] Section 2041. Akers, *supra* note 64; Howard M. Zaritsky, Anne W. Coventry and Matie B. Little, Presented at the American Bar Association Section of Taxation Fiduciary Income Committee Meeting: *Focus on Grantor Trusts – Section 675* (May 8, 2010).
[138] Rev. Rul. 85-13, 1985-1 C.B. 184; ZARITSKY, *supra* note 37 at § 11.03[2].
[139] Importantly (and as described in more detail below), a trustee's power to loan property to the grantor without adequate security will not pose the same transfer tax risk as a power to loan property to the grantor without requiring adequate interest.
[140] Section 675(3).
[141] *Id*.
[142] *See Mau v. United States*, 355 F.Supp 909 (1973); Rev. Rul. 86-82, 1986-1 C.B. 253.
[143] *See Rothstein v. United States*, 735 F.2d 704 (1984); *Bennett v. Comm'r*, 76 T.C. 470 (1982); *Buehner v. Comm'r*, 65 T.C. 723 (1976); ESPERTI, *supra* note 41 at § 4.03[5][c].
[144] ESPERTI, *supra* note 41 at § 4.03[5][c].
[145] *See Benson v. Comm'r*, 76 T.C. 1040 (1981); *Bennett*, 76 T.C. 470; ESPERTI, *supra* note 41 at § 4.03[5][c]; Akers, *supra* note 22.
[146] *See Mau*, 355 F.Supp 909; Rev. Rul. 86-82, 1986-1 C.B. 253.
[147] Section 675(4).
[148] Treas. Reg. § 1.675-1(b)(4).
[149] Treas. Reg. § 1.675-1(b)(4)(iii); Rev. Proc. 2011-3, 2011-1 I.R.B. 111 (Dec 31, 2010).
[150] Treas. Reg. § 1.675-1(b)(4).
[151] *Id*.
[152] Priv. Ltr. Rul. 9311021 (Dec. 18, 1992) (regarding beneficiary holding substitution power); Priv. Ltr. Ruls. 9037011, 199908002, 200434012 (regarding third party holding substitution power).
[153] Rev. Proc. 2008-46, 2008-30 I.R.B. 224 (Jul. 28, 2008); Rev. Proc. 2007-45, 2007-29 I.R.B. 89 (Jun. 22, 2007); Howard Zaritsky, Presented at American Bar Association Section of Taxation Fiduciary Income Tax Committee Meeting: *Section 675(4)(C)—Planning and Problems with the Nonfiduciary Power to Substitute Assets* (May 7, 2011).
[154] Section 1001. *See also* Zaritsky, *supra* note 153.
[155] Sections 2036, 2038. Note that Sections 2036 and 2038 operate to cause estate inclusion regardless of whether any borrowing on these terms actually takes place (the mere existence of the right to borrow is sufficient to cause inclusion).
[156] Akers, *supra* note 64; Anne Coventry, Presented at the American Bar Association Section of Taxation Fiduciary Income Tax Committee Meeting: *Section 675(2) and Section 675(3): Grantor Trust Status Based on Borrowing Power* (May 8, 2010).
[157] Treas. Reg. § 1.671-3(b).
[158] Section 1014. *See* Akers, *supra* note 64.
[159] *Estate of Jordahl v. Comm'r*, 65 T.C. 92 (1975); Rev. Rul. 2008-22, 2008-16 I.R.B. 796.
[160] Sections 2042, 2036(b). *See* Zaritsky, *supra* note 153. Note that after the date this article was originally published, the Service released Revenue Ruling 2011-28, 2011-49 I.R.B. 830, which provides that a grantor's retention of the right, exercisable in a non-fiduciary capacity, to acquire a life insurance policy held by a trust by substituting assets of equivalent value generally will not, by itself, cause the value of the insurance policy to be included in the grantor's estate under Section 2042.
[161] Treas. Reg. § 1.671-3(b)(3).
[162] Section 676(a); Treas. Reg. § 1.676(a)-1.
[163] Section 676(b).
[164] Section 676(b).
[165] Treas. Reg. § 1.676(a)-1; *Chandler v. Comm'r*, 119 F.2d 623 (3d Cir. 1941); Whitcomb, *supra* note 56.
[166] Treas. Reg. § 20.2036-1(b)(3)(i) (stating that a decedent retains the right to designate who may possess or enjoy trust property even if his power is exercisable only in conjunction with another person, whether or not such person has an adverse interest); Treas. Reg. § 25.2511-2(e) (stating that a donor is not considered to hold a power if such power may be exercised only in conjunction with a person having a substantial adverse interest).
[167] Treas. Reg. § 20.2036-1(a)(3)(i); ESPERTI, *supra* note 41 at § 4.03[6][a].
[168] ZARITSKY, *supra* note 37 at § 9.05[1][a].
[169] If trust assets are available to satisfy claims of the grantor's creditors, trust property may be included in the grantor's estate for estate tax purposes under Section 2036. *See also*, Akers, *supra* note 22.

[170] ZARITSKY, *supra* note 37 at § 9.05[1][a].
[171] Section 677.
[172] Section 677(a).
[173] Section 677(a).
[174] Treas. Reg. § 1.677(a)-1(c).
[175] Treas. Reg. § 1.677(a)-1(b)(2).
[176] ZARITSKY, *supra* note 37 at § 10.06.
[177] Treas. Reg. § 1.677(a)-1(b)(2).
[178] ZARITSKY, *supra* note 37 at § 10.03.
[179] Treas. Reg. § 1.677(a)-1(d).
[180] Carter H. Hood and Matie B. Little, Presented at the American Bar Association Section of Taxation Fiduciary Income Tax Committee Meeting: *Grantor Trust Status under Section 677: Trust Income for the Benefit of the Grantor* (May 7, 2011).
[181] ZARITSKY, *supra* note 37 at § 10.04[1].
[182] Rev. Rul. 75-267, 1975-2 C.B. 255.
[183] ESPERTI, *supra* note 41 at § 4.03[7][b]. *See, e.g.*, *Iverson v. Comm'r*, 3 T.C. 756 (1944); *Weil v. Comm'r*, 3 T.C. 579 (1944); *Corning v. Comm'r*, 104 F.2d 329 (6th Cir. 1939); *Rand v. Comm'r*, 40 B.T.A. 233 (1939).
[184] Akers, *supra* note 22. *See, e.g.*, Priv. Ltr. Rul. 8852003 (Dec. 30, 1988); Priv. Ltr. Rul. 6406221750A (Jun. 22, 1964).
[185] *Booth v. Comm'r*, 3 T.C. 605 (1944); *Dunning v. Comm'r*, 36 B.T.A. 1222 (1938).
[186] Section 677(b).
[187] Treas. Reg. § 1.677(b)-1.
[188] Treas. Reg. § 1.677(b)-1(d). Such a power to discharge other legal obligations of the grantor will be treated as a constructive distribution to the grantor under Section 677(a) and will trigger grantor trust status.
[189] Treas. Reg. § 1.677(b)-1(e).
[190] Treas. Reg. § 1.677(b)-1(f).
[191] Treas. Reg. § 1.677(b)-1(b).
[192] Treas. Reg. § 1.151-1(a)(2).
[193] ZARITSKY, *supra* note 37 at § 10.07[3][b].
[194] Treas. Reg. § 25.2511-2; Rev. Rul. 77-378, 1977-2 C.B. 347.
[195] Treas. Reg. § 20.2036-1(b)(2).
[196] Rev. Rul. 77-378.
[197] Assuming Section 2702 does not apply.
[198] Akers, *supra* note 22; Rev. Rul. 2004-64.
[199] Section 677(a)(3). Rev. Rul. 81-164, 1981-1 C.B. 458; *First Nat'l Bank of Birmingham v. Comm'r*, 36 B.T.A. 651 (1937).
[200] *United States v. Estate of Grace*, 395 U.S. 316 (1969).
[201] Akers, *supra* note 22.
[202] *See* Akers, *supra* note 64 (regarding the income tax treatment of grantor retained annuity trusts that allow annuity payments to be made from trust corpus if income is insufficient).
[203] Treas. Reg. § 1.677(a)-1(g).
[204] Treas. Reg. § 1.671-3(b)(2); Rev. Rul. 75-267.
[205] Akers, *supra* note 22.
[206] Section 679(a)(1).
[207] Treas. Reg. § 1.679-4(a).
[208] Treas. Reg. § 1.679-1(b).
[209] Treas. Reg. § 1.679-1(c).
[210] Treas. Reg. § 301.7701-7.
[211] Section 7701(a)(30)(E); Treas. Reg. § 301.7701-7(a)(1).
[212] Section 679(c)(1).
[213] Treas. Reg. § 1.679-2(a).
[214] Treas. Reg. §§ 1.679-4(i), 1.679-4(ii).
[215] Treas. Reg. § 1.679-2(c)(1).
[216] Treas. Reg. § 1.679-2(c)(2).
[217] Treas. Reg. § 1.679-2(c)(2).

[218] Section 6048.

[219] Section 6677.

[220] For an excellent discussion of these rules (prior to the Hiring Incentives to Restore Employment ("HIRE") Act of 2010 (Pub. L. No. 111-147, Mar. 18, 2010)), *see* A. Christopher Sega and Jessica Baumgarten Baggenstos, Presented at the American Bar Association Section of Taxation Fiduciary Income Tax Committee Meeting: *Inbound, Outbound and Rebound: Section 679 and the Taxation of Foreign Trusts with US Beneficiaries* (January 23, 2010).

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Newly-Enacted REIT Legislation Paves the Way for REIT-Friendly Guidance

By: Todd D. Keator[1]

Introduction

A "Real Estate Investment Trust" (a "REIT") is an entity that otherwise would be taxable as a corporation but that instead makes a special election to be taxable as a REIT. REITs provide taxpayers with two distinct advantages: the ability to attract capital from public markets, and the ability to deduct dividends paid to shareholders, resulting in only a single layer of tax at the shareholder level. The key downside to REITs, however, is the stringent income and asset tests that REITs must comply with. Very generally, these tests mandate that (a) at least 75% of a REITs assets must consist of "real estate assets" (including interests in real property and interests in mortgages on real property), cash and government securities, and (b) that (i) at least 95% of the REIT's gross income must be derived from certain passive sources, including dividends, interest, rents from real property, and gain from the sale or stock, securities and real property, and (ii) at least 75% of the REIT's gross income must be derived from certain real estate sources, including dividends from other REITs, interest on obligations secured by mortgages on real property, rents from real property, and gain from the sale of real property.[2] As a result, REITs face a constant battle to police their asset base and sources of gross revenue to ensure REIT compliance, yet grow and produce additional revenue from novel sources as new opportunities arise.

Code Section 856(c)(5)(J)

Prior to the enactment of Code Section 856(c)(5)(J), REITs occasionally received income from sources not listed in the REIT income tests and sought letter rulings from the IRS as a result. The legislative history of Code Section 856(c)(5)(J) references two of these rulings – Private Letter Ruling 200039027 and Private Letter Ruling 200127024. In Private Letter Ruling 200039027,[3] the IRS ruled that settlement payments received by a REIT in connection with the development of real property were excluded from the REIT's income for purposes of the 75% and 95% gross income tests. Likewise, in Private Letter Ruling 200127024,[4] the IRS ruled that a break-up fee received by a REIT as a penalty from a failed merger was excluded from the REIT's income for purposes of the 75% and 95% gross income tests. Both rulings were issued based on the original legislative intent that REITs should receive only passive income and on findings that Congress did not intend to discourage REITs from pursuing legal remedies. More recently, in Private Letter Ruling 200614024,[5] the IRS considered a situation where a REIT received state tax credits generated as a result of developing and rehabilitating real property that had been contaminated by an oil spill. The IRS ruled that "taxable income associated with the receipt of the State tax credits will not be considered in determining whether Taxpayer satisfies the REIT income tests . . . ." The IRS reasoned that receipt of the credits was closely connected to development and rehabilitation of the underlying contaminated real estate, and that furtherance of this public policy did not interfere with the policy objectives of Congress in enacting the REIT income tests.

In 2008, as a means to provide the IRS with more power to interpret the REIT income tests, Congress enacted Code Section 856(c)(5)(J) as part of the Housing and Economic Recovery Act of 2008.[6] That section provides:

> To the extent necessary to carry out the purposes of this part, the Secretary is authorized to determine, solely for purposes of this part, whether any item of income or gain which—
>
> (i) does not otherwise qualify under paragraph (2) or (3) may be considered as not constituting gross income for purposes of paragraphs (2) or (3), or
>
> (ii) otherwise constitutes gross income not qualifying under paragraph (2) or (3) may be considered as gross income which qualifies under paragraph (2) or (3).

Legislative history explains that the provision authorizes the IRS "to issue guidance that would allow other items of income to be excluded for purposes of the computation of qualifying gross income under either the 75 percent or the 95 percent test, respectively, or to be included as qualifying income for either of such tests, respectively, in appropriate cases . . . ."[7] In essence, the provision bestows broad authority upon the

IRS to determine whether an item of income not specifically enumerated in the 75% or 95% gross income tests nevertheless should either be excluded from both the numerator and denominator of the equation or should be included in both the numerator and denominator of the equation. Somewhat surprisingly, the provision remained dormant until mid-2011, when the IRS first utilized its new power in a series of private letter rulings issued in the second half of 2011. These rulings are analyzed below.

Private Letter Rulings Interpreting Code Section 856(c)(5)(J)

1. Private Letter Ruling 201122016.[8] In PLR 201122016, real property owned by a REIT was taken by State under eminent domain. State paid an "Initial Amount" to the REIT for the taking and the REIT filed a claim for additional compensation. Later, a state court granted the REIT's claim and awarded an "Additional Amount" of compensation plus interest, attorney fees and costs. The REIT requested rulings from the IRS concerning the affect of its claim for the Additional Amount (with interest, attorney fees and costs) on its asset and income tests.

The IRS found that the REIT's claim for compensation was not specifically described in the REIT asset tests set forth in the Code or Regulations. Nevertheless, the IRS ruled that the claim would be ignored for purposes of determining whether the REIT satisfied the REIT asset test under Code Section 856(c)(4).[9] The IRS further ruled under Code Section 856(c)(5)(J) that the interest and costs derived by the REIT from the claim also would be ignored in determining whether the REIT satisfied the 75% and 95% gross income tests.

The conclusion regarding interest and costs falls precisely within the purposes and scope of Code Section 856(c)(5)(J). With the enactment of Code Section 856(c)(5)(J), the IRS obtained power and discretion to exclude the income at issue without the need to resort to statutory gymnastics. The conclusion to exclude the claim from the REIT asset test, however, is somewhat surprising. It is clear that Code Section 856(c)(5)(J) grants the IRS discretion to exclude non-listed items of income from the income tests. However, this authority does not stretch to the REIT asset test. While the conclusion to exclude the claim from the asset test is defendable on policy grounds, there was no statutory basis for this conclusion. Rather, the IRS would have been more justified in concluding that the claim itself was a real estate asset as had been done in the past.[10]

2. Private Letter Ruling 201123003.[11] In PLR 201123003, a REIT owned timberland and real estate in a foreign country. The REIT, through its subsidiary, participated in a carbon emissions program run by the foreign government. Under the program, the foreign government allocates "Carbon Emission Units" (each of which represents one ton of carbon dioxide removed from the atmosphere) to certain forest owners to account for the carbon captured by their forests. Under the program, each time a forest owner harvests trees it must either replant a sufficient number of trees or surrender an adequate number of units. Thus, the program effectively imposes land use restrictions on the forest owner and the units serve as compensation for such restrictions. Forest owners that hold units may use them in future compliance periods or sell them. Allocated units are issued to forest owners at no cost. The REIT requested guidance as to the affect of the units on its asset and income tests.

Regarding the asset test, the IRS found that to qualify as a real estate asset, "any asset other than the physical real estate itself must be inextricably tied or connected to the real estate" to fall within the definition. In this case, the IRS ruled that the units were "inextricably linked to the specific stands of growing trees that sequester carbon dioxide" and accordingly that the units qualified as real estate assets.

Regarding the income test, the IRS ruled that receipt of the units from the foreign government was qualifying income for the REIT under Code Section 856(c)(5)(J). The IRS reasoned that this was an "appropriate case" to invoke the authority granted in Code Section 856(c)(5)(J) "because of the relationship of the income to REIT qualifying assets." The IRS found that the income derived by the REIT from allocation of the units was "inextricably linked to the underlying timberland and standing timber thereon, which are qualifying REIT assets" and therefore that treating the income as qualifying income under Code Section 856(c)(5)(J) was "consistent with the purposes of the REIT provisions."

PLR 201123003 provides useful insights into the situations in which the IRS might be expected to apply Code Section 856(c)(5)(J). Specifically, the IRS stated that Code Section 856(c)(5)(J) should apply because the income derived by the REIT from receipt of the units was "inextricably linked" to the REIT's ownership of the underlying timberland, which was a qualifying REIT asset.

3. Private Letter Ruling 201123005.[12] PLR 201123005 also addresses carbon credits but under different facts. In the ruling, a REIT owned timberlands through a subsidiary. Unrelated "Company" developed a "Program" pursuant to which forest owners agreed to manage their existing forests and maintain trees in the forests over a set term of years. Company in turn sold the right to take credit for the carbon sequestered by the forest over this term to customers who desired to offset their carbon footprints. The Program was purely contractual and participation was voluntary.

The facts of the ruling indicate that the Company agreed to purchase from the REIT certain carbon dioxide offset credits from a defined portion of the REIT's timberland. The amount paid to the REIT was based on the total amount of carbon that could be sequestered from the standing timber on the designated timberland. The ruling noted that the credits were not granted by any governmental authority; rather, they were simply a measure of the carbon absorption capability of the trees. By selling the credits, the REIT became obligated to use sustainable forest management, which included harvesting timber, thinning, clearing, or reducing the volume of the carbon or timber in the designated timberland. However, if the volume of carbon or timber in the designated timberland was reduced other than for forest management issues, the REIT was obligated to substitute a different portion of the forest or be subject to sanctions, including decertification of existing credits (which would require remitting payment back to the Company). The REIT requested a ruling concerning whether income from the sale of the credits qualified for purposes of the 75% and 95% gross income tests.

The IRS noted that the income derived by the REIT from selling credits did not fit squarely within any of the qualifying income categories. Nevertheless, the IRS found this to be an "appropriate case to invoke the authority granted in § 856(c)(5)(J)." According to the IRS, such treatment was appropriate because the income derived by the REIT was "inextricably linked to the underlying timberland and standing timber thereon."

As in PLR 201123003, the IRS was willing to invoke Code Section 856(c)(5)(J) in a situation where the income at issue was found to be "inextricably linked" to the underlying real estate assets. However, a key difference between PLR 201123003 and PLR 201123005 is that in the former ruling, the REIT realized income upon receiving credits from the foreign government as part of a mandatory carbon reduction program, whereas in the latter ruling the REIT realized income from voluntarily issuing credits and selling them to the Company under a purely contractual arrangement. In both situations, however, receipt of the credits or cash served to compensate the REIT for land-use restrictions (whether mandatory or contractual) placed on the REIT's timberland. Together, the rulings indicate that where a REIT owns a qualifying real estate asset and voluntarily or involuntarily agrees to limit its right of use (*i.e.*, land use restrictions) of such asset in exchange for compensation, if not otherwise listed under the 75% or 95% gross income tests, the compensation should be qualifying income per Code Section 856(c)(5)(J).

4. Private Letter Ruling 201137004.[13] In PLR 201137004, a REIT, through a wholly-owned subsidiary taxed as a partnership for federal tax purposes ("Subsidiary"), owned and leased commercial real estate located in the United States. Subsidiary, through a disregarded entity, borrowed funds from an unrelated party (the "Loan"). The Loan bore both fixed-rate and variable-rate interest and was used to acquire or carry real estate assets. The REIT desired to manage risk associated with the fixed interest portion of the Loan, and so entered into an interest rate swap agreement with a counterparty (the "Swap"). Under the Swap, the REIT agreed to pay floating rate interest to the counterparty and the counterparty agreed to pay fixed rate interest to the REIT, each based on the same notional principal amount. The REIT identified the Swap as a hedge on the date it entered into the agreement, contemporaneously identified the related transaction and risk being hedged, and represented that it entered into the Swap in the normal course of its trade or business to manage the risk of interest rate fluctuations with respect to the Loan. The REIT requested a ruling that the Swap income was qualified REIT income.

The IRS began its analysis by restating the general qualifying income rules for REITs and the exceptions for income from hedging transactions. Generally, Code Section 856(c)(5)(G) provides that income of a REIT from a "hedging transaction" (as defined in Code Section 1221(b)(2)(A)(ii) or (iii)) that is clearly identified does not constitute gross income for purposes of the 75% or 95% gross income tests to the extent that the transaction hedges indebtedness incurred or to be incurred by the REIT to acquire or carry real estate assets. Under Code Section 1221(b)(2)(A)(ii), a "hedging transaction" includes any transaction entered into by the taxpayer in the normal course of trade or business primarily to manage the 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. The IRS also referenced Code Section 856(c)(5)(J)(i) in its statement of legal authority.

After reciting the applicable law, the IRS found that the Swap income did not fall within any of the specific categories in the 75% or 95% gross income tests. The IRS also ruled that the Swap did not meet the definition of a hedging transaction because it was not entered into by the REIT with respect to debt incurred *by the REIT* but rather with respect to debt incurred by a different taxpayer – *i.e.*, the Subsidiary. Nevertheless, the IRS looked to Treasury Regulation Section 1.856-3(g) for guidance.

Treasury Regulation Section 1.856-3(g) provides that for purposes of the REIT rules, a REIT that is a partner in a partnership is deemed to own its proportionate share of each of the assets of the partnership and will be deemed to be entitled to the income of the partnership attributable to such share. Based on this rule, the IRS ruled that solely for purposes of the 75% and 95% gross income tests, the determination of whether the Swap constituted a hedging transaction had to take into account Treasury Regulation Section 1.856-3(g), which would treat the REIT as owning its proportionate share of the assets and earning its proportionate share of the income of the Subsidiary. Of key importance, the IRS ruled that although the Loan was a *liability* rather than an *asset* of the Subsidiary, it was consistent with the purposes of the REIT rules "to attribute to Taxpayer the liability for its proportionate share of the Loan for purposes of section 856(c)(2) and (3)." Based on this conclusion, the IRS ruled that the Swap income was excluded from the REIT's gross income for purposes of the 75% and 95% gross income tests.

Although the IRS referenced Code Section 856(c)(5)(J)(i) in its statement of law, it did not rely on this provision for its ultimate conclusion to exclude the Swap income. Rather, the conclusion rests on a finding that, under Treasury Regulation Section 1.856-3(g), the Swap in fact qualified as a hedging transaction, but only for purposes of the 75%

and 95% gross income tests. It is difficult to understand why the IRS rested its conclusion on a finding that Treasury Regulation Section 1.856-3(g) – which applies only to assets and income of REIT subsidiary partnerships – should be extended to liabilities of the Subsidiary. Perhaps this conclusion could be justified prior to the enactment of Code Section 856(c)(5)(J) as a means to a logical end. But following the enactment of Code Section 856(c)(5)(J), which clearly empowers the IRS to exclude non-listed sources of income from the gross income tests, the IRS should have tied its conclusion to such section rather than relying on a convoluted interpretation of Treasury Regulation Section 1.856-3(g). The reason for such failure is not apparent and is particularly troubling in light of the fact that the IRS specifically referenced Code Section 856(c)(5)(J)(i) in its statement of law.

5. Private Letter Ruling 201145008.[14] In PLR 201145008, a REIT (through a subsidiary partnership) purchased a participation interest in a mezzanine loan from a Bank. The REIT represented that its interest in the loan constituted a qualifying real estate asset. The issuer of the loan filed for Chapter 11 bankruptcy protection, and the REIT filed a lawsuit against the Bank alleging that at the time the REIT purchased the participation interest, the Bank either knew or should have known that the loan was in default or that events which could lead to its default existed. The claim asserted breach of contract by the Bank. The parties settled and the Bank made a cash payment to the REIT in satisfaction of all claims. The issue was whether the settlement payment counted against the REIT's 75% and 95% gross income tests.

The IRS found that the settlement payment constituted gross income that did not specifically qualify under either the 75% or 95% gross income tests. Nevertheless, pursuant to Code Section 856(c)(5)(J)(i), the IRS ruled that the settlement payment would be excluded from the REIT's gross income for purposes of such tests. Notably, the IRS was silent about whether the settlement payment was "inextricably linked" to real estate assets of the REIT.

Conclusion

Code Section 856(c)(5)(J) is a new and powerful tool that must be considered by REITs faced with novel sources of income not specifically enumerated under the 75% and 95% gross income tests. The recent flurry of Private Letter Rulings addressing Code

Section 856(c)(5)(J) indicates that the IRS is more than willing to consider non-listed sources of income and in many cases will issue favorable rulings. Where the questionable income is "inextricably linked" to "real estate assets" held by the REIT, the IRS appears inclined to include the income in both the numerator and denominator of the formula. Where such income is not inextricably linked to real estate assets, the IRS appears more inclined to exclude the income for purposes of the 75% and 95% gross income tests.

In most cases, REITs will prefer for an item of gross income to be included in the gross income tests instead of being excluded entirely. Consider the following example: Timber-REIT has $130 of gross income for the year from the following sources: $94 of gain from the sale of timber, $6 from selling bio-diesel made from excess wood pulp (non-qualifying income), and $30 of income from the sale of carbon offset credits. If the carbon credits are excluded from the gross income tests, then Timber-REIT fails the 95% test because only 94% of its gross income qualifies ($94/$100). But if the carbon credits are included in the 95% test, then Timber-REIT will have 95.4% qualifying income ($124/$130). Thus, REITs seeking rulings on questionable sources of income should take measures to tie the income as closely as possible to qualifying real estate assets in an effort to ensure that the income is "inextricably linked" to such property. If the IRS agrees, the IRS will be more willing to include the income for both the 75% and 95% gross income tests, which generally will be to the REIT's advantage.

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[2] Other sources of income qualify under the REIT gross income tests, as more specifically set forth in Code Sections 856(c)(2) and 856(c)(3).

[3] October 10, 2000.

[4] July 9, 2001.

[5] April 7, 2006.

[6] P.L. 110-289.

[7] Technical Explanation of Division C of H.R. 3221, The "Housing Assistance Tax Act of 2008," JCX-63-08 (July 23, 2008).

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[8] June 3, 2011.

[9] *Cf.* P.L.R. 200916014 (April 17, 2009) (ruling that a REIT's claim for state tax credits generated from the rehabilitation of real property would be excluded from the REIT's assets for purposes of determining compliance with the REIT asset test).

[10] *Cf.* PLR 200813009 (March 28, 2008) (ruling that real estate intangibles that were "inextricably linked" to the underlying real estate assets were themselves real estate assets); PLR 201123003 (June 10, 2011) (discussed infra). Arguably, the intangible claim also was "inextricably linked" with the real property taken via eminent domain and so should have been treated as a real estate asset for the same reason.

[11] June 10, 2011.

[12] June 10, 2011.

[13] September 16, 2011.

[14] November 10, 2011.

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Property Tax Valuation of Texas Real Estate: An Overview

By: Mary A. Van Kerrebrook [1]

Texas government is largely funded by property taxes, which are typically levied by a city or municipal utility district, a county, and a school district. The government's heavy reliance on property taxes makes them a significant cost of business, particularly in the real estate industry. Owners should monitor their tax values, and act timely to address over-assessments. Failure to meet the deadlines in the Tax Code usually precludes the chance to obtain a reduced tax assessment for that year.

The State Comptroller's office, and many appraisal districts, have web sites with a wealth of information and forms for use in the tax protest process. The Comptroller's information is at *www.window.state.tx.us/taxinfo/proptax.*

This paper is an informational overview, and is not legal advice on any specific facts, property, or protest. This paper focuses primarily on property tax issues on commercial real estate: different deadlines and other provisions may apply to homesteads and other types of property.

THE ADMINISTRATIVE PROCESS

A. <u>Rendition</u>

Texas law requires property owners to render business personal property for taxation.[2] Appraisal districts may also require real property renditions.[3] Renditions must generally be delivered to the appraisal district after January 1 and before April 15.[4] The appraisal district may allow up to two 15-day extensions, if the owner makes a written request showing good cause for an extension.[5]

The required rendition contents are set out in Section 22.01(a), and abbreviated renditions are allowed for business personal property with an aggregate value of less than $20,000.[6] Renditions must be sworn to,[7] and may include an estimate of the property's market value. However, the owner is not later bound by the rendered value.[8] Rendition is not a prerequisite to administrative and judicial review of an assessment.

B. The Appraisal District's Notice of Value

When the property's assessed value is more than that rendered, or is increased from the prior year, the appraisal district must notify the property owner in writing of the proposed value by May 1 (April 1 for homesteads), or as soon as thereafter practicable.[9] The notice includes the prior value and the proposed new value, and explains the deadlines and procedure for protesting.[10]

The owner's failure to receive the notice does not affect the validity of the tax appraisal, the imposition of any tax based on the appraisal, or tax collection proceedings.[11] The failure of notice *does* entitle the owner to protest the lack of notice before the appraisal review board ("ARB"),[12] in tandem with other grounds for protest. Protests for failure to give notice require timely compliance with Section 42.08's tax tender requirements (discussed below), and must be filed before the tax delinquency date.[13]

C. The Protest

Property owners who disagree with the proposed value must timely file a protest with the ARB.[14] The most common grounds for protesting a tax assessment are market value and equalization.[15] *It is a good idea for protests to include both types of challenges*, because failure to include one of them may make it impossible to obtain relief on the omitted basis, even if it later turns out to support a good argument.

Market Value. Most tax protests are filed because the owner disagrees with the proposed market valuation. Real estate must generally be assessed at its market value as of January 1 of the tax year.[16] Market value is determined based on generally accepted appraisal techniques, applied to the individual property.[17] The appraisal district must consider each of the three recognized appraisal methods (cost, income and market data) and use that which is most appropriate.[18] Chapter 23 of the Tax Code identifies data which must be compiled for each appraisal method, and is generally consistent with usual appraisal methodology. Chapter 23 also sets out valuation methodologies which must be used for certain types of property, including inventory, oil and gas interests, and furniture, fixtures and equipment.[19]

Equalization. Property owners may also challenge "unequal" assessments. For example, if property is assessed at 100% of its market value, but nearby comparable properties are assessed at 75% of market value, the owner should be able to obtain relief on an equalization challenge. The most commonly-used equalization provision states that:

> [A] property is appraised unequally if the appraised value of the property exceeds the median appraised value of a reasonable number of comparable properties appropriately adjusted.[20]

Taxpayers are entitled to equalization relief when these criteria are met, even if the appraisal district's value is already at or lower than the market value.[21] The main questions therefore are: what constitutes a "reasonable number," what other properties are "comparable," and what are "appropriate adjustments."

Case law shows how to frame equalization challenges. Leading cases include *Covert v. Williamson Central Appraisal District*, 241 S.W.3d 655 (Tex. App. Austin—2007, pet. denied); *Harris County Appraisal District v. Kempwood Plaza, Ltd*., 186 S.W.3d 155 (Tex. App.—Houston [1st Dist.] 2006, no pet.), and *Harris County Appraisal District v. United Investors Realty Trust*, 47 S.W.3d 648 (Tex. App.—Houston [14th Dist.] 2001, pet. denied).

D. Lessees' Right to Protest

Lessees who are contractually obligated to reimburse the owner for property taxes are also entitled to protest tax assessments.[22] This type of lease provision is most common with single-tenant properties. Such a lessee is entitled to receive all ARB notices and orders. An owner's failure to forward a reappraisal notice to the lessee does not affect the lessee's protest deadlines.[23] It is a good idea to list both the owner and the lessee on the protest; among other things this will help ensure that the protest is processed appropriately.

E. Deadline for Protest

Written protests must generally be filed with the ARB by June 1, or by the thirtieth day after notice of value was delivered to the property owner, whichever is later.[24] If a notice of protest is filed after the deadline but before the ARB approves the appraisal records, a property owner is entitled to a hearing and determination if the taxpayer shows good cause for the failure to timely protest. If someone other than the property owner will present the protest, an Appointment of Agent form must be sent to the Appraisal District before or at the protest hearing.

F. When Ownership Changes after January 1

If property is sold after January 1, but before the protest deadline, the buyer may proceed with the protest in the same manner as the seller.[25] If property changes hands after a protest is filed, the new owner may continue the protest on application to the ARB.[26] The original owner of the property (the owner as of January 1) remains entitled to appeal to district court even after conveying the property.[27] Property taxes are a personal obligation of the person owning the property on January 1; a person is not relieved of this obligation by selling the property. Thus, sellers should monitor protest proceedings initiated or continued by the new owner.

G. Contents of the Protest

The notice of protest must identify the protesting property owner, the property which is the subject of the protest, and the basis for the protest.[28] The specific grounds of protest (market value, equalization, or both) should be clear.[29] Though its use is not required, the State Comptroller has a pre-printed form for notices of protest. The form is on most appraisal district web sites, and on the State Comptroller's web site.

Those who file timely protests receive a hearing before the ARB. At least 15 days before the hearing, the ARB must send written notice of the hearing's date, time, and place.[30] At least 14 days before the hearing, the appraisal district must also send an explanation of the protest process, and notification that the owner is entitled to inspect and obtain copies of data, and other information which the chief appraiser intends to introduce at the hearing.[31]

Many appraisal districts hold informal pre-hearing settlement conferences, or "informals." These often result in resolution of the protest without an ARB hearing.

H. The Appraisal Review Board Hearing

Taxpayers must attend their ARB hearings in person, by representative or by affidavit. This is a prerequisite to any further appeal.[32] The taxpayer should offer evidence supporting his arguments. If the protest mentions both market and equalization, the taxpayer should present some evidence on both, although he may rely more heavily on one argument. The evidence may be in person, or by affidavit submitted before the hearing. The hearing is before a three-person panel of the ARB. A property owner denied his right to a hearing may sue to compel the hearing. An audio recording of the hearing will generally be made, and can later be obtained from the appraisal district if needed.

Carefully review the ARB's hearing procedures before the hearing. For example, certain types of information may be requested on each appraisal approach.

The ARB issues a written Order Determining Protest, which is supposed to be sent by certified mail.[33] The mailing must inform the owner of the right to appeal by lawsuit or other means, along with the applicable deadlines.[34]

I. Agreements on Value

When appraisal district and property owner representatives agree on a property's value, whether in an ARB hearing or not, the agreement is final. This can inadvertently happen in an ARB hearing if the appraisal district representative agrees with the owner's stated opinion of value. The ARB will still issue an order stating that the owner has the right to appeal, but the appraisal district may then move to have the suit dismissed due to the agreement. To avoid this, owner representatives should insist that any settlement be entered into the appraisal records under Section 1.111(e) of the Tax Code. And if the ARB asks the owner to state an opinion of value at the start of the hearing, the owner should give it, prefaced by the statement that the owner's opinion may be revised upward or downward during the hearing.

J. When All Else Fails: "Substantial Error" Protests

Some owners do not pay attention to their assessments until they receive their tax bills in October or later. By then, the May 31 protest deadline is long-gone. The legislature has created an escape route for these situations: the "substantial error" protest provision of section 25.25(d) of the Tax Code. This allows a protest to be filed before the tax delinquency date (generally February 1 of the following year), and requires at least a one-third difference between the assessed and the actual taxable value of the property. Taxpayers who cannot meet the one-third threshold will not receive any relief under this provision. Substantial error protests are not available if a standard protest was filed and argued before the ARB.

The substantial error protest, like the standard protest, results in an ARB hearing and an order determining protest. Timely compliance with the tax tender requirement of section 42.08 (discussed below) is required. Attorney fees are recoverable in lawsuits based upon substantial error protests.[35]

PROPERTY TAX VALUATION LAWSUITS AND OTHER REMEDIES

Either the property owner or the chief appraiser may appeal the ARB's decision to district court.[36] The review is *de novo* and the ARB's value is not always admissible.[37]

Jurisdiction for these lawsuits lies in the state district courts in the county where the ARB is located.[38] When valuation and/or equalization are the sole issue(s), the only defendant is the appraisal district. When ARB actions or inactions are in issue, it is advisable to also name the ARB as a defendant. The lawsuit must be filed within sixty days of the date on which the ARB order was received.[39] The sixty days start when notice is delivered.[40]

A. Whether or Not to Sue

The legal fees for a property tax valuation lawsuit will probably be lower, and the process more streamlined, when taxpayers engage a lawyer who is well-versed in tax valuation lawsuits. Such a lawyer will help ensure that all deadlines are met, and that the case is procedurally and substantively postured to maximize the changes of a favorable outcome. A good property tax valuation lawyer will also candidly advise a potential client at the outset on whether a suit would likely be cost-effective, if another venue for appeal might be best, or if further appeal would be unproductive. If a property owner has a tax consultant, his or her opinions on potentially achievable value differences may also help determine whether suit should be filed.

B. Conditional Tax Tender

Before the delinquency date (normally February 1 of the year after the tax year), an appealing taxpayer must pay taxes based on the lesser of: (1) the amount due on the portion of the taxable value of the property not in dispute; or (2) the amount of taxes due on the property under the order from which the appeal is taken. [41] Lawsuits are not jeopardized when an owner pays more than is required. Taxpayers who follow these guidelines are not "delinquent" even if the amount paid is actually less than the ultimate tax billed.[42]

If the taxpayer fails to make conditional tax tenders before the delinquency date, the suit may be dismissed. Either party may request a hearing on whether the taxpayer has complied with section 42.08. If the court finds that a property owner has not substantially complied, the court shall dismiss the lawsuit.[43] If the property owner has substantially, but not fully, complied, the court shall dismiss the action if the property owner does not fully comply within 30 days.[44] The court may also excuse the conditional tax tender for taxpayers who demonstrate an inability to pay under section 42.08(d), but this should not be relied on.

Taxpayers who intend to pay less than their full tax bills, during a lawsuit contesting assessed value, must state in their first lawsuit filing the amount of taxes that they propose to pay.[45] There is no case law yet on this provision, and no guidance on how it interacts with the "substantial compliance" provisions discussed above. So, when a taxpayer intends to make a conditional tax tender on property which is being litigated, it is essential that the taxpayer discuss this with the lawyer handling the suit, before suit is filed.

C. The Trial

Trials of tax valuation lawsuits are usually short. Either party may request a jury. The owner's evidence typically consists of testimony from the property owner (if the owner is an individual) or a representative of the company which owns the property, and from at least one appraiser. Real estate brokers are occasionally also called as witnesses. Other testimony should be obtained as needed. For example, if deferred maintenance is an issue, a contractor might be called to establish the cost of needed repairs. The owner's lawyer will also testify to establish legal fees.

Appraisal districts often offer testimony from their staff appraisers. In significant cases, appraisal districts may also engage outside appraisers to testify.

D. The Trial Court's Judgment and Revisions to the Tax Roll

The Court's judgment sets the taxable value of the property. If the court finds against the owner, the owner is liable for interest on any unpaid taxes.[46]

After the judgment and any appeal, the appraisal role is corrected to reflect the final determination.[47] The property owner must be provided with a copy of the final corrected or supplemental tax bill which explains the corrections or supplementation.[48]

Taxpayers who obtain reductions in their tax liability, and who have already paid the taxes, are entitled to refunds from the taxing units.[49] The refunds include interest on the amount refunded at the prime rate plus two percent (not to exceed eight percent), from the delinquency date until the refund date.[50] Interest increases to twelve percent when a taxing entity delays the refund for more than sixty days after the appraisal role is corrected. Attorney's fees may be recovered if the taxing entity is sued for the tax refund 180 days or more after the tax roll is corrected.

E. Attorney Fees

The prevailing owner may be awarded reasonable attorney fees.[51] The attorney fees are capped at the greater of $15,000 or 20% of the total amount by which the property owner's tax liability was reduced. The total attorney fees award may never exceed the lesser of the total tax reduction, or $100,000.

F. SOAH Hearings and Arbitrations

The State Office of Administrative Hearings ("SOAH") recently started a pilot program of handling appeals of ARB determinations; this is an alternative to suit in district court. The pertinent law is set out in Chapter 2003, Subchapter Z of the Texas Government Code. Particularly if a taxable value differential is not great enough to justify suit, the property owner may want to consider filing a SOAH appeal.[52] There is also a binding arbitration provision in Chapter 41A of the Texas Tax Code. Arbitration is available for homesteads, and for any other property for which the ARB's value is $1 million or less. Arbitration is only available for market value claims, not for equalization claims.[53]

SOME NOTABLE PROPERTY TAX ISSUES IN BUYING AND SELLING TEXAS REAL ESTATE

A. Suggested Questions for Due Diligence Checklists

All good transactional lawyers know to include a property tax proration provision in their earnest money contracts. But transactional lawyers can do more to help their clients with the property tax implications of buying or selling real estate.

1. The buyer's lawyer: What is the property's tax valuation now? What should it be as of January 1, next year? Should the buyer hire a tax consultant during due diligence to help answer these questions?

Buyers sometimes make major miscalculations on—or simply ignore—the property tax consequences of buying Texas real estate. During "boom years," a buyer might pay $20 million for property assessed at $10 million, based on pro-formas which assume that property taxes will remain constant. This can cause an unpleasant surprise later on.

Sophisticated buyers may engage tax consultants or property tax valuation lawyers during the due diligence process. Particularly if a property will sell for more than its assessed value, this is a smart move. The lawyer or consultant can help project whether the tax assessment will increase and at what pace, so that these projections may be built into the buyer's proforma. The buyer's counsel in this situation should suggest that the buyer obtain property tax advice before irrevocably committing to the purchase.

2. Both lawyers: Given the expected closing date and applicable protest deadline, who should take responsibility for filing a protest/lawsuit for the current year? At what point will responsibility for handling the protest or lawsuit pass from the seller to the buyer? Who will receive notifications? Will a new tax consultant/lawyer be engaged or will the seller's consultant/lawyer continue to handle the protest/suit? Who will monitor protest and suit deadlines and keep both parties apprised of deadlines if the closing is delayed?

3. Both lawyers: If the sale is for an amount lower than the assessed value, and a reduction in assessed value can therefore be realized, who will protest on this basis, and who will receive what share of the tax refunds?

4. Both lawyers: If a property tax valuation suit is pending for prior years on the closing date, who will pay the lawyer and who will obtain the refunds?

5. The buyer's lawyer: When will the appraisal district find out the purchase price? Should the buyer report the purchase price to the appraisal district?

In a depressed market, the buyer may want to report the purchase price, as it may support a lower value than the assessment. In that event, the closing statements may be submitted with the protest, and/or to the ARB. In some instances, appraisal districts may argue that a sale price does not reflect market value. But more often, appraisal districts are willing to assess property at the price at which it changed hands in a recent arm's-length transaction. The buyer must remember that this is not automatic, and that he must timely follow the protest requirements to try to obtain this result.

What happens when a property sells for more than its assessed value? While Texas is a non-disclosure state, appraisal districts frequently find out purchase prices. When a deed is recorded, appraisal districts and the State Comptroller's office routinely send out forms asking buyers and sellers for the sale price. These official-looking forms are often routed to low-level bookkeepers who process them without reading the fine-print notation that the form is not required to be completed. Real estate brokers also like to send out press releases when they handle large transactions. It can be a rude awakening for a plaintiff in a valuation lawsuit to learn that his broker gave the purchase price to a local newspaper.

When a property's value is litigated in court, many judges are inclined to order disclosure of sales prices, particularly if the sale is recent enough to reflect on the market as of January 1 of the operative tax year. What is "recent enough?" The call is subjective, but it may be notable that a recent amendment to the Tax Code states that appraisal districts are not generally supposed to use sales as comparables, if the sale is more than 24 months remote from the valuation date.[54]

B. Agricultural Valuation and Roll-back Issues

Agricultural valuations are allowed under Sections 23.52 and 23.53 of the Texas Tax Code. Appraisal districts must assess agricultural properties at both the agricultural productivity rate ("ag rate"), and the market rate, but taxes are paid only on the ag rate as long as the exemption is in place. When agricultural property is developed ("change in use"), roll-back taxes are usually imposed[55] for the previous five years. The rollback tax is the difference between the taxes paid on the land's agricultural value and the taxes that would have been payable based on the higher market value. The owner must also pay seven percent interest for each year, from the dates on which the taxes would have been due.

If an owner believes that his property might undergo a change in use within five years and that the appraisal district's value is high, the owner should protest the market value, even though the taxes for that year will be paid based on the agricultural value. Otherwise, the roll-back taxes will be based on the over-assessment.

Roll-back taxes are the personal responsibility of the record title owner as of January 1 of the pertinent year, in addition to creating a lien on the property for those amounts. While appraisal districts are empowered to determine that change of use occurred in mid-year, it is more common for them to find a change in use as of January 1.

Thus, when buying or selling agricultural land: (a) buyers and sellers should determine whether the sale is likely to trigger a roll back, and (b) agricultural buyers should obtain all documentation needed, and make all plans necessary, to demonstrate the continuing agricultural use of the property, and should calendar all of the application and protest deadlines.

Applications for agricultural valuation are due annually, by May 1 of the tax year.[56] There is a provision for late applications (generally due in July); but late applications require payment of a penalty if the application is approved.[57] Agricultural use application forms may be obtained from the appraisal district.

When an agricultural use application is filed, the appraisal district may: (a) grant the application, (b) deny the application, triggering the owner's right to protest to the ARB, (c) ask for additional information within a given time frame, and deny the application if the information is not timely received, or (d) if the appraisal district believes that there may have been a change in use, it may ask for a requalification of the property.

Roll-backs should be managed pro-actively by developers and their lawyers. For large tracts being developed in phases, the owner may notify the appraisal district that a change of use is occurring on certain land only, and should carve out the portion of the property which remains in agriculture. The Tax Code states that if the change of use applies to only part of a parcel, the additional tax applies only to that part.[58]

CONCLUSION

The Texas Property Tax Code provides potential remedies for property owners who believe that their property is over-assessed. But these remedies must be sought in the proper forums, and in compliance with rigid deadlines. When taxpayers comply with these requirements, it is likely that over-assessments will be corrected. But taxpayers who are not familiar with the processes and deadlines may find themselves having to pay more taxes than they would have had to pay if they had timely and properly sought relief.

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[2] TEX. TAX CODE §22.01(a).

[3] TEX. TAX CODE §22.01(b). Note that while many of the Tax Code provisions discussed also apply to personal property, this paper focuses on real property.

[4] TEX. TAX CODE §22.23(a).

[5] TEX. TAX CODE §22.23(b).

[6] TEX. TAX CODE §22.01(f).

[7] Unless the rendition is filed by the property owner or by an employee of the property owner. TEX. TAX CODE §22.24.

[8] *Hunt County Tax Appraisal District v. Rubbermaid, Inc*., 719 S.W.2d 215, 221 (Tex.App.—Dallas 1986, writ ref'd n.r.e.).

[9] TEX. TAX CODE §25.19(a). No notice is required for increases of $1,000 or less. TEX. TAX CODE §25.19(e).

[10] TEX. TAX CODE §25.19(b). The notice must also separately list the market value of the land and the market value of the improvements. TEX. TAX CODE §25.19(h).

[11] TEX. TAX CODE §25.19(d).

[12] TEX. TAX CODE §41.411(a).

[13] TEX. TAX CODE §41.44(c).

[14] TEX. TAX CODE §41.41.

[15] Section 41.41 protests may also be filed based on denials of agricultural or timber partial exemptions. TEX. TAX CODE §41.41.

[16] TEX. TAX CODE §23.01(a). Exceptions include agricultural land (appraised based on capacity to produce agricultural products under a prescribed formula, TEX. TAX CODE §23.41), timber land (TEX. TAX CODE §23.71-79), and open space land (TEX. TAX CODE §23.81-87).

[17] TEX. TAX CODE §23.01(b). Appraisal districts have long used mass appraisal techniques; this is allowed as long as appraisal districts comply with the Uniform Standards of Professional Appraisal Practice. TEX. TAX CODE §23.01(b).

[18] TEX. TAX CODE §23.0101.

[19] Respectively, TEX. TAX CODE §§23.12, 23.175, and 23.24.

[20] TEX. TAX CODE §41.43(b)(3). The corresponding provision for relief in litigation is TEX. TAX CODE §42.26(a)(3).

[21] *Harris County Appraisal District v. United Investors Realty Trust*, 47 S.W.3d 648 (Tex. App.—Houston [14th Dist.] 2001, pet. denied).

[22] TEX. TAX CODE §41.413(b).

[23] TEX. TAX CODE §41.413(d).

[24] TEX. TAX CODE §41.44(a)(2). The deadline for homesteads is before May 1. TEX. TAX CODE §41.44(a)(1).

[25] TEX. TAX CODE §41.412(a).

[26] TEX. TAX CODE §41.412(b).

27 *HUD v. Nueces County Appraisal District*, 875 S.W.2d 377, 380 (Tex. App.—Corpus Christi 1994, no writ).

28 TEX. TAX CODE §41.44(d).

29 *See Harris County Appraisal District v. Texas National Bank of Baytown*, 775 S.W.2d 66 (Tex. App.—Houston [1st Dist.] 1989, no writ).

30 TEX. TAX CODE ANN. §41.45(a), §41.46.

31 TEX. TAX CODE §41.461.

32 *Webb County Appraisal District v. New Laredo Hotel Inc.*, 792 S.W.2d 952, 953 (Tex. 1990).

33 TEX. TAX CODE §41.47(a)(d).

34 TEX. TAX CODE §41.47(e).

35 TEX. TAX CODE §42.29(a).

36 TEX. TAX CODE §42.01, 42.02.

37 TEX. TAX CODE §42.23(a).

38 TEX. TAX CODE §42.22.

39 TEX. TAX CODE §42.21(a).

40 *Harris County Appraisal District v. Drever Partners, Inc.*, 938 S.W.2d 196 (Tex. App.—Houston [14th Dist.] 1997, no writ).

41 TEX. TAX CODE §42.08.

42 TEX. TAX CODE §42.08(a).

43 *See Lawler v. Tarrant Appraisal District*, 855 S.W.2d 269 (Tex. App.—Fort Worth 1993, no writ) (Compliance with statutory provision is a prerequisite to district court's subject matter jurisdiction to determine property owner's rights).

44 *See Harris County Appraisal District v. Bradford Realty, Ltd.*, 919 S.W.2d 131, 134 (Tex. App.—Houston [14th Dist.] 1994, no writ) (Whether taxpayer substantially complied with statute is a factual matter to be determined by the court).

45 TEX. TAX CODE §42.08(b-1).

46 TEX. TAX CODE §42.42(c).

47 TEX. TAX CODE §42.41.

48 TEX. TAX CODE §42.42(a).

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[49] TEX. TAX CODE §42.43.

[50] TEX. TAX CODE §42.43.

[51] TEX. TAX CODE §42.29.

[52] The SOAH pilot program is available for properties in most of Texas' major metropolitan areas. For more information on the SOAH program, see the SOAH website at www.soah.state.tx.us

[53] TEX. TAX CODE §41A.01.

[54] "A sale is not considered to be a comparable sale unless the sale occurred within 24 months of the date as of which the market value of the subject property is to be determined, except that a sale that did not occur during that period may be considered to be a comparable sale if enough comparable properties were not sold during that period to constitute a representative sample." TEX. TAX CODE §23.013.

[55] TEXAS TAX CODE §23.55.

[56] TEX. TAX CODE §23.54.

[57] TEX. TAX CODE §23.541.

[58] TEXAS TAX CODE §23.55(d).

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The Resurgence of Whistleblowers in IRS Bond Enforcement

By: W. Mark Scott [1]

I. There and Back Again

The IRS Office of Tax Exempt Bonds received a significant number of whistleblower tips during my tenure as director (from its inception in 2000 to November of 2005); enough so that I established a formal review process and review committee to screen tips to determine whether an examination was merited.[2] Generally these tips were received by phone or mail, and were directed to the office or to a particular person working in my former office.

Tips came in from a variety of sources. Several were from attorneys who simply wanted to show that other law firms were providing similar opinions! The examinations opened through these tips resulted in a high percentage of adverse audit results.[3]

During this period of time, the only way for a tipster to seek an award was either by filing a formal claim through the longstanding IRS whistleblower award statute or by bringing an action pursuant to the False Claims Act.[4] Both of these routes had severe disadvantages. Under the old whistleblower statute, the IRS held sole and complete discretion as to whether to award a payment to an informant.[5] And the False Claims Act excluded federal tax claims.[6] As a result, tips were most often received informally, generally through phone conversations with the whistleblower.

Sometime after my departure, the number of informal tips received from whistleblowers fell off precipitously.[7]

II. The New Law

In 2006, Congress greatly expanded the existing IRS whistleblower statute to make it easier for tipsters to receive an award directly from the IRS and to increase the potential amount of the award.[8] Under the newly enacted statute, if certain requirements are met, the IRS is required to pay an award.[9] The law also requires the IRS to create a separate whistleblower office to administer the award program.[10] Since the enactment of this new law and the creation of the Whistleblower Office, the IRS has received over 1,300 whistleblower submissions.[11] Of these, the IRS Office of Tax Exempt Bonds had received 32 separate tips by May of 2011.[12]

III. THE WHISTLEBLOWER, CLAIM PROCESS, AND AWARD

a. Who Can Be Paid an Award?

Only certain persons are authorized to receive an award under the new whistleblower statute.[13] Persons not eligible to receive an award include IRS employees when they learn of the tax noncompliance in the course of their work activities, persons who have access to federal tax information as part of their official duties with a state or local government, persons who have access to federal tax information as part of their official capacity as a member of a state body or commission, and persons who are not natural persons (i.e., corporations or partnerships).[14]

The whistleblower may be someone who participated in the tax scheme. This may not prevent the whistleblower from receiving an award; however, this will generally be a negative factor in determining the amount of the award.[15]

Whistleblowers may be represented by counsel, but claims cannot be anonymous and must identify the whistleblower.[16] Nevertheless it is not unusual for a whistleblower to engage counsel to ensure the claim is properly prepared and submitted, to provide assistance to the IRS during the examination process, to negotiate the highest possible award and, if necessary, to seek review of the award amount in the U.S. Tax Court.[17]

b. How is a Claim Filed?

To submit a formal claim for award, an informant files an IRS Form 211, *Application for Award for Original Information*.[18] The completed application is submitted directly to the Whistleblower Office and not to the IRS Office of Tax Exempt Bonds.[19] The tipster will attach documentary support with the form. The tipster, or his counsel, may also prepare an analysis of the data in an attempt to accelerate the IRS examination.

In the claim, the informant is required to reveal *how* the information came to his attention, *when* he acquired the information, and a description of his relationship with the taxpayer.[20]

c. How is a Claim Worked by the IRS?

The Whistleblower Office will review the claim to ensure it is complete, for a determination of whether it meets certain threshold requirements, and for a possible referral to the Criminal Investigation division.[21] The threshold analysis will determine whether the claim meets the dollar limits of the new law (discussed below) and whether the claim was filed by a person entitled to an award.[22]

If the claim is complete, meets this threshold analysis, and is not forwarded to the IRS criminal investigators, the Whistleblower Office will contact the subject matter expert in the IRS operating division.[23]

These subject matter experts review the submitted information to determine if it may be tainted, meaning it may be subject to attorney-client privilege or any other legal protections that would preclude the IRS from using it in an examination.[24] If it is determined that the information may be tainted, the Office of Chief Counsel reviews the claim and determines which documents should and should not be forwarded to the examination division.[25]

The subject matter expert may also debrief the tipster.[26] Based on the written claim and debriefing, the subject matter expert makes a recommendation as to whether the lead should be followed up by an examination.[27] During the examination, the IRS may request further information from the whistleblower.[28] Generally this relationship will involve seeking additional information only, but a formal agreement may be entered into between the government and the whistleblower if a closer working relationship is necessary.[29] The tipster's identity will rarely be disclosed to the taxpayer.[30]

d. How does the IRS Determine the Award Amount?

To be eligible for a payment under the new law, the tax, penalties, interest, additions to tax, and additional amounts in dispute must exceed $2,000,000.[31] If the allegedly noncompliant individual is a person, the individual's gross income must exceed $200,000 for any of the taxable years at issue in the claim.[32] If the claim does not meet this threshold analysis, it is worked as a claim submitted under prior law, where the determination of an award is entirely within the discretion of the IRS.

How the "amount in dispute" determination applies to claims submitted for tax-exempt bond violations has not been publicly announced. The use of tax exposure computed for closing agreement purposes would generally ease the burden of meeting the $2,000,000 threshold. But it is unclear whether the same tax exposure computation used to determine settlement amounts in bond examinations and voluntary closing agreements should be the basis for the determination of the amount in dispute.[33] Or, assuming something akin to tax exposure is used, whether the computation should be adjusted to, for instance, eliminate the application of future value principles to past due amounts or the present value principles to those tax amounts due in future years. Other adjustments might also be considered. Should the determination of tax exposure, which is simply a guess as to the amount of potential forgone taxes owed by bondholders, be reduced to take into account that some portion of this estimated amount may be attributed to individual bondholders that do not meet the $200,000 threshold? What if the amount in dispute relates to overdue rebate? Should the amount in dispute be reduced to take into account an agreement by the issuer to retire the bonds early? These are some of the many unanswered questions.

Once the threshold amounts are met, the new law kicks in. If the IRS follows up on the tip and conducts an examination that results in a closing agreement with the issuer, the amount of the award depends, foremost, on whether the information received is based principally on "specific allegations" contained in public documents, such as judicial or administrative proceedings, government reports, or media accounts. If so, the award is capped at 10% of the collected proceeds and may be any amount under 10% (including zero).[34]

Presumably, although it is not entirely clear, the term "specific allegations" refers specifically to allegations of tax violations and not to general allegations. For instance, in the context of tax-exempt debt, if a media report includes a discussion of how bond proceeds have not been spent as planned, but invested at a higher yield, but the story does not raise any potential tax law violations as a result of these actions, is the claim award limited to the 10% cap?

If the 10% cap does not apply, then the award must be at least 15%, but no more than 30%, of the collected amount.[35]

The IRS Whistleblower Office will apply a number of factors to determine how much to award within the ranges noted above (zero to 10%, or 15% to 30%). Positive factors include prompt action by the informant, identifying an issue that was unknown to the IRS, identifying taxpayer behavior that would be difficult to detect, producing details in a clear and organized manner, and a positive impact between the claim and the behavior of the taxpayer.[36] Negative factors include delayed reporting by the tipster and the tipster being actively involved in the noncompliance.[37] In fact, the statute permits the Whistleblower Office to reward less than the 15% minimum amount when an informant was actively involved in the noncompliance.[38] The Whistleblower Office has determined that awards paid to "significant planners and initiators" will be reduced by at least 66%, awards paid to "moderate planners and initiators" will be reduced between 33% and 66%, and awards paid to "minimal planners and initiators" will be reduced between 0% to 33%.[39]

To date, not a single claim submitted to the IRS Office of Tax Exempt Bonds has resulted in the payment of an award.[40]

Finally, section 7623(b)(4) of the Internal Revenue Code provides the Tax Court jurisdiction to hear appeals of award determinations, including the amount or denial of an award, under the expanded program.[41]

Generally informants will wait many years before receiving an award.[42] In addition to the time involved in performing the initial review in the Whistleblower Office and conducting the tax examination, the taxpayer may seek an administrative review in the IRS Office of Appeals or proceed to U.S. Tax Court. In addition, the taxpayer may seek a refund of any amounts paid and, potentially, sue for such a refund in District Court or the Court of Federal Claims.[43] For these reasons, the IRS has determined that it cannot issue an award until the statute of limitations for filing a claim for refund has expired.[44]

In this context, therefore, informants who refer bond violations may be at an advantage to other whistleblowers because adverse bond examinations are almost always closed by closing agreement. By their nature, closing agreements are final and cannot be appealed.[45] Accordingly, payment of the award should be made shortly after the date the closing agreement is executed.

Finally, the Whistleblower Office has determined that all awards will be subject to withholding.[46]

IV. A WHISTLEBLOWER BASED EXAMINATION

a. How do I know if a Bond Examination Resulted from a Tip?

The IRS will preserve the identity of a tipster, and will presumably not indicate that the source of the examination is a tip received through the filing of a formal claim with the Whistleblower Office.[47] The IRS, however, may provide vital clues that would indicate that the examination was the result of a whistleblower tip. IRS personnel have indicated, for instance, that the examination opening letter for a tax-exempt bond examination resulting from a tip will indicate that the specific bonds are not being audited as part of the general examination selection or as part of a specific audit program.[48] Instead, the letter will indicate that the bonds were selected for examination because of the receipt of specific information about the particular bond issue.[49] In addition, it should be apparent to controversy counsel based simply on the types of questions being asked by the agent that the examination was a result of specific information received by the IRS.

IRS examiners should build their cases independent of the whistleblower's assertions and corroborate all of the information provided by the whistleblower. Therefore issuers should be granted a fair and defensible examination process. It is the responsibility of controversy counsel to ensure this actually happens.

b. A Possible Early Response

If an issuer or borrower knows that a whistleblower tip has been or will be made, and that the tip has validity, the issuer or borrower could quickly proceed to the IRS on a voluntary basis if an examination has not been opened.[50] Per the IRS, the settlement terms should be more favorable to the issuer than a settlement if the same violation had been discovered during an examination.[51]

V. CONCLUSION

After several years of receiving very few tips, the IRS Office of Tax Exempt Bonds has recently received 32 tips relating to outstanding tax-exempt bonds. With the recent announcement of more layoffs in the banking industry, I expect to see a continued resurgence of examinations initiated from whistleblower tips.

[1] W. Mark Scott is with the Law Office of W. Mark Scott, PLLC. He may be contacted at mark@scottpllc.com.

[2] *See* former Internal Revenue Manual (IRM) §4.81.1.6, which established processes specific to tips received by the Office of Tax Exempt Bonds.

[3] The Treasury Inspector General for Tax Administration issued a report in 2005, which includes a number of obvious errors, but does accurately show 36 separate whistleblower tips received by the Office of Tax Exempt Bonds in 2004. (The number of tips shown in the report for 2002 and 2003 is in error.) Treasury Inspector General for Tax Administration, *Statistical Portrayal of the Tax Exempt Bonds Office's Enforcement Activities From Fiscal Year 2002 Through Fiscal Year 2004,* Report 2005-10-186, p. 12 (Sept. 2005).

[4] Prior to 2006, Internal Revenue Code (IRC) §7623 provided simply that the IRS was authorized to pay an award in certain situations. Regulations issued under section 7623 authorized an award up to 15% of the amount (other than interest) collected by reason of the information and required a formal claim on Form 211, *Application for Reward of Original Information.* Treas. Reg. §301.7623-1. Allegations of fraud against the U.S. Government are filed with the Department of Justice under the False Claims Act False Claims Act, 31 U.S.C. §3729 et seq.

[5] The decision of the IRS to pay an award, or to pay a certain amount, was not reviewable by any court. *See, e.g., Wolf v. Commissioner*, TC Memo 2007-133 (May 30, 2007).

[6] The False Claims Act includes a "qui tam" provision. This provision allows whistleblowers to pursue an action in the name of the government. 31 U.S.C. §3730(a). Tax cases are specifically excluded under this provision. 31 U.S.C. §3729(e). The largest whistleblower proceeding in TEB history related to yield burning in advance refunding escrows. This proceeding was pursued as a qui tam action by Mr. Michael Lissack and, ultimately, resulted in a settlement approaching $200 million, with 15% paid to Mr. Lissack. Notwithstanding the payment of this award, courts of law subsequently declined to follow the government's treatment of Mr. Lissack's action as a qui tam suit and have, instead, found that Mr. Lissack's action to be barred under the tax restriction applicable to such suits. *United States ex rel. Lissack v. Sakura Global Capital Markets Inc*, 377 f.3d 145 (2nd Cir. 2004).

[7] A portion of this drop in tips could, in part, be attributed to the required processing of tips by the newly created Whistleblower Office.

[8] The Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, div. A, title IV, §406, 120 Stat. 2922 (Dec. 20, 2006).

[9] IRC §7623(b).

[10] The Whistleblower Office was established in December of 2006. IR-2007-201 (Dec. 19, 2007) ("Procedure Unveiled for Reporting Violations of the Tax Law, Making Reward Claims); *see also* IR-2005-25 (Feb. 2, 2007) ("IRS Begins Work on Whistleblower Office; Whitlock Named First Director").

[11] Internal Revenue Service, *Fiscal Year 2010 Report to the Congress on the Use of Section 7623.*

[12] Per Cliff Gannett, director, at American Bar Association May 2011 meeting.

[13] Nothing prevents whistleblowers from submitting a claim for which they are not eligible. Whistleblowers not eligible for an award may simply choose to submit their tip directly to the IRS Office of Tax Exempt Bonds.

[14] The extent of the existing restriction on state and local government employees is somewhat unclear as the IRM and Notice provisions are inconsistent, with the Notice providing a more limited description of the exclusion. Presumably the IRS only intends to preclude claims filed by state and local government employees who have received federal tax information pursuant to the exception to the IRC §6103 disclosure statute. IRM §25.2.2.5 (June 18, 2010); Par. 3.04 of Notice 2008-4, 2008-1 C.B. 253; IRC §6103(d).

[15] IRM §25.2.2.9.2, ¶ 11.B. (June 18, 2010).

[16] IRC §7623(b)(6)(B); Par. 3.04(6) of Notice 2008-4.

[17] IRC §7623(b)(4).

[18] Par. 3.02 of Notice 2008-4.

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[19] *Id.*
[20] Par. 3.03(8) of Notice 2008-4.
[21] IRM §25.2.2.4 (Jun. 18, 2010); IRM §25.2.2.7 (Jun. 18, 2010).
[22] IRM §25.2.2.7 (Jun. 18, 2010).
[23] In the case of tax-exempt bonds, the current subject matter expert is Derek Knight, a field manager in the Office of Tax Exempt Bonds.
[24] IRM §25.2.2.7 (Jun. 18, 2010).
[25] *Id.*
[26] IRM §25.2.2.6 (Jun. 18, 2010).
[27] *Id.*
[28] *Id.*
[29] IRC §6103(k)(6) and (n); Treas. Reg. §301.6103(n)-2.
[30] Par. 3.06 of Notice 2008-4. One circumstance mentioned in the Notice where the whistleblower's identity would be disclosed by the U.S. government is when the claimant is called as a witness in a judicial proceeding.
[31] IRC §7623(b)(5)(B); Prop. Treas. Reg. §301.7623-1 proposes to broaden the amounts included in this threshold by including amounts denied on refund claims and reductions in overpayment balances.
[32] IRC §7623(b)(5)(A).
[33] *See* IRM §4.81.6.5.3.1 (Aug. 5, 2011), for IRS instructions on how to compute taxpayer exposure.
[34] This lower percentage is not applicable if the informant was the original source for the public disclosure. Par. 3.09 of Notice 2008-4.
[35] IRC §7623(b).
[36] IRM §25.2.2.9.2 (Jun. 18, 2010).
[37] *Id.*
[38] IRC §7623(b)(3).
[39] IRM §25.2.2.9.2 (June 18, 2010).
[40] Per discussions with IRS personnel.
[41] *But see Cooper v. Commissioner*, 135 T.C. 70 (July 8, 2010) (wherein the tipster was denied the right to challenge the IRS's refusal to pursue his claim).
[42] GAO report
[43] IRC §7422.
[44] IRM §25.2.2.12 (Jun.18,2010).
[45] IRC §7121(b).
[46] Par. 3.10 of Notice 2008-4.
[47] Par. 3.06 of Notice 2008-4.
[48] Per Cliff Gannett, director, at American Bar Association May 2011 meeting.
[49] Letter 4559, referred to at IRM 4.81.5.6.1 (Oct. 1, 2009).
[50] IRM §7.2.3.1.2 (Aug. 5, 2011).
[51] IRM §7.2.3.1.1 (Aug. 5, 2011).

SECTION OF TAXATION
State Bar of Texas

January 26, 2012

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RE: **Request for the Issuance of Additional Guidance Regarding the Application of Section 197(f)(9) of the Internal Revenue Code of 1986, as amended**

Dear Commissioner Shulman and Chief Counsel Wilkins:

On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed request for the issuance of additional guidance by the Internal Revenue Service (the "Service") regarding the application of section 197(f)(9) of the Internal Revenue Code of 1986, as amended.

1414 Colorado Street, Austin, TX 78701
(512) 427-1463 or (800) 204-2222

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THE REQUEST FOR ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THIS REQUEST AND THESE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE REQUEST FOR THE ISSUANCE OF ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED FOR THIS REQUEST FOR ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS AND THIS REQUEST AND THESE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We commend the Service for permitting us to submit this request for additional guidance and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Mary McNulty

Mary McNulty
Chair, Section of Taxation
State Bar of Texas

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REQUEST FOR ADDITIONAL GUIDANCE WITH RESPECT TO THE APPLICATION OF THE ANTI-CHURNING RULES OF SECTION 197(f)(9) OF THE INTERNAL REVENUE CODE

This request for additional guidance with respect to the application of the anti-churning rules of section 197(f)(9) of the Internal Revenue Code of 1986, as amended, and supporting comments are presented on behalf of the Section of Taxation of the State Bar of Texas. The principal drafters of these comments were Jeffrey M. Blair, Eric Larson, and David S. Peck. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Stephanie Schroepfer is the Chair of COGS, and R. David Wheat reviewed this request for additional guidance on behalf of COGS.

Although many of the people who participated in preparing, reviewing and approving these comments have clients who will be affected by the federal tax law principles addressed by these comments and frequently advise clients on the application of such principles, none of the participants (or the firms or organizations to which such participants belong) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the subject matter of these comments.

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Date: January 26, 2012

I. EXECUTIVE SUMMARY.

The following requests additional guidance with respect to the future application of the anti-churning rules of section 197(f)(9) of the Internal Revenue Code of 1986, as amended.[1]

The following is a summary of our request:

A. We respectfully request that the Service provide additional guidance advising that the Service will not apply the anti-churning rules of section 197(f)(9) to future transactions. Given the fact that more than 15 years have passed since the enactment of section 197 of the Code, the purposes for the enactment of section 197(f)(9) are of little relevance today. The application of section 197(f)(9) continues to present obstacles to transactions completely outside the purposes of that section and lead to unfair and unequal treatment of taxpayers.

B. Alternatively, we request that the Service provide the following guidance that would reduce the scope and the corresponding burden of the anti-churning rules of section 197(f)(9) of the Code to future transactions by advising that with respect to future transactions:

- the anti-churning rules of section 197(f)(9), if applicable to a particular section 197 intangible, will only apply to the portion of the value of the section 197 intangible that existed as of August 10, 1993 and will not apply to any increase in value of the section 197 intangible after August 10, 1993; and
- the election to recognize gain under section 197(f)(9)(B) will only apply to the value of any section 197 intangible that existed as of August 10, 1993 and will not apply to any increase in value of that section 197 intangible after August 10, 1993.

II. BACKGROUND

Prior to 1993, taxpayers were only able to amortize intangible assets that had useful lives if those lives could be estimated with reasonable accuracy.[2] At that time, no amortization deduction was allowed for acquired goodwill and going concern value. This resulted in a great deal of litigation between taxpayers and the Service to determine whether assets acquired in connection with the purchase of a business should be classified as nonamortizable goodwill or some other type of intangible asset that had a useful life that could be estimated with reasonable accuracy. On April 20, 1993, the United States Supreme Court held in *Newark Morning Ledger Co. v. United States* that, if a taxpayer could show that an asset had an ascertainable value and a limited useful life, then that taxpayer could depreciate that asset regardless of whether that asset was properly described as goodwill or some other type of acquired intangible asset.[3] In response to *Newark Morning Ledger Co.*, Congress enacted section 197 of the Code as part of the Omnibus Budget Reconciliation Act of 1993 ("OBRA").[4] Section 197 permits a taxpayer to capitalize acquired section 197 intangibles (including goodwill and going concern value) and amortize those intangibles ratably over a 15-year period, beginning with the month in which such an intangible is

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1 Except as otherwise specified, all section references herein are references to the applicable sections of the Internal Revenue Code of 1986, as amended.

2 *See* Treas. Reg. §1.167(a)-3 (as in effect on January 1, 1993).

3 *Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993). The Court stated that "[t]he significant question for purposes of depreciation is not whether the asset falls 'within the core of the concept of goodwill' Brief for United States 19, but whether the asset is capable of being valued and whether that value diminishes over time." *Id.* at 566.

4 Pub. L. No. 103-66, §13261, 107 Stat. 540 (1993).

acquired.[5] One of the purposes of enacting section 197 was to simplify the law regarding the amortization of intangibles by eliminating the need to distinguish between intangibles whose useful life can be reasonably estimated and those whose useful life cannot be reasonably estimated.[6]

Included in the new section 197 were the anti-churning rules of section 197(f)(9).[7] The stated purpose of section 197(f)(9) is to "prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a deduction would not have been allowable under present law into amortizable property to which the bill applies."[8] Section 197(f)(9) does this by excluding from the definition of "amortizable section 197 intangible" any goodwill, going concern value or other section 197 intangible (i) for which a deduction for depreciation or amortization would not have been allowed prior to the enactment of section 197, (ii) that was acquired after August 10, 1993, and (iii) that would otherwise meet the definition of a "section 197 intangible" but for section 197(f)(9) if: (x) the intangible was held or used at any time during the period beginning on July 25, 1991 and ending on August 10, 1993 (the "Transition Period") by the taxpayer or a related person; (y) the intangible was acquired from a person who held such intangible at any time during the Transition Period and, as part of the transaction, the user of such intangible does not change, or (z) the taxpayer grants the right to use such intangible to a person (or a person related to such person) who held or used such intangible at any time during the Transition Period.[9]

III. REQUEST FOR ADDITIONAL GUIDANCE

During the seventeen plus years after section 197(f)(9) became law, the Department of Treasury and the Service have issued Treasury Regulations and other guidance as to its application.[10] We commend the Treasury Department and the Service for the guidance already issued. However, due to the reasons described in more detail below, we believe that additional guidance is needed to keep section 197(f)(9) from reaching beyond its original purpose, to prevent unfairness and unnecessary complexity and to avoid obstacles to non-abusive transactions. Our requests for additional guidance are set forth as two alternatives. Our primary request is for guidance that would effectively result in a repeal of the application of the anti-churning rules of section 197(f)(9) on a going-forward basis. Alternatively, we request that the Service provide additional guidance that would significantly reduce the impact of these anti-churning rules on future transactions.

A. Effective repeal of the anti-churning rules of section 197(f)(9) of the Code.

1. <u>Section 197(f)(9) of the Code has outlived its original purpose</u>.

The anti-churning rules of section 197(f)(9) have outlived their original purpose. As noted above, the stated purpose of section 197(f)(9) was to "prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a deduction would not have been allowable under present law into amortizable property to which the bill applies."[11] While conversion of nonamortizable intangibles under pre-1993 law into amortizable intangibles under post-1993 law was

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5 §197(a).

6 *See* Omnibus Budget Reconciliation Act of 1993, conference report on section 197, H.R. Rep 213, 103d Cong., 1st Sess. 672, 690 (1993) (the "Conference Report").

7 Pub. L. No. 103-66, §13261, 107 Stat. 540 (1993).

8 Conference Report at 691.

9 §197(f)(9)(A); Treas. Reg. §1.197-2(h)(1).

10 *See, e.g.,* Treas. Reg. 1.197-2(h) (guidance regarding the application of the anti-churning rules of §197(f)(9)); Rev. Rul. 2004-49, IRB 939 (§197(f)(9) anti-churning rules do not apply to reverse §704(c) allocations).

11 Conference Report at 691.

undoubtedly a significant concern at the time section 197 was enacted, that concern seems of little relevance today, particularly in light of other sections of the Code, such as section 1239, that address similar concerns. If, as Section 197(a) would seem to suggest, the useful life of amortizable section 197 intangibles is 15 years, any goodwill, going concern value, or other section 197 intangible that existed as of the enactment date of August 10, 1993 would no longer exist and there would no longer be any section 197 intangibles that should properly be subject to the anti-churning rules of section 197(f)(9).

A stated purpose of section 197 is to simplify the law regarding the amortization of intangibles.[12] Congress made it clear that the severe backlog of cases in audit and litigation was a matter of great concern and any principles established in such cases would no longer have precedential value due to the passage of the new section 197.[13] Congress did so by establishing a clear 15-year amortization period for all types of intangible assets, regardless of whether such assets could be said not to have an estimated useful life, such as goodwill or going concern value. The anti-churning rules of section 197(f)(9) are usually described by practitioners as a complex and complicated section of the Code.[14] Further, the anti-churning rules only apply to goodwill, going concern value, and other section 197 intangibles that were not amortizable before the enactment of section 197; they do not apply to other types of section 197 intangibles. Accordingly, the continued application of the anti-churning rules of section 197(f)(9) perpetuate, rather than eliminate, the need to distinguish between goodwill/going concern and other types of intangibles (the exact distinction that Congress desired to eliminate), and are otherwise counter-productive to the intended goal of simplification of the law in this area.

Accordingly, for the reasons stated above, we recommend that the Service issue guidance advising that the Service will not apply the anti-churning rules of section 197(f)(9) to future transactions. This view is consistent with the view expressed by state and national bar associations.[15]

2. <u>As currently applied, Code section 197(f)(9) leads to the unfair and unequal treatment of taxpayers</u>.

Similarly situated taxpayers are treated differently as a result of the current application of the anti-churning rules of section 197(f)(9). One such difference is based on when the business is started. A business that was started on or before August 10, 1993 is currently subject to the anti-churning rules of section 197(f)(9) with respect to all of its section 197 intangibles and will continue to be subject to these rules in the future. On the other hand, if the same business was started as of August 11, 1993, the anti-churning rules would not apply.

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12 Conference Report at 690.

13 *Id.*

14 *See, e.g.*, Romina Weis, *Fifteen Years of Anti-Churning: It's Time to Make Butter*, 122 Tax Notes 227, 228 (Jan. 12, 2009) (stating that the anti-churning rules are complex); Phillip S. Postlewaite and John S. Pennell, *Applying the 15 Year Amortization Regs. for Intangibles in a Partnership Setting*, 92 J Tax'n 353 (June 2000) (describing the anti-churning rules as complicated).

15 *See* Letter from Peter H. Blessing, Chair of New York State Bar Tax Section, to Michael Mundaca, Assistant Secretary (Tax Policy), et. al. (June 25, 2010) (indicating in the New York State Bar Association Tax Section's recommendations to the 2010-2011 IRS Guidance Priority List that the IRS should issue guidance terminating the anti-churning rules of section 197(f)(9) "in light of the passage of time"); Letter from Stuart M. Lewis, Chair of American Bar Association Section of Taxation, to Douglas Shulman, Commissioner of the Internal Revenue Service (July 28, 2010) (indicating in the American Bar Association Section of Taxation's recommendations to the 2010-2011 IRS Guidance Priority List that the Service should issue guidance suspending the enforcement of the anti-churning rules of section 197(f)(9) in the "interests of sound tax administration.").

If a business that was started on or before August 10, 1993 had only $1 of value of goodwill or going concern value as of such date, such a business would be subject to the anti-churning rules with respect to any increase in the value of that goodwill or going concern value, whereas a business that had no goodwill or going concern value as of August 10, 1993 would not be subject to the subsequent creation or increase in the value of its goodwill or going concern value. Although it is often the case that some disparities in treatment will occur under any bright line rule, the above disparities seem particularly arbitrary and no longer appear to serve a substantive purpose.

The current application of section 197(f)(9) of the Code also results in similar transactions being treated differently based on the forms of those transactions. For example, if a business has been conducted through a single member limited liability company ("LLC") (treated as a disregarded entity for federal income tax purposes) and the sole owner sells a membership interest in that business of less than 80% to an unrelated third party, then the anti-churning rules would prevent the unrelated third party from obtaining a stepped-up basis in its share of the assets of the LLC. However, if that same LLC were structured as a partnership (e.g., by having a 1% member and a 99% member), then that same sale to a third party could provide the third party with a full step-up in the basis under section 743(b) (assuming the LLC had a valid section 754 election in effect) and any resulting amortization deductions for its proportionate share of the LLC's section 197 intangibles. This seems to be patently unfair treatment to an uninformed taxpayer.

Similarly, suppose two individuals are equal members in an LLC (treated as a partnership for federal income tax purposes) that owned valuable section 197(f)(9) intangibles as of August 10, 1993. If one member sold all of its interest to the other member, then the acquiring member would not be entitled to any amortization deductions under the anti-churning rules of section 197(f)(9). However, if that same member were to acquire ninety-nine percent (99%) of the other member's LLC interest, then the Section 743(b) rules described above would apply, allowing the purchaser to recognize amortization deductions on the section 197(f)(9) intangibles.[16] This seems to be an unneeded trap for any unwary member who fails to make a minor adjustment in the purchase of another member's interest in an LLC.

The bright line rules set forth under section 197(f)(9) result in some taxpayers being forced to engage in overly complicated tax planning and transaction structuring to avoid the inadvertent application of section 197(f)(9), while other taxpayers unwarily step into traps set by section 197(f)(9). Given the little remaining benefit served by section 197(f)(9), the cost of maintaining the regime far exceeds the benefits.

3. Requested Guidance.

We believe that the anti-churning rules of section 197(f)(9) have outlived their intended purpose and that the burdens of maintaining those rules far outweigh the benefits provided. In addition, we believe that the continued application of section 197(f)(9) is contrary to the purpose of section 197, which is to simplify the law in this area, Section 197(f)(9) perpetuates unfair and unequal tax treatment to taxpayers in similar situations, presenting traps for the unwary taxpayer. Accordingly, we believe that the Service should issue guidance that the Service will not apply the anti-churning rules of section 197(f)(9) to future transactions.

[16] McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶16.02[3][b] Example 16-4 (Thomson Reuters/WG&L 4th ed. 2007 & Sup. Feb. 2011).

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B. Guidance narrowing the scope of section 197(f)(9)

Alternatively, if the Service does not completely eliminate the continued application of section 197(f)(9) to future acquisitions of section 197 intangibles, the Service should limit the future application of these rules in a manner consistent with the original Congressional intent of Code section 197(f)(9).

1. Increases in Goodwill, Going Concern Value and other section 197 intangibles should not be subject to the anti-churning limitations of section 197(f)(9).

Guidance is needed to address the proper treatment of any increase in value of section 197 intangibles that existed during the Transition Period. In enacting section 197, Congress established an estimated 15-year useful life for goodwill, going concern value and other section 197 intangibles. The Conference Report indicated that the anti-churning rules were intended to "prevent taxpayers from converting existing goodwill, going concern value, or any other section 197 intangible for which a deduction would not have been allowable under present law into amortizable property to which the bill applies."[17] Consistent with that objective, the application of the anti-churning rules should be limited to the value of the goodwill, going concern value or other nonamortizable intangible that was held by the business as of August 10, 1993 and should not apply to any subsequent increase in such value. The purpose of section 197(f)(9) is to prohibit certain churning transactions from creating amortization deductions with respect to section 197 intangibles that existed as of August 10, 1993. Applying the anti-churning rules to section 197 intangibles that did not exist as of August 10, 1993 (e.g., goodwill and going concern value that were created after August 10, 1993) is contrary to the stated purpose of section 197(f)(9), which is to prevent only the amortization of "existing" goodwill, going concern value and other section 197 intangibles as of August 10, 1993. Any growth in the value of goodwill, going concern value or other section 197 intangibles after August 10, 1993 should be properly viewed as outside the scope of the anti-churning rules of section 197(f)(9). Similar limitations have been applied in other areas of the Code.[18]

Accordingly, we request the Service limit the future application of section 197(f)(9) only to the value of the section 197 intangibles that existed as of August 10, 1993 and provide that section 197(f)(9) will not apply to any increase in value after August 10, 1993.

2. Guidance should be issued with respect to the election available under Code section 197(f)(9)(B).

In certain circumstances, taxpayers may avoid the anti-churning rules of section 197(f)(9) by making an election under section 197(f)(9)(B). This election is only available in situations where the transaction would not be subject to section 197(f)(9) but for the rule in section 197(f)(9)(C)(i) that treats a person as a "related person" by substituting 20% for 50% in applying Code sections 267(b) and 707(b)(1). If this election is made, the seller is taxed at the highest marginal ordinary income rate applicable to that seller on the full amount of the gain realized on the disposition of the section 197(f)(9) intangible. In that case, the buyer is then permitted to amortize the basis step-up in the acquired section 197(f)(9) intangible. The buyer is not permitted, however, to amortize any amounts allocable to the seller's tax basis, if any, in such a section 197(f)(9) intangible.

Currently, it is rare that taxpayers take advantage of this election because in making this election the seller loses certain benefits that would otherwise be available in a taxable asset sale, for example: (i) deferral of

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17 *See* Conference Report at 691.

18 *See, e.g.*, §1374 (built-in gains rules applied to corporations electing to be treated as an S corporation as of a date certain with future appreciation not being subject to the built-in gains taxes of section 1374).

gain under the installment method under Code section 453; (ii) loss of lower long-term capital gains tax rates on the sale of capital assets; (iii) lower marginal ordinary income tax rate that would otherwise be available (e.g., lower rates for amounts below $250,000 for individuals or below $10 million for corporations). Consistent with the guidance requested above, guidance should be issued advising that the election (if made) would be limited to the amount of gain that existed as of August 10, 1993.

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SECTION OF TAXATION
State Bar of Texas

January 30, 2012

Mr. Douglas H. Shulman
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

RE: **Response to Announcement 2011-78 Request for Comments Regarding Proposed Guidance Concerning Governmental Plan Status Under Section 414(d) of the Internal Revenue Code of 1986, as amended**

Dear Commissioner Shulman:

On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of Treasury and the Internal Revenue Service for comments concerning proposed issuance of guidance relating to governmental plan status under Section 414(d) of the Internal Revenue Code of 1986, as amended.

THE REQUEST FOR ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THIS REQUEST AND THESE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE REQUEST FOR THE ISSUANCE OF ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED FOR THIS REQUEST FOR ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS AND THIS REQUEST AND THESE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

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We commend the Service for permitting us to submit this request for additional guidance and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Mary McNulty

Mary McNulty
Chair, Section of Taxation
State Bar of Texas

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RESPONSE TO REQUEST FOR COMMENTS REGARDING PROPOSED ISSUANCE OF GUIDANCE WITH RESPECT TO GOVERNMENTAL PLAN STATUS UNDER SECTION 414(d) OF THE INTERNAL REVENUE CODE

This response to the Announcement 2011-78 request for comments with respect to governmental plan status under Section 414(d) of the Internal Revenue Code of 1986, as amended ("*Code*"), is presented on behalf of the Section of Taxation of the State Bar of Texas. The principal drafters of these comments are Stephanie Schroepfer and Henry Talavera, Vice-Chair of the Employee Benefits Committee. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Substantive comments were provided by Neal Thomas. Stephanie Schroepfer is the Chair of COGs and Felicia Finston and David D'Alessandro, Vice Chair of COGs, reviewed this response to request for comments on behalf of COGS.

Although many of the people who participated in preparing, reviewing and approving these comments have clients who will be affected by the federal tax law principles addressed by these comments and frequently advise clients on the application of such principles, none of the participants (or the firms or organizations to which such participants belong) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the subject matter of these comments.

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Date: January 30, 2012

I. EXECUTIVE SUMMARY.

This comment letter is in response to the request of the Internal Revenue Service (the "*IRS*") and the Department of the Treasury (the "*Treasury*") for comments concerning the proposed definitions of "political subdivision of a State" and "agency or instrumentality of a State or a political subdivision of a State" for purposes of Section 414(d) of the Code (the "*Proposal*").[1]

Definition of political subdivision

With respect to the definition of political subdivision in the Proposal, we suggest that the IRS and the Treasury consider:

- expanding the list of examples of local authorities to include local entities that are commonly created pursuant to State statutes or created pursuant to other local government laws, ordinances or other official action, such as local hospital districts created to provide medical care for indigent persons residing in a city or county, mental health and mental retardation authorities created to provide mental health services and mental retardation services for indigent persons residing in a city or county, local housing authorities created to provide affordable housing for local needy residents, airport authorities, transit authorities created to provide affordable mass transit for needy residents of a city or county, or city, county or local river or water authorities, school districts and special districts (or any entity similar to those described above created for legitimate governmental purposes);

- clarifying that an entity need not have all possible sovereign powers;

- expanding the group of persons who may govern the entity to include officials or bodies such as a governing board and county commissioners;

- specifying that the governing officials may be appointed by the State or public officials of a county, city or municipality or special district within a State; and

- establishing a safe harbor under which an entity will be deemed to be a political subdivision if either:

    - a State, including, but not limited to, the attorney general's office, determines that an entity is part of the State or part of a city, county or municipality (or a similar determination is made by a county or municipality or by a State or Federal court); provided that the facts underlying any such determination have not materially changed since such determination; or

    - a State, city, county or any municipality, or a combination of such entities, has the authority to appoint all of the governing officials of the entity and the removal of any such person appointed is either expressly reserved to the appointing State, city, county or municipality or the removal is subject to the general ouster laws under applicable State law.

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[1] Except as otherwise specified, all section references herein are references to the applicable sections of the Internal Revenue Code of 1986, as amended.

Definition of agency or instrumentality of a State or of a political subdivision of a State

With respect to the definition of "agency or instrumentality of a State or of a political subdivision of a State" for purposes of Section 414(d) of the Code, we suggest that the IRS and the Treasury consider:

- making certain technical revisions to the factors in the Proposal, as discussed below in this letter to reflect the manner in which local governmental entities are frequently established and operated,

- clarifying that the failure to satisfy one or more particular factors, other than that the entity serve a governmental purpose, does not necessarily indicate that the entity is not an agency or instrumentality of a State or of a political subdivision for purposes of Section 414(d), and

- clarifying that any list of factors relevant to a determination of an entity's status as an agency or instrumentality of a State or of a political subdivision for purposes of Section 414(d) is a nonexclusive list.

Plan coverage of only governmental employees

If the IRS and the Treasury include in any guidance concerning Section 414(d) governmental plan status a requirement concerning the coverage of the plan, we recommend that the IRS and the Treasury consider including a requirement that the plan be maintained for the benefit of employees, substantially all of whom are employees of one or more political subdivisions of a State and/or agencies or instrumentalities of a State or of a political subdivision of a State that maintain the plan.

II. DEFINITION OF POLITICAL SUBDIVISION OF A STATE

Summary of the Current Proposal Under Consideration by the IRS and Treasury

Under the Proposal, it appears that in order to qualify as a "political subdivision of a State" for purposes of Section 414(d) of the Code, a governmental entity would have to be:

☐ A regional, territorial, or local authority (such as a county or municipality)

☐ created or recognized by State statute to exercise sovereign powers (which generally means the power of taxation, the power of eminent domain, and the police power)

☐ the governing officers either are appointed by State officials or publicly elected.

Recommendations for Consideration

We recommend that the IRS and the Treasury consider expanding the list of examples of local authorities to include:

(1) local entities that are commonly created pursuant to State statutes, such as local hospital districts created to provide medical care for indigent persons residing in a city or county, mental health and mental retardation authorities created to provide mental health services and mental retardation services for indigent persons residing in a city or county,

local housing authorities created to provide affordable housing for local needy residents, airport authorities, transit authorities created to provide affordable mass transit for needy residents of a city or county, or city, county or local river or water authorities, school districts and special districts,

(2) cities,

(3) counties, and

(4) other similar authorities or entities created by State statute or other local government laws, ordinances or other official action by any entity listed in the directly preceding paragraphs (1) through (3).

We also recommend that the IRS and the Treasury consider specifying that the list of examples of local authorities include entities that have been determined to be part of the government by State or Federal courts or by the State, including, but not limited to, the attorney general's office (or a similar determination is made by a county or municipality). We propose that the IRS and the Treasury consider making any such determination conclusive and binding on all persons, including, but not limited to, the IRS, regarding the governmental status of the entity under Section 414(d) of the Code.

We recommend that the IRS and the Treasury consider clarifying that it would not be necessary for an entity to have all possible sovereign powers in order to qualify as a political subdivision of a State (within the meaning of Section 414(d)). We note that the State political subdivision at issue in ***National Labor Relations Board v. Natural Gas Utility District of Hawkins County, Tennessee***, 409 U.S. 600 (1971) had the power of eminent domain but had no power to levy or collect taxes.

We recommend that the IRS and the Treasury consider expanding the group of persons who may govern an entity in order for the entity to qualify as a political subdivision of a State for purposes of Section 414(d). Under the proposal, the entity would have to be governed by "officers," a corporate concept. It is common for governmental entities to be governed by public officials such as members of a governing board, or other persons such as county commissioners.

We also recommend that the IRS and the Treasury consider modifying the Proposal so that the governing officials may be appointed by public officials of a county, city or municipality within a State.

We also recommend that the IRS and the Treasury consider establishing a safe harbor under which an entity would be deemed to be a governmental entity under Section 414(d) if a State, county or municipality, or a combination of such entities, has the authority to appoint all of the governing officials of the entity and if the removal of any such person appointed is either expressly reserved to the State, county or municipality or the removal is subject to the general ouster laws under applicable State law. We also recommend that the IRS and the Treasury consider establishing a safe harbor under which an entity would be deemed to be a governmental entity under Section 414(d) if a State, including, but not limited to, the attorney general's office, determines that an entity is part of the State or part of a city, county or municipality (or a similar determination is made by a county or municipality or by a State or federal court); provided that the facts underlying any such determination have not materially changed since such determination.

Summary of Recommendations Concerning Definition of Political Subdivision of a State

We recommend that the IRS and the Treasury consider modifying the three-prong definitional test in order to qualify as a "political subdivision of a State" for purposes of Section 414(d) so that the factors are as follows:

- A regional, territorial, or local authority (such as, but not limited to, a municipality, city or county, or a transit authority, housing authority, airport authority, hospital district, or mental health/mental retardation authority (or a similar entity created for legitimate governmental purposes) of a State, municipality, city, or county; or an entity that has been determined by a political subdivision of a State, municipality or county for purposes of applicable State or local laws);

- That is created or recognized by State statute or created pursuant to other local government laws, ordinances or other official action with the direct or indirect authority to exercise one or more sovereign powers or other legitimate governmental purpose (including, but not limited, to the power of taxation, the power of eminent domain, or the police power); and

- Whose governing officials either are (1) appointed by State officials or by public officials of a municipality, city or county within a State, or (2) publicly elected.

III. DEFINITION OF AGENCY OR INSTRUMENTALITY OF A STATE OR OF A POLITICAL SUBDIVISION OF A STATE

Summary of the Current Proposal Under Consideration by the IRS and Treasury

Under the Proposal, it appears that in order to qualify as an "agency or instrumentality of a State or of a political subdivision of a State" for purposes of Section 414(d) of the Code, a governmental entity would have to satisfy a facts and circumstances test that would take into account the following factors:

- **FACTOR ONE:** The entity's governing board or body is controlled by a State or a political subdivision of a State (hereafter called a "*PS*"). (For example, an entity's governing board or body is controlled by a State or PS if the public officials of the State or PS have the power to appoint, and to remove and replace, a majority of the entity's governing board or body. This factor is not considered satisfied if the power to control is materially restricted (for example, if any board member of the entity can be replaced only with an individual chosen from a list of designees selected by the other members of the governing board or body).

- **FACTOR TWO:** The members of the governing board or body are publicly nominated and elected.

- **FACTOR THREE:** A State or PS has fiscal responsibility for the general debts and other liabilities of the entity, including responsibility for the funding of benefits under the entity's employee benefit plans.

- **FACTOR FOUR:** The entity's employees are treated in the same manner as employees of the State or PS for purposes other than providing employee benefits (for example, the entity's employees are provided civil service protection).

- **FACTOR FIVE:** In the case of an entity that is not a PS, the entity is delegated the authority to exercise sovereign powers (which generally means the power of taxation, the power of eminent domain, and police powers) of the State or PS, and the delegation of authority is pursuant to a statute of a State or PS.

☐ **FACTOR SIX:** The entity's operations are controlled by a State or PS.

☐ **FACTOR SEVEN:** The entity is directly funded through tax revenues or other public sources. (This requirement is not satisfied if an entity that is not otherwise an agency or instrumentality is paid from public funds under a contract to provide a governmental service or is funded through grants by the State or federal government).

☐ **FACTOR EIGHT:** The entity is created by a State government or PS pursuant to a specific enabling statute that prescribes the purposes, powers and manners in which the entity is to be established and operated.

☐ **FACTOR NINE:** The entity is treated as a governmental entity for federal income or employment taxation purposes (such as the authority to issue tax-exempt bonds under section 103(a) or other federal laws).

☐ **FACTOR TEN:** The entity is determined to be an agency or instrumentality of a State or PS for purposes of State laws. (For example, the entity is subject to open meetings laws or the requirement to maintain public records that apply only to governmental entities, or the State attorney general represents the entity in court under a State statute that only permits representation of State entities).

☐ **FACTOR ELEVEN:** The entity is determined to be an agency or instrumentality of a State or PS by a State or federal court.

☐ **FACTOR TWELVE:** A State or PS has the ownership interest in the entity and no private interests are involved.

☐ **FACTOR THIRTEEN:** The entity serves a governmental purpose.

Recommendations for Consideration

With respect to Factor One of the Proposal, we recommend that the IRS and the Treasury consider explicitly stating that public officials of a State or PS will be deemed to have the power to remove members of an entity's governing board or body if such members are subject to removal under the general ouster laws of the State or PS which provides procedures for removing public officials from office for misfeasance or nonfeasance. ***See, e.g., National Labor Relations Board v. Natural Gas Utility District of Hawkins County, Tennessee***, 409 U.S. 600 (1971), wherein the Supreme Court disagreed with the National Labor Relations Board's finding that that State reserved no power to remove or otherwise discipline those responsible for a governmental entity's operations since the governmental entity's officials were subject to removal under Tennessee's General Ouster Law,[2] which provided procedures for removing public officials from office for misfeasance or nonfeasance. For example, Factor One could be modified as follows:

> ☐ FACTOR ONE: A PS includes all subdivisions of a State, including, but not limited to, any counties or cities and their respective subdivisions. Public officials of a State or PS will be deemed to have the power to remove members of an entity's

[2] Tenn. Code Ann. §8-2701 *et seq* (1955).

governing board or body if such members are subject to removal under the general ouster laws of the State or PS which provide procedures for removing public officials from office for misfeasance or nonfeasance. If the State or PS has the power to appoint and remove officials of such entity, this factor shall be conclusive that such entity is a governmental entity.

With respect to Factor Two of the Proposal, we recommend that the IRS and the Treasury consider modifying the Proposal so that the governing officials may be appointed by public officials of a State, county, city or municipality. For example, Factor Two could be modified to provide as follows:

- ☐ FACTOR TWO: The members of the governing board or body are publicly nominated and elected or are appointed by State officials or by public officials of a municipality, city or county within a State.

We recommend that the IRS and the Treasury consider not including Factor Three of the Proposal in any future guidance (the proposed requirement that a State or PS have fiscal responsibility for the general debts and other liabilities of the entity, including responsibility for the funding of benefits under the entity's employee benefit plans). For some local governmental entities (particularly those with the authority to assess taxes or issue bonds), no other governmental entity has fiscal responsibility for their general debts and other liabilities.

With respect to Factor Four of the Proposal, we recommend that the IRS and the Treasury consider clarifying that it would not be necessary for an employee to be treated in the same manner as employees of a State or PS for all purposes. For example, the word "certain" could be added before the word "purposes" in Factor Four of the Proposal. Perhaps some examples of certain purposes could be included, such as governmental immunity from lawsuits, or being subject to State statutes, which are only applicable to State employees, in the same manner as other State employees.

With respect to Factor Five of the Proposal, we recommend that the IRS and the Treasury consider clarifying that it would not be necessary for an entity to have all possible sovereign powers in order to qualify as an agency or instrumentality of a State or an agency or instrumentality of a PS for purposes of Section 414(d). We also suggest that the IRS and the Treasury consider modifying Factor Five of the Proposal to specify that a State or PS may exercise sovereign powers for the benefit of, or on behalf of, an entity. For example, Factor Five could be modified to provide as follows:

- ☐ FACTOR FIVE: In the case of an entity that is not a PS, the entity is delegated the authority to exercise one or more sovereign powers (such as the power of taxation, the power of eminent domain, or the police power) and the delegation of authority is pursuant to a statute, ordinance or other official action of a State or PS; or a State or PS exercises one or more sovereign powers for the benefit of, or on behalf of, the entity; or the entity is an instrumentality or agency that derives its existence from and acts on behalf of a State or PS with a substantial amount of sovereign powers.

With respect to Factor Six of the Proposal, we recommend that the IRS and the Treasury consider clarifying that the day-to-day operations of an entity will be deemed to be controlled by a State or by a PS if the day-to-day operations of the entity are ultimately managed by an official who reports to, is hired by, and may be removed by, a board or body that satisfies the requirements set forth in Factor One of the Proposal (as Factor One of the Proposal is suggested to be modified).

With respect to Factor Seven of the Proposal, we recommend that the IRS and the Treasury consider clarifying that it would not be necessary for an entity to receive all of its funds through tax revenues or other public sources in order to qualify as an agency or instrumentality of a State or an agency or instrumentality of a PS for purposes of Section 414(d). Many governmental entities assess fees to defray their expenses. For example, public mass transit authorities may assess nominal fees for fares. Airport authorities may raise revenue from fees collected from airlines and airport customers. Housing authorities raise revenue from the federal government, such as grants from the Department of Housing and Urban Development ("HUD"). Public hospitals established primarily to provide medical care for indigent persons may receive fees from insurance companies and patients as well as from Medicare, Medicaid and the Children's Health Insurance Program (CHIP). We recommend that the IRS and the Treasury consider clarifying that the receipt of fees from the populace, the U.S. government, a State or a PS would not jeopardize an entity's status as an agency or instrumentality of a State or of a PS for purposes of Section 414(d). We also recommend that the IRS and the Treasury consider deleting the requirement preventing any funding through grants by the State or federal government to the extent that the entity receives reimbursements from State or federal governmental programs such as Medicare, Medicaid, CHIP or HUD (or a similar U.S. governmental agency or program). The federal government funds many State programs. Preventing funding of a PS by the U.S. government through grants could potentially cause many entities to be considered non-governmental entities. We also recommend that the caveat in Factor Seven of the Proposal be modified to make it clear that interlocal agreements will not jeopardize the governmental entity status of an entity under Section 414(d).

With respect to Factor Ten of the Proposal, we recommend that the IRS and the Treasury consider expanding the factor to include a determination that the entity is determined to be a political subdivision of a State for purposes of State laws. Similarly, with respect to Factor Eleven of the Proposal, we recommend that the IRS and the Treasury consider expanding the factor to include a determination by a State or federal court that the entity is a political subdivision of a State. Many State laws regulating governmental entities have not been structured utilizing precisely the same language as is proposed to apply with respect to Section 414(d). In some cases, governmental entities that would not qualify as a political subdivision of a State under the Proposal test have been determined to be political subdivisions of a State or PS for purposes of State laws. The fact that different terminology has been used by State governments on the one hand and the IRS and the Treasury on the other hand should not weigh against a governmental entity in determining whether it qualifies as an agency or instrumentality of a State or PS. Furthermore, we recommend that any determination by a State or Federal court, or by a State, county or city, that the entity is a governmental entity be conclusive as to that matter.

With respect to Factor Twelve of the Proposal, we recommend that the IRS and the Treasury consider modifying the ownership language to specify that no proprietary interests in the organization exist and that one of more States or PSs have the powers and interests of an owner or have ultimate control by appointment and removal of governing members of the entity. This language would be consistent with the standards articulated in Revenue Ruling 1957-128. There, the IRS determined that certain States had the powers and interests of an owner as, through their officers, the States had the right collectively to dispose of the assets of the organization involved.

We recommend that the IRS and the Treasury consider clarifying that any list of factors relevant to a determination of an entity's status as an agency or instrumentality of a State or PS for purposes of Section 414(d) is a nonexclusive list. Further, we recommend that the IRS and the Treasury clarify that the failure to satisfy one or more particular factors, other than Factor Thirteen, does not necessarily indicate that the entity is not an agency or instrumentality of a State or PS for purposes of Section 414(d).

IV. PLAN COVERS ONLY EMPLOYEES OF GOVERNMENTAL EMPLOYERS

If the IRS and the Treasury include in any guidance concerning Section 414(d) governmental plan status a requirement concerning the coverage of the plan, we recommend that the IRS and the Treasury consider including a requirement that the plan be maintained for the benefit of employees, substantially all of whom are employees of one or more political subdivisions of a State and/or agencies or instrumentalities of the State or PS that maintains the plan.

THE IRS APPEALS PROCESS: A PRIMER IN RESOLVING FEDERAL TAX DISPUTES WITHOUT LITIGATION

By Mary A. McNulty and Lee Meyercord[1]

When faced with a Revenue Agent's Report ("RAR"), a taxpayer may file a protest within 30 days and cause the case to be sent to the IRS Office of Appeals for resolution. Part I of this Article summarizes the Appeals process. Part II summarizes the taxpayer's options regarding any issues that are not settled in Appeals.

I. SUMMARY OF APPEALS PROCESS

A. APPEALS MISSION AND OVERVIEW

The Appeals Office is an informal administrative forum for taxpayers who disagree with an auditor's determinations in the RAR. The objective of the Appeals Office is to resolve tax controversies, *without litigation*, on a basis that is fair and impartial to both the Government and the taxpayer.[2] This impartiality is ensured in part because the Appeals Office is independent and separate from the IRS Exam team who conducted the audit.[3] To maintain this independence and impartiality, the Appeals Officers cannot discuss substantive issues in the case with the Exam team without the taxpayer's participation.[4]

The Appeals Office is highly successful: in tens of thousands of cases each year, the Appeals Officers negotiate and settle between 85 to 90% of these cases.[5] This high settlement rate results in part from how an Appeals Officer's success is evaluated – by their success in compromising with taxpayers, not by how much they uphold the IRS auditor's findings.[6] Appeals Officers are instructed to attempt to reach an agreement with the taxpayer on all issues susceptible to resolution.[7] Not only are the overwhelming majority of cases settled, but over 70% of the cases are settled in a manner that is satisfactory to the taxpayer. In addition, according to the IRS's own statistics, the Appeals process historically results in a tax liability that is 40% lower than the initial proposed liability.[8]

There are two steps to the Appeals process. First, the taxpayer files a formal protest with the Appeals Office. Second, after receiving the formal protest and reviewing all the relevant documents, the Appeals Officer holds an Appeals conference. Each step is addressed in more detail below.

B. FORMAL PROTEST LETTER

The first step in the Appeals process is to file a formal written protest letter within 30 days of receiving the RAR.[9] A "protest" is the term for officially appealing an IRS determination. A written protest is required in all cases in which the total amount of proposed additional tax exceeds $10,000.[10] The filing of the protest gives the Appeals Office jurisdiction over the case.[11]

The protest is the taxpayer's opportunity to explain its view on each protested issue. Although there is no specific form, the protest must contain the following items: the taxpayer's name and address, the date and symbols from the RAR regarding the proposed adjustments, the tax periods or years involved, a statement of the adjustment being protested, a statement of the facts supporting the taxpayer's position on any factual issue, and a statement outlining the law or other authority on which the protest relies.

Generally, the Appeals Officer will not reopen an issue on which the taxpayer and Exam are in agreement, nor raise a new issue, unless the grounds for the action are "substantial" and the potential effect on tax liability is "material."[12] The "substantiality" test requires the Appeals Officer to be "quite certain" at the time the issue is raised that the government will prevail if the issue is raised, and the issue cannot be raised "casually, indiscriminately or haphazardly" or for bargaining purposes.[13] The "material" requirement requires the amount of tax liability to be "material" in an absolute sense.[14]

Unlike the Appeals Officer, the taxpayer may raise new arguments or present new facts to the Appeals Office.[15] If the taxpayer submits evidence for the first time to Appeals, however, the Appeals Officer may, in its discretion, transmit this evidence to the Exam team for consideration and comment.[16]

After the protest is filed, the Exam team will review the protest and submit a rebuttal to Appeals. The purpose of the rebuttal is not to restate the positions taken in the RAR, but rather, to respond to new information or issues raised in the protest.[17] The Appeals Officer will receive the protest, rebuttal, examiner's report, examiner's work papers, correspondence, and other relevant papers. For each issue in dispute, the Appeals Officer may request additional documents or information.

C. APPEALS CONFERENCE

Once the Appeals Officer has received all of the relevant documents from the Exam team, the Appeals Officer will schedule an Appeals conference. This conference will be set at a date and location reasonably convenient to the taxpayer and their representatives.[18] The Appeals conference typically takes place about three months after the IRS rebuttal is submitted. In complex cases covering multiple issues over a number of years, multiple conferences may be held to fully discuss all the issues. These conferences are informal and are a frank discussion between the Appeals Officer and the taxpayer about the issues. The Appeals Officer first meets with the Exam team. Due to the prohibition on ex parte communications, the Appeals Officer invites the taxpayer to be present at that conference. The taxpayer is a silent participant at the conference with the Exam team, unless the Appeals Officer specifically asks the taxpayer to respond.

1. Presentation of Taxpayer's Arguments

The Appeals conference provides the taxpayer with the opportunity to present its position to the Appeals Officer. This presentation includes responding to the Exam team's arguments and answering the Appeals Officer's questions. The rules of evidence that apply in courts do not apply in the Appeals hearing, so the taxpayer (or its representative) can submit evidence to the Appeals Officer that may not be admissible in a court of law. There is no sworn testimony, although the Appeals Officer may require factual matters to be submitted in the form of an affidavit or declared to be true under penalty of perjury.[19] Taxpayers also can bring experts to the Appeals conference to assist with technical factual points.

An Appeals Officer is permitted to request technical advice from the National Office on any technical or procedural questions that develop during consideration of the case.[20] Similarly, a taxpayer may request technical advice from the National Office while at Appeals, but only on the grounds that a lack of uniformity exists as to the disposition of the issue or that the issue is so unusual or complex as to warrant consideration by the National Office.[21] This technical advice is issued in the form of a Technical Advice Memorandum, in which the National Office advises as to how tax law, treaties, regulations, revenue rulings or other IRS publications apply in a particular situation. If the technical advice is favorable to the taxpayer, the Appeals Officer is bound by the technical advice.[22] If the technical advice is unfavorable to the taxpayer, then the Appeals Officer is not bound by the advice, and the Officer may settle the issue under existing authority without regard to the technical advice.[23] Both Appeals Officers and taxpayers are seeking less technical advice in recent years, due primarily to the inclusion of a technical adviser on the Appeals team.

2. Negotiating a Settlement

After the taxpayer has presented its position, the Appeals Officer will discuss settlement with the taxpayer. A settlement can resolve each issue on the basis of the probable results in litigation or involve mutual concessions of issues based upon the relative strengths of the opposing positions when there is substantial uncertainty as to the outcome in litigation.[24] The Appeals Officer will consider the "hazards-of-litigation" in determining an appropriate settlement. Under this hazards-of-litigation standard, the Appeals Officer will determine what a court might decide on the basis of provable facts, the effect of the testimony likely to be presented, and the expected interpretation and application by the court of the Internal Revenue Code provisions and applicable regulations in the light of decided cases. The Appeals Officer is not allowed, however, to settle a case for nuisance value -- i.e., to avoid the expense of going to court.[25] There is no clear line that divides nuisance value from good faith offers, but a concession of 10% or less appears to be the guideline frequently used.[26] In the end, the Appeals Officer either reaches a basis of settlement with the taxpayer or determines that there is no mutually acceptable basis for settlement. A settlement can be reached on some or all of the issues.

3. Post-Appeals Conference Settlement Alternatives

If the taxpayer does not settle some issues during the Appeals conference, the taxpayer may pursue arbitration or mediation.[27] If the settlement negotiations failed because of an unresolved factual issue, the taxpayer can request arbitration to resolve the factual issue.[28] Alternatively, a taxpayer may request post-appeals mediation for factual or legal issues. Mediation is a nonbinding process in which a mediator, a neutral third party, tries to help the

Appeals Officer and the taxpayer reach their own negotiated settlement.[29] Both mediation and arbitration are at the taxpayer's election, and both procedures are conducted through the Appeals Office. Part II below sets forth the taxpayer's options if no settlement is reached in Appeals.

4. Documenting the Settlement

Appeals Officers do not have final authority to settle tax cases. Therefore, any settlement reached with an Appeals Officer is not binding until it is approved by a reviewing Officer in the Appeals Office. If the Appeals Officer recommends acceptance of the taxpayer's proposed settlement and the reviewing Officer disapproves (which is rare), then the taxpayer may have a conference with the reviewing Officer.[30]

Once a settlement is reached with the Appeals Officer and approved by the reviewing Officer, the settlement will be documented by either a Form 870, Form 870-AD, or a Closing Agreement.[31] All three forms waive the restrictions on the assessment and collection of any deficiency that results from the settlement.[32] The forms differ in their level of finality. The Form 870 is solely a waiver of restrictions on assessment and does not prevent a taxpayer from subsequently filing a claim for refund in district court or the Court of Federal Claims or the IRS from subsequently making additional assessments of tax.

In contrast, the Form 870-AD includes language precluding both the taxpayer and the IRS from reopening the case. A case closed by Appeals on the basis of concessions by both parties with a Form 870-AD will not be reopened by the IRS in the absence of fraud, malfeasance, concealment or misrepresentation. The Form 870-AD is the most commonly used form in settling an appeal.

The third option, a Closing Agreement, is used in limited circumstances. A Closing Agreement is used when the agreement involves concessions of continuing issues that affect later years or related cases. A Closing Agreement bars the filing of a refund claim under contract principles and can only be rescinded following the showing of fraud, malfeasance or misrepresentation of material fact.[33] A Closing Agreement is final and must be signed by the Chief of Appeals.[34]

Regardless of the form used to document the settlement, the IRS will not sign the form until Joint Committee has completed its review.[35] All cases involving a refund or credit in excess of $2 million must be submitted to the Joint Committee for review.[36] In determining whether the $2 million jurisdictional amount is met, any refund of previously paid penalties or interest is included in the jurisdictional amount, and the credit or refund is offset by any agreed deficiency for that year.[37] Joint Committee review may also be necessary if the closing agreement will impact a case that is or will be reported to Joint Committee.[38]

If Joint Committee review is required, Appeals will submit a report summarizing the facts and decision of Appeals. The report will be reviewed by an experienced Joint Committee staff member. In straight-forward cases the refund can be approved in about a month, but more complicated cases tend to take longer.[39] Generally, the majority of cases are approved by the

Joint Committee without issue; however, in the event Appeals and the Joint Committee cannot agree, a conference can be held. [40]

II. ISSUES NOT RESOLVED IN APPEALS PROCESS

If the taxpayer is unable to reach a settlement with Appeals, the IRS will issue a notice of deficiency. This notice describes the tax deficiency and states that the taxpayer has 90 days to file a petition with the Tax Court for a redetermination of the deficiency. Because of Appeals' high success rate in carrying out its mission to resolve federal tax controversies without litigation, tax litigation is becoming increasingly rare. Administrative resolutions are less expensive and time-consuming for taxpayers and therefore often the preferred route for taxpayers.

When faced with a 90-day letter, the taxpayer has three options: (1) petition the U.S. Tax Court for a redetermination of the deficiency; (2) permit the 90-day period to lapse and pay the assessed tax, file a claim for refund with the IRS, and then institute a refund suit in federal district court or the U.S. Court of Federal Claims; or (3) permit immediate assessment of the deficiency and pay the additional tax.[41] A taxpayer may make a "qualified offer" to settle the case. If the IRS rejects the qualified offer and the issue is ultimately settled in court for an amount equal to or less than a qualified offer, the taxpayer is treated as the prevailing party and may recover administrative and litigation fees and costs.[42]

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[2] I.R.M. 8.1.1.1(1) (10/23/2007); Treas. Reg. § 601.106(f)(1).

[3] The independence of the Appeals Office is mandated by Congress. IRS Restructuring and Reform Act of 1998, HR 2676, 105th Cong. 2d Sess. § 1001(a)(4) (1998).

[4] Rev. Proc. 2000-43, 2000-2 C.B. 404. The Service is currently re-examining the rules on *ex parte* communications in an effort to strengthen them and improve the appearance of impartiality. Notice 2011-62, 2011-32 I.R.B. 126.

[5] I.R.M. 8.1.1.1 (10/23/2007); *see* INTERNAL REVENUE SERV., ANNUAL REPORT FOR 1988 36 (1998) (stating "Appeals officers, located in major cities, met with taxpayers and their representatives and were usually successful in resolving disputed issues. Appeals closed approximately 93,000 cases, of which 90 percent were agreed"). Current publications suggest the Appeals office closes over 100,000 cases annually. GOV. ACCOUNTABILITY OFFICE, TAX ADMINISTRATION: OPPORTUNITIES TO IMPROVE COMPLIANCE DECISIONS AND SERVICE TO TAXPAYERS THROUGH ENHANCEMENTS TO APPEALS' FEEDBACK PROJECT 1 (2006) [hereinafter GAO Appeals Report].

[6] The emphasis on settling cases is demonstrated in Revenue Procedure 79-34, which notes that the Appeals Process is characterized by the satisfactory number of agreed settlements. Rev. Proc. 79-34, 1979-2 C.B. 498.
[7] I.R.M. 8.6.4.1.7 (10/26/2007).

[8] This percentage may be dated. While this number is currently cited with some frequency, the only statistical data from the I.R.S. was published in 1991. FREDERICK DAILY, STAND UP TO THE IRS 114 (1st ed. 1992).

[9] Treas. Reg. §§ 601.105(d)(2), 601.106(a)(1)(iii).

[10] Treas. Reg. § 601.106(a)(1)(iii)(c).

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[11] In a pre-statutory notice of deficiency case, the Appeals Office acquires jurisdiction when the taxpayer requests Appeals Office consideration and files a protest of the determination of tax liability. Treas. Reg. § 601.106(b).

[12] Treas. Reg. § 601.106(d)(1).

[13] I.R.M. 8.6.1.6.2(1) (11/06/2007).

[14] I.R.M. 8.6.1.6.2(6) (11/06/2007).

[15] In fact, a report by the Government Accountability Office states that 44% of the cases in which Appeals did not sustain the compliance decisions were because of new facts introduced to Appeals. GAO Appeals Report, at 10.

[16] Treas. Reg. § 601.106(f)(6).

[17] I.R.M. 8.6.1.6.4(1) (11/06/2007).

[18] I.R.M. 8.6.1.3.1(1) (11/06/2007).

[19] Treas. Reg. § 601.106(c).

[20] Treas. Reg. § 601.106(f)(9)(ii)(a); Rev. Proc. 2004-2, 2004-1 I.R.B. 83.

[21] Treas. Reg. § 601.106(f)(9)(iii)(a).

[22] Treas. Reg. § 601.106(f)(9)(viii)(c).

[23] *Id*.

[24] *See, e.g.*, I.R.M. 8.6.4.1.1 (10/26/2007) (addressing mutual-concession settlements); I.R.M. 8.6.4.1.2 (10/26/2007) (discussing split-issue settlements).

[25] Treas. Reg. § 601.106(f)(2); I.R.M. 8.6.4.1.3 (10/26/2007).

[26] Saltzman & Saltzman, ¶ Appeals Settlement Practice and Procedures, IRS Practice and Procedure.

[27] I.R.C. § 7123(b).

[28] Rev. Proc. 2006-44, 2006-2 C.B. 800.

[29] Rev. Proc. 2009-44, 2009-40 I.R.B 462.

[30] Treas. Reg. § 601.106(f)(3).

[31] I.R.C. § 7121.

[32] Treas. Reg. § 601.106(d)(2).

[33] I.R.C. § 7121(b).

[34] I.R.M. 8.13.1.6 (11/09/2007); Treas. Reg. § 301.7121-1(a).

[35] I.R.M. 8.7.9.5.6(1) (11/09/2007); *see also* I.R.M. 8.7.9.5.1(2) (11/09/2007) (providing “no settlement should be made effective until receipt of notice that the JCT has no objection to the proposed overpayment.”).

[36] I.R.C. § 6405(a).

[37] I.R.M. 8.7.9.1 (8/28/2009); I.R.M. 8.7.9.6.3(3) (11/09/2007).

[38] I.R.M. 8.7.9.5.6(3) (11/09/2007). In this situation, advance review of the closing agreement can be requested in an informal procedure.

[39] Donald C. Alexander & Brian S. Gleicher, *IRS Procedures: Examinations and Appeals*, 623 TAX MNGT. PORT. (BNA) A-115 (2010).

[40] *Id*. (estimating almost 90% of cases are approved without question, and even in the rare circumstance the Joint Committee questions the refund, the Joint Committee and IRS ultimately agree over 90% of the time).

[41] Treas. Reg. § 601.103(c).

[42] I.R.C. § 7430(c).

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The Nuts & Bolts of Tax Refund Litigation

By: Robert C. Morris and Michelle A. Spiegel[1]

We often advise our clients that the most cost efficient and effective way of resolving a federal tax dispute is to do so at the lowest level possible of the IRS. We all know, however, that this goal is not always achievable for whatever reason.

A taxpayer that cannot reach an acceptable settlement with the IRS must decide whether it wants to litigate its tax case and in which forum.[2]

Some of the common factors[3] that taxpayers consider when determining where to file their suit are:

1. What is the amount of the purported tax deficiency and can the taxpayer afford to pay that amount? This factor alone may dictate the taxpayer's choice of forum. The United States Tax Court is the only one of the traditional forums[4] where a taxpayer can litigate without having first paid the disputed tax.

2. What type of tax does the dispute involve? The IRS's decision to impose certain taxes, like employment or excise taxes, can only be challenged in one of the refund forums.

3. Does the dispute involve a highly-technical issue? If the dispute involves a highly-technical tax issue, this fact may favor the taxpayer filing its lawsuit in the United States Tax Court where the judges are experienced tax practitioners. Conversely, if the taxpayer's case is more dependent on arguments based in equity, some practitioners believe that the taxpayer is better off having its case heard in a district court.

4. Does the taxpayer want a jury trial? The only forum in which a jury trial is available is a United States district court. It's important to keep in mind, however, that either the taxpayer or the government can demand a jury. Therefore, if the taxpayer wants to avoid a jury

trial, the taxpayer may consider filing its suit in the United States Tax Court or the United States Court of Federal Claims where neither party can demand a jury.

5. What is the governing legal precedent and where is the decision appealable? For taxpayers located in Texas, a decision by the United States Tax Court or a district court will be appealable to the United States Court of Appeals for the Fifth Circuit.[5] Conversely, decisions by the United States Court of Federal Claims are appealable to the United States Court of Appeals for the Federal Circuit.[6] The taxpayer should check the precedent for the applicable court of appeals before filing a lawsuit.

6. What are the applicable discovery rules? Although the United States Tax Court has issued some recent amendments to its rules, many practitioners believe that the discovery rules of the United States Tax Court are more restrictive (and taxpayer-favorable) than those in the district courts or United States Court of Federal Claims, particularly with respect to depositions.

7. What adjustments can the IRS still propose to the taxpayer's tax return that were not set forth in the statutory notice of deficiency? Litigation in the United States Tax Court tolls the statute of limitations while the case is pending.[7]

Although the majority of taxpayers file their suit in the United States Tax Court, there are a number of tax cases tried each year in the United States district courts and the United States Court of Federal Claims. This article summarizes the milestones and procedural aspects of prosecuting a tax refund case in the United States district courts and presents an illustrative timeline of two recent refund cases tried in different U.S. district courts.

MILESTONES AND PROCEDURAL ASPECTS OF PROSECUTING A TAX REFUND ACTION IN UNITED STATES DISTRICT COURT

Procedural Event/Milestone	**Deadline/Comments**
Notice of Deficiency	The IRS must generally wait 90 days to assess the

Procedural Event/Milestone	**Deadline/Comments**
	purported deficiency from the date that the Statutory Notice of Deficiency was issued. I.R.C. Section 6213(a).
Tax and Penalties Paid	A taxpayer must make full payment of the disputed tax and penalties as a prerequisite to filing its lawsuit. Flora v. U.S., 362 U.S. 145 (1960).
Claim for Refund	A taxpayer must file a timely refund claim before filing its lawsuit in district court. I.R.C. Section 7422(a). Refund claims must be filed within three years from the time the return was filed or within two years from the time the tax was paid, whichever period expires later. I.R.C. Section 6511(a). A refund claim must set forth: (1) each ground upon which a credit or refund is claimed, and (2) facts sufficient to apprise the IRS of the exact basis of each claim. A taxpayer that fails to clearly raise an issue or theory in its refund claim is barred by the "Variance Doctrine" from advancing that issue or theory in its refund suit. U.S. v. Felt & Tarrant Co., 283 U.S. 269 (1931); Stevens Engraving Co. v. United States, 53 F.2d 1 (5th Cir. 1931).
Claim for Refund Denied	The IRS must send the notice of disallowance of the refund claim by certified or registered mail. I.R.C. Section 6532(a)(1).
Complaint	A taxpayer must file their refund suit within two years from the mailing of the notice of disallowance. I.R.C. Section 6532(a). The two-year period for filing a refund suit may be extended by agreement. I.R.C. Section 6532(a)(2); Treas. Reg. § 301.6532-1(b). A taxpayer cannot file a suit for refund before the expiration of six months from the filing of a refund claim unless the IRS denies the refund claim within that six-month period. There is competing authority as to whether the two-year period to file a refund suit ever starts if the IRS does not deny the claim for refund. Compare Detroit Trust Co. v. United States, 131 Ct. Cl. 223 (1955) (refund suit that was filed 28 years after claim was filed was timely when IRS never denied claim for refund) with Wagenet v. United States, (taxpayer's refund suit was barred by six-year statute of limitation set forth by 28 USC § 2401

Procedural Event/Milestone	**Deadline/Comments**
	even though refund claim was never denied). Local courts may have additional rules and requirements. At a minimum, the Complaint must contain: (1) a short and plain statement of the grounds on which the court's jurisdiction depends; (2) a short and plain statement of the claim showing that the plaintiff is entitled to relief; and (3) a demand for judgment for the relief claimed. Fed. R. Civ. P. 8(a). The Complaint is generally hand-filed with the clerk of the district court in which the action is brought, and the Clerk issues a summons that the taxpayer must serve (with the Complaint) on the local U.S. Attorney (or a designated assistant or employee) and by sending a copy of each by registered or certified mail to the U.S. Attorney General at the Department of Justice in Washington, D.C. Fed. R. Civ. P. 3, 4, 5(e).
Answer	The government must file and serve its Answer within 60 days after it has been served. Fed. R. Civ. P. 12(a).
Reply	A taxpayer normally is not required to file a reply to the government's Answer in a tax refund suit. Any averments in the Answer to which no response is required are treated as denied. Fed. R. Civ. P. 8(d). A reply is necessary where the government raises a counterclaim or the court orders the taxpayer to file a reply. Fed. R. Civ. P. 12.
Conference of the Parties	After the government files its Answer, the parties are meet and develop a proposed discovery plan to be submitted to the court. "Except in a proceeding exempted from initial disclosure under Rule 26(a)(1)(B) or when the court orders otherwise, the parties must confer as soon as practicable—and in any event at least 21 days before a scheduling conference is to be held or a scheduling order is due under Rule 16(b)." Fed. R. Civ. P. 26(f).
Initial Disclosures	At the Conference of the Parties or within 14 days thereafter, the taxpayer and the government must make initial disclosures, including the identification of each individual likely to have discoverable, relevant information that the disclosing party may use to support its claims or defenses. Fed. R. Civ. P. 26(a). Failure to make a complete initial disclosure may preclude the use of the information

Procedural Event/Milestone	**Deadline/Comments**
	not disclosed. Fed. R. Civ. P. 37(c)(1). In a refund suit, testimony by IRS officials and production by the IRS are governed by Treas. Reg. § 301.9000-1.
Scheduling Order/Pre-trial Order	Scheduling Orders are primarily governed by the rules of the local district court. The Southern District of Texas L.R. 16.1 requires that within 140 days of the filing after a Complaint or notice of removal, the judge will conduct an initial pre-trial conference under Fed. R. Civ. P. 16 and enter a scheduling order unless specifically exempted by the rule. A scheduling order setting cutoff dates for new parties, motions, expert witnesses and discovery, setting a trial date, and establishing a time framework for disposition of motions will be entered at the conference.
Motion for Summary Judgment	A party may file a motion for summary judgment at any time until 30 days after the close of all discovery. Fed. R. Civ. P. 56(b). Local rules, however, sometimes alter this rule. In the Northern District of Texas, “Unless otherwise directed by the presiding judge, no motion for summary judgment may be filed within 90 days of the trial setting.” L.R. 56.2(a).
Responses to Motion for Summary Judgment	The adverse party cannot rest on mere allegations or denials, but must affirmatively set forth by counter-affidavits or other competent evidence or specific facts showing that there is a genuine issue of fact for trial. Fed. R. Civ. P. 56(c). The local rules of a district court govern the timing of a response to a motion for summary judgment. For example, in the Northern District of Texas, a response and brief to an opposed motion must be filed within 21 days from the date the motion is filed. L.R. 7.1(e).
Commencement of Discovery	Discovery (interrogatories, requests for production, and requests for admissions) can begin right after the Complaint has been served. Fed. R. Civ. P. 33(a), 34(b), 36(a).

Procedural Event/Milestone	**Deadline/Comments**
Discovery Responses	Discovery responses are normally due within 30 days. However, when the government is served with discovery with, or shortly after, the filing of a Complaint, the Government has 45 days after service of the Complaint to file responses or objections. On motion, the court may grant a shorter or longer time. See e.g., Fed. R. Civ. P. 56(a)(3).
Expert Witness Reports	Expert witness reports must be provided to the other party at least 90 days before the trial date. The expert witness's report must contain: (1) a complete statement of all opinions to be expressed and the basis and reasons for these opinions; (2) the information considered by the expert witness in forming the opinions; (3) any exhibits to be used; (4) the qualifications of the expert witness, including a list of all of his or her publications for the preceding 10 years; (5) the amount of compensation to be paid; and (6) a list of all other cases in which the witness testified within the preceding four years. Fed. R. Civ. P. 26(a)(2).
Trial	Each court must provide by rule for scheduling trials. Fed. R. Civ. P. 40. The length of trial varies by the case.
Post-Trial Briefs	In a bench trial, the court must make findings of facts and state its conclusions of law. Fed. R. Civ. P. 52(a). Courts will often request that parties submit proposed findings of fact and conclusions of law to assist the Court in its Rule 52 responsibilities.
Opinion Issued by District Court	Our experience ranges from six months to two years
Motion for New Trial	A motion for new trial must be filed no later than 28 days after the entry of judgment. Fed. R. Civ. P. 59(b).
Notice of Appeal to Circuit Court	A notice of appeal must be filed within 60 days after the entry of judgment. Fed. R. App. P. 3 and 4. Where one party files a timely notice of appeal, the other may file a notice within 14 days after the filing of the first notice, or within 60 days after the entry of judgment, whichever period expires later. Fed. R. App. P. 26(a).

Procedural Event/Milestone	Deadline/Comments
Briefs to Circuit Court	The date of docketing starts the time running for filing briefs. The appellant must serve and file a brief. The appellee must serve and file a brief after the appellant's brief is served. The appellant may serve and file a reply brief within 14 days after service of the appellee's brief but a reply brief must be filed at least 7 days before argument, unless the court, for good cause, allows a later filing. Fed. R. App. P. 31(a). If an appellant fails to file a brief within the time provided, an appellee may move to dismiss the appeal. An appellee who fails to file a brief will not be heard at oral argument unless the court grants permission. Fed. R. App. P. 31(c).
Opinion Issued by Circuit Court	Experiences vary.

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United States District Court Case Timeline
(District of New Jersey)

Notice of Deficiency Issued
April 8, 2004

Tax and Interest Paid
September 13, 2004

Claims for Refund Filed
December 23, 2004

Claim for Refund Denied
February 16, 2005

Complaint Filed
May 16, 2005

Initial Disclosures Exchanged
August 30, 2005

Meet and Confer; Pre-Trial Conference
September 2005

Discovery Commences
September 2005

Motion for Partial Summary Judgment
July 28, 2006

Expert Witness Reports Exchanged
October 12, 2007

Partial Summary Judgment Order
December 4, 2007

Motions in Limine Filed
December 31, 2007

Discovery Completed
January 2008

Trial
January 15, 2008 – March 11, 2008

Post-Trial Submissions Filed
June 13, 2008

Opinion Issued
August 28, 2009

Motion for New Trial Filed
September 14, 2009

Motion for New Trial Denied
April 28, 2010

Notice of Appeal to Third Circuit
May 12, 2010

Briefs Submitted to Third Circuit
August – November 2010

Oral Arguments Before Third Circuit
March 28, 2011

Opinion Issued by Third Circuit
June 20, 2011

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United States District Court Case Timeline
(Southern District of Texas)

Claims for Refund Filed
December 17, 2004

Claim for Refund Denied
May 17, 2005

Complaint Filed
June 9, 2005

Initial Disclosures Exchanged
October 2005

Meet and Confer; Pre-Trial Conference
November 2005

Discovery Commences
November 2005

Expert Witness Reports Exchanged
October 30, 2006

Pre-Trial Submissions
November 15, 2007

Motions in Limine Filed
November 28, 2007

Discovery Completed
January 2007

Trial
December 3, 2007 – December 6, 2007

Post-Trial Submissions Filed
December 17, 2007

Opinion Issued
July 24, 2008

Notice of Appeal to Fifth Circuit
September 18, 2008

Appeal Dismissed
March 1, 2010

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[1] Robert C. Morris and Michelle A. Spiegel are with Fulbright & Jaworski L.L.P. in Houston, Texas.
[2] The traditional forums for litigating a federal tax dispute are the United States Tax Court, United States Court of Federal Claims, and the applicable United States district court.
[3] The factors listed in this article are by no means an exhaustive list of factors that taxpayers should consider.
[4] The United States Bankruptcy Court also hears federal tax disputes. Most taxpayers, however, prefer to avoid the United States Bankruptcy Court for obvious reasons.
[5] I.R.C. Section 7482(a)(1) and (b)(1).
[6] 28 U.S.C. § 1295(a)(3).
[7] I.R.C. Section 6503(a)(1).

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Annual Briefing with the Texas Comptroller of Public Accounts
September 23, 2011

Jointly Held By:
TSCPA State Taxation Committee
State Bar of Texas State & Local Tax Committee
Tax Executives Institute

* * * * *

Briefing Summary
By Brad Brookner CPA
TSCPA State Taxation Committee

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Texas Society of Certified Public Accountants

TSCPA State Taxation Committee
Annual Briefing with Texas Comptroller of Public Accounts
September 23, 2011

Welcoming Remarks:

- Alyson Outenreath, SBOT Tax Section State and Local Tax Committee
- Christi Mondrik, TSCPA State Taxation Committee
- Mitch Frank, TEI Region VI

Opening Remarks
Mike Reissig, Associate Deputy Comptroller

- Issues facing the Comptroller's office
  - Legislature cut Comptroller's budget by $40M (10%)
  - Full Time Equivalents had to be reduced to 300
    - This was accomplished without layoffs
    - Hiring freeze in effect for most positions
    - Prior departures and recent retirements achieved the required reductions
  - Comptroller's office will be more focused on supporting audits and hearings and less focused on letter rulings and other guidance (these activities will continue but at a slower pace)

State Revenue Issues and Predictions
John Heleman, Revenue Estimating

- Current state of the economy
  - The Good
    - The U.S. appears to be coming out of one of its worst recessions
    - Employment figures are one of the most important measures
      - U.S. lost 1 in every 16 jobs
      - Texas only lost 1 in every 15 jobs
      - U.S. has added 1 million new jobs out of the 130 million lost
      - At its peak Texas had lost 400,000 jobs of which almost all have been added back
  - The Bad
    - While new jobs are growing the unemployment rate (8.5%) is not decreasing fast. This is due to new people entering the workforce and people working longer.
    - Housing is one of the cores of the recession
      - U.S. housing market/values decreased much sharper than for Texas
      - Texas had built less in recent year helping values
      - Prior to the recession Texas had been building 160,000 new homes per year. That number is now at 60,000 which matches homes built 15 years ago.

- Bright Spots
  - Oil and Gas
    - Not as significant a portion of the TX economy as 20 years ago
    - Rig count is at almost all time highs
      - 900 operating wells currently in Texas
      - 1600 operating wells in the US
      - Next largest state is OK with 200
      - Oil prices have been stabilizing around $70-80/barrel after spikes to $150 and decreases to $35
  - Sales Tax Revenue
    - Stronger revenue than past few years
      - Supported by O&G/field services
      - Manufacturing is recovering
      - Retail is still moderate
  - Franchise Tax
    - $4B in collections last year – better than prior years but still lower than legislative estimates ($6B) from 2006

Tax Policy Procedures Update
Bryant Lomax, Tax Policy Division

- Tax Policy responds to over 30,000 ruling per year
- There are many repetitive requests, particularly in certain areas involving the revised franchise tax, such as passive entities
- Sales tax questions still comprise 55% of the ruling requests
  - There are only 18 sales tax policy analysis, 3 being senior analysts
  - Average response time is 21 days for 70% of the requests
  - There has been significant turnover, particularly of senior analysts, resulting in newer analysts taking more time and needing more guidance/review
- Tax Policy also performs the following:
  - Approximately 60 training seminars
  - Reviewed 533 tax bills
  - Supports the Independent Audit Review process
- Upcoming changes for Ruling requests
  - General Rulings – generic questions that are not fact specific
  - Declaratory Rulings – specific fact patterns and technical questions
    - Will only be answered if the following is provided
      - Taxpayer named
      - Very clearly defined facts, no ambiguous issues
      - Supporting documents provided such as contracts, sales agreements, etc.
      - No audit is ongoing
  - Phoned in questions will still be answered
- STAR documents will still be handled the same but they intend to pull certain letter rulings as corresponding issues are put into Rules issued by the Comptroller's office.

Sales Tax Policy Update
Robin Corrigan, Tax Policy Division

- Affiliate and/or click-through nexus.
  - Response: Click through bills did not get passed by the legislature. However, affiliate nexus statutes were strengthened in SB1 but Comptroller's office always took very strong stand for affiliate nexus in the past
- Implementation of new resale provisions effective October 1, 2011 (S.B. 1, Article 12, Revised Resale Definition).

- Response: This focus mainly on sales to the federal government and TPP transferred to the federal government under a services contract.
- Rule 3.206 is being updated

- H.B. 590 and Comptroller Ruling 201108160L (Aug. 2, 2011) regarding purchasing offices and sourcing of local sales and use taxes.
  - Response: HB 590 strengthened 2003 legislation against the use of purchasing office for local sales and use tax rebates.
  - Depending on the facts, local offices will not be viewed as the sales office.
  - There will be no further anonymous taxability rulings on place of business
- The Comptroller's intention regarding Rule 3.286, particularly with respect to nexus in relation to software licenses and computer servers. Is the new draft Rule being published soon?
  - Response: Tax Policy is working on Rule update (working on 50 total Rule updates)
  - Web hosting is data processing
  - Use of servers does not create nexus
  - Software stored on servers does not create nexus
- Ruling 200808142L, which provides that electronic design automation (EDA) software used to develop software is exempt. Is there any thought to revisiting the exemption of EDA software?
  - Response: Letter needs to be read closely. It clarifies that EDA software can be exempt or taxable depending on use including divergent use
- Local taxation of sales, at the well site, by oil field service companies. Is the well site considered the place of business where the sale closes? Or does the Comptroller look to the location of the company headquarters? What is the authority for the Comptroller's position?
  - Response: Depends on what is sold
  - Tangible personal property (TPP)
  - Real Property Remodeling
  - Repair of TPP
  - Discussion started on what is the Location of Seller and the "3 sales per site" rule
- Aircraft business purpose rulings: Are new rulings being issued that are broader than past rulings? Is the Comptroller considering promulgating a "business purpose" rule? To what extent will the "business purpose" approach to aircraft rulings be expanded to sales of other assets? Will the "business purpose" approach be expanded to other tax types (e.g., franchise tax) or is it limited solely to aircraft fact patterns under the sales tax? Why has aircraft been targeted under what seems to be a special analysis?
  - While Tax Policy is not moving to a "substance over form" test or disregarding legal fiction, it is using both criteria in analyzing situations. The tax policy representatives said they could not give any guidance because each fact pattern would have to be analyzed individually. No Rule is forthcoming. Tax Policy will presume use in Texas unless proven otherwise. Tax Policy has moved away from focusing on separate legal entity treatment if facts warrant such treatment.

Tax Return Processing
Art Earle, Electronic Reporting Section, Account Maintenance Division

- E-filing is being driven by legislation and market demand
- Advantages include immediate updates to account status and confirmation of delivery
- Franchise Tax
  - E-filing - working with additional software compliance packages to increase availability
  - Webfile – Adobe form input and not as robust as e-filing
  - TexNet – Payment system only. Does not satisfy filing of forms
- Form processing has been dramatically improved, resulting in fewer entities being in "bad standing". 1.3 million returns are filed annually so mistakes are made. Most errors

involve incorrect forms, extension affiliate lists not matching the return affiliate schedule, mismarking of the nexus box, PIR/OIR errors and accounting dates
- Comptroller is continuing to improve e-filing to make it easier. To receive a taxpayer's e-filing number a preparer can call 1-800-442-3453. The preparer must know prior year Total Revenue or tax liability to protect data.
- For fiscal year taxpayer franchise tax forms are generally ready in January. Forms for a tax year sent before January of that year will be returned to the taxpayer.

Criminal Investigation Division (CID) Update
Ann O'Connell, Criminal Investigation Division
Martin Cano, Criminal Investigation Division

- Very small percentage of taxpayers ever have CID involved
- 24 people in the division; they focus on cigarette tax, sales tax, motor fuels tax and motor vehicle tax
- Focus is on intentional tax fraud and criminal conduct including forgeries and tampering
- Sec. 111 is the overriding enforcement statute but each tax generally has additional rules
- Mistakes made in compliance are not the intended targets of the CID
- SB 934 changed penalties (mainly for collection without remittance) to the same as theft charges by increasing punishment and fines
- More information can be found at http://www.window.state.tx.us/about/cid/
- Penal code was changed to
  - Add organized crime to be a tax felony.
  - Add conspiracy and money laundering to be a tax crime
- HB11 Goods – Resale Crime
  - Focus on retailers that are not keeping records
  - Sec. 154/155 taxes – not recording sales can be a 3rd degree felony
  - Sec. 151 tax – not recording sales can be a Class C misdemeanor.

Audit & Business Account Research Team Update
Tony Luna, Audit Division

- What is the Comptroller's plan with respect to implementing the new changes to document retention policies?
  - Response: Scanned documents are accepted. E-records are accepted. Daily summary Z-tapes should be sufficient and daily cash register tapes are not necessarily needed.
- Increased frequency of lien filings and fraud penalty assessments where understatement exceeds 25%, particularly in estimated audits and where there is no apparent analysis of intent.
  - Usually only assessed when taxpayer won't provide records and documents. Used as a last option
- Increased frequency of lien filings when redetermination hearing requests are pending.
  - Tony has not heard of this but requested he be contacted if it occurs.
- Increased frequency of assessments under Tex. Tax Code Sec. 111.0611 regarding personal liability for fraudulent tax evasion.
  - Comptroller's office is using this provision if they determine the corporate officers or owners were involved.
- What taxpayers and issues are currently being targeted by BART?
  - "Large ticket" purchases such as aircraft
- Perception that BART review is cursory and that matters are more difficult to resolve than they would be with a field auditor.
  - This is probably correct as BART is not an audit group.
- What are the most common franchise tax report errors? Are some common errors getting better/worse? What are the most common COGS mistakes/disputes?

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- Most common errors are for COGS, apportionment, deduction election and combined filing.
- Error frequency is hard to determine because audits are still fairly new and working on the first year or two of filing.
- Most common COGS items include labor, freight, disputes over what is "Direct" and service companies taking COGS

- Does the Comptroller have plans to use contingency fee auditors?
  - No, Bill of Rights does not allow it
  - Exception for Unclaimed Property area where they already use them.
  - Contract auditors are utilized and receive $47/hour

Administrative Hearings Section Update
Robin Robinson, Administrative Hearings Section

- There are currently 11 attorneys down from 20 in prior years. Authority to hire 5 recently approved
- Currently 2,600 hearings
- Position Letter changes – Selection choice added for email receipt
- Settlement – 75% of cases are settled
- Hearings Section does not handle insolvency reviews or payout plans. Handle with the auditor.

Litigation Update
Don Neal, Litigation & Taxation Section

Sales and Use Tax Cases

- ***GTE Southwest, Inc. v. Combs, et al***, Case No. 03-08-00561-CV in the Third Court of Appeals; Case No. 10-0629 in the Texas Supreme Court
  - Equipment purchased and used by a local exchange carrier in providing telecommunications service to customers is not exempt from sales tax under the manufacturing exemption.

- ***Combs et al. v. Chevron USA, Inc.***, Case No. 10-0823 in the Texas Supreme Court; Case No. 03-07-00127-CV in Third Court of Appeals
  - The purchase of scaffolding and related services was the rental of tangible personal property which was taxable, *not* the provision of a non-taxable service.
  - Taxpayer could not raise new tax contentions for the first time in motion for rehearing.

- ***Roark Amusement & Vending, L.P. v. Combs, et al***, Case No. 03-10-00105-CV in the Third Court of Appeals.
  - Court of Appeals held that taxpayer's purchase of plush toys used in coin-operated machines qualified for resale exemption, because the toys eventually were transferred to participants who played the coin-operated machine games.
  - Comptroller has filed a petition for review with Texas Supreme Court.

- ***Combs et al v. Health Care Services Corp (formerly Blue Cross Blue Shield of Texas)***, Case Nos. 03-09-00617-CV and 03-10-00675-CV in the Third Court of Appeals
  - held that items purchased by taxpayer for use in implementing three contracts for the federal government qualified for the sale for resale exemption because of title passing clauses in FARs
  - Comptroller has filed petitions for review with the Texas Supreme Court

- ***Austin Engineering, Co. Inc. v. Combs, et al***, Case No. 03-10-00323-CV in the Third Court of Appeals

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- held a fact issue existed as to whether taxpayer's purchases of erosion control devices for use at certain construction sites qualified for exemption in § 151.311 (for Items Related to Tax-Exempt Contracts).

Franchise Tax Cases

- ***Southwestern Bell Telephone, L.P., v. Combs, et al,*** Case No. 09-0128 in the Texas Supreme Court; Case No. 07-07-00172-CV in the Seventh Court of Appeals
  - telephone access fees were properly apportioned to Texas under the franchise tax because the fees were for access to telephone lines in Texas, and were not exempt as revenue from "interstate calls" or "calls in interstate commerce."

- ***TGS-NOPEC Geophysical Company v. Combs, et al.,*** Case Number: 08-1056 in the Texas Supreme Court.
  - Held that the receipts from taxpayer's sale of geophysical data pursuant to a license agreement, should be apportioned based on location of payor because they were receipts from the sale of an intangible

Collection Actions

- ***State of Texas v. BFI Waste Services of Texas, LP,*** Case No. 03-10-00504-CV in the Third Court of Appeals
  - held that BFI, as the legal successor to Texas Waste Systems, could be held liable for the sales and use tax liability of its predecessor under Section 111.020 (Tax Collection on Termination of Business) and 111.010 (Suit to recover taxes), even though the Comptroller had not directly assessed BFI for the sales and use tax liability of its predecessor.

- ***Saeed Khan v. State of Texas, et al,*** Case No. 03-09-00708-CV in the Third Court of Appeals
  - upheld the validity of the Comptroller's audit estimation procedures in the absence of taxpayer records, the validity of the 50% penalty assessed when there is gross underreporting, and the validity of imposing personal liability upon the owner of the taxpayer for an unpaid tax liability.

Miscellaneous Fees

- ***Commission on State Emergency Communications v. TracFone Wireless, Inc. et al,*** Case No. 03-10-00111-CV in the Third Court of Appeals
  - held that the fee for 9-1-1 services imposed by Section 771.0711, Health & Safety Code, applied to *prepaid* wireless telecommunications connections prior to the 2009 legislative amendments

- ***Combs, et al v. Texas Entertainment Association, et al,*** Case No. 09-0481 in the Texas Supreme Court
  - held that the sexually oriented business fee does *not* violate the right to freedom of speech guaranteed by the First Amendment to the United States Constitution.

Franchise Tax Policy Update
Janet Spies, Tax Policy Division
Jennifer Specchio, Tax Policy Division

- Does the Comptroller have any plan to pursue economic nexus legislation?

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  - Response: No, while they believe the statute allows an economic nexus argument to be made under the U.S. Constitutional nexus standard Tax Policy will continue to not push this. However, Janet said the legislature has been inquiring about ways to increase revenue and this is one area that Tax Policy has discussed with them. She would not be surprised if future legislative session discusses this further.
- In response to *Taylor Hill Inc. v. Combs*, will the Comptroller be changing her position on disallowing a service industry taxpayer to take the compensation deduction after such a taxpayer is audited and it's discovered in the audit that such taxpayer made a COGS election due to misunderstanding that the COGS deduction was not available to them? Stated differently, will the Comptroller be changing her policy of forcing a taxpayer to take the 30% standard deduction in an audit situation?
  - Response: No, the Taylor Hill case had very specific facts and the court decided that the statute required staff leasing companies to use the compensation deduction under Sec. 171.101(b). Since staff leasing companies are not allowed to make the COGS election the court determined they must use the compensation deduction by statute.
- Is the Comptroller considering changing her position on disallowing an LLC wholly owned by a 501(c)(3) charity to be exempt from Texas franchise tax? Current rules require an IRS determination letter to be exempt from Texas franchise tax, but the IRS does not issue determination letters to such LLCs pursuant to federal law. Charities perceive this as a "gotcha" because they frequently use wholly-owned LLCs to segregate real property and other liability-ridden assets from endowment funds.
  - Response: No, each legal entity requesting to be exempt from tax must have its own IRS determination letter.
- Additional information on Ruling 201101133L, where the Comptroller addresses the deductibility of interest expense as COGS by a lending institution. The Ruling states that the lending institution must offer loans to the "general" public in order to deduct interest expense. However, the Ruling does not clearly define that criterion.
  - Response: Tax Policy has determined that in fact patterns where loans are only made to the combined group's customers who purchase goods from the combined group those customers are not the public. Therefore, a captive finance company does not qualify as a lending institution.
- What is the Comptroller's position on series LLCs? Is the entire series LLC treated as one taxable entity or is each series treated as a separate taxable entity?
  - Response: Series LLCs are treated as one taxable entity (analogy: eggs in a carton). There is only one registered company with the Secretary of State's office so only one taxable entity is deemed to exist.
- Is the Comptroller considering changing her policy of treating an entity disregarded for federal tax purposes as still a regarded entity for Texas franchise tax purposes when applying the sourcing rules to the gain from the sale of such entity? Such a position would cause such sale to be treated as a sale of assets for sourcing purposes rather than the sale of an intangible. What would the statutory basis be for such position?
  - Response: Tax Policy is still reviewing this position. They had recently stated in other conferences that the sale of membership interest in a disregarded entity would be treated as the sale of the disregarded entities assets following the federal treatment. However, after internal and external discussions in recent weeks they are reevaluating that position.
- When applying the passive entity rule providing that income from non-operated mineral interests is considered passive income but not in the case where the operator of such non-operated minerals interests is affiliated with the recipient, what is the Comptroller's position on who is considered the "operator" when such operating duties have been assigned to a contract operator? Does the Comptroller look to the operator named in the joint operating agreement or the contract operator to whom operating duties have been assigned?

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  - Response: Both the operator per the JOA and the contracted operator are considered to be the operator. Tax Policy's position is that the JOA operator can't contract away their responsibility as the operator.
- Temporary Credit for Business Loss Carryforwards
  - The Comptroller's office will be issuing letters to all Reporting Entities that utilized Temporary Credits on any of the 2008 through 2011 Reports. The focus of these letters is to determine who the greater than 50% parent is so the Comptroller can identify taxable entities that change combined groups.
  - The letters are being mailed on 9/30/11 and responses are due on 10/31/11.
  - Taxpayers who don't respond will have their Temporary Credit denied and assessments will be mailed to them.
  - Tax Policy Newsletter Article: http://www.cpa.state.tx.us/taxinfo/taxpnw/tpn2011/tpn1109.html#issue2
  - Copy of Letter: http://www.cpa.state.tx.us/taxinfo/taxforms/2e-017.pdf

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BAKER & MCKENZIE

State Bar of Texas
14th Annual International Tax Symposium

International Tax Planning Strategies

Melinda Phelan & Jonathan Martin, Houston

Friday, November 4, 2011

Plano, Texas

Your Trusted Tax Counsel®

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AGENDA

- Repatriation Strategies
- Supply Chain Restructuring
- Inversion Transactions
- IP Migrations

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Repatriation

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Defining the Repatriation Problem

- For those companies that are not in an overall foreign loss (OFL) position, the issue is typically how to get access to low-tax cash without:
  - Incurring a significant residual U.S. tax liability; and
  - Violating the company's APB 23 assumption (i.e., permanent reinvestment of foreign earnings abroad).
- For those companies in an OFL position (i.e., they must "recapture" foreign losses before benefiting from FTCs), the objective may be to get access to low-tax ***or*** high tax cash without significant residual tax or violating APB 23 assumption.

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Restructuring to Avoid Anti-Hopscotch -- Section 304 Transactions and Other Internal Restructurings

- The problem: The old 956 hopscotch rule has been repealed for investments in "U.S. property" (e.g., CFC loans to U.S. affiliates) after 12/31/10.
- The new law:
  - Deemed-paid taxes from section 956 inclusions limited to the *lesser* of:
    - Foreign taxes deemed paid using hopscotch rule or
    - Foreign taxes that would be deemed paid if a hypothetical distribution was made through chain of ownership, without regard to any foreign taxes that would be imposed on an actual distribution
  - The rule is thus a one-way street
  - The rule is a problem for higher-taxed CFCs trapped under a lower-taxed CFC or under a CFC with an E&P deficit

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Restructuring to Avoid Anti-Hopscotch -- Section 304 Transactions and Other Internal Restructurings

- Not a permanent disallowance – excess foreign taxes remain in CFC's tax pool
- Applies to acquisitions by CFC of U.S. property after Dec. 31, 2010
- Normal hopscotch rule still applies to subpart F income inclusions (at least for now)
  - But, section 960(c)(2) contemplates further regulations or guidance to prevent abuse

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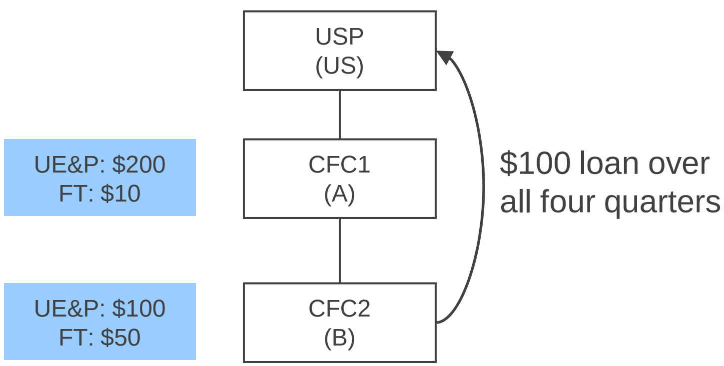
Example

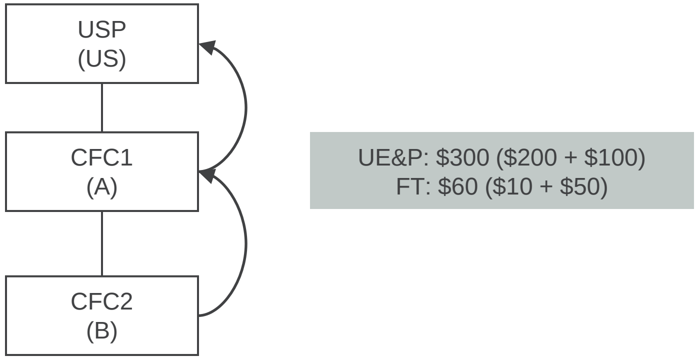
<u>Old Rule</u>

<u>Tentative Credit</u>



<u>New Rule</u>

<u>Hypothetical Credit</u>



$100 / $100 x $50 = **$50 deemed-paid foreign income taxes**

$100 / $300 x $60 = **$20 deemed-paid foreign income taxes**

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Restructuring to Avoid Anti-Hopscotch -- Section 304 Transactions and Other Internal Restructurings

- How to avoid the limitations under the new rule:
  - Section 304 Transaction to hopscotch high-tax E&P pools over low tax pools, or *vice versa*
  - Spin-offs and other internal restructurings

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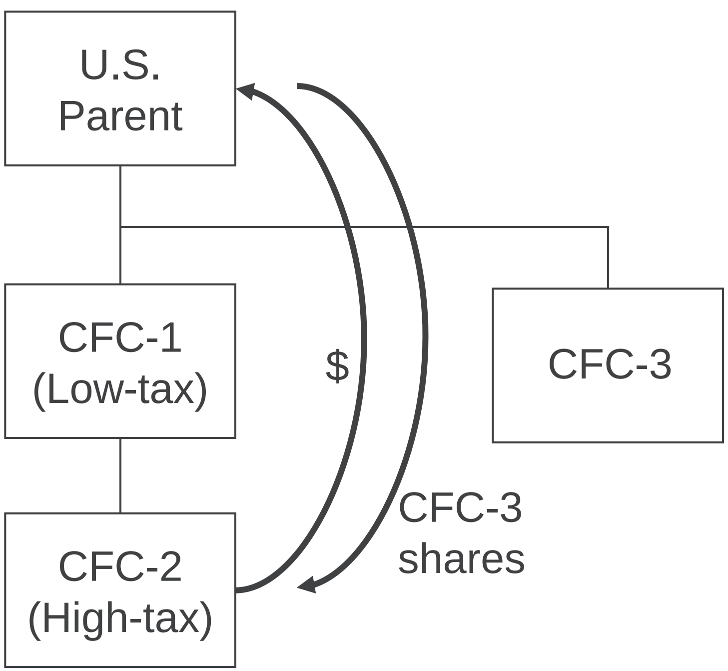
Restructuring to Avoid Anti-Hopscotch – Section 304 Transaction



Assume: USP sells CFC-3 shares to CFC-2

- No investment in U.S. property under 956

Advantages

- Section 304 deemed dividend from CFC-2 high tax earnings direct to US parent
- No blending of low tax and high tax pools
- No GRA needed. Treas. Reg. 1.367(a)-9T

However…

- Section 304 dividend constrained by value of CFC-3
- CFC-2 may not be desirable holdco for CFC-3

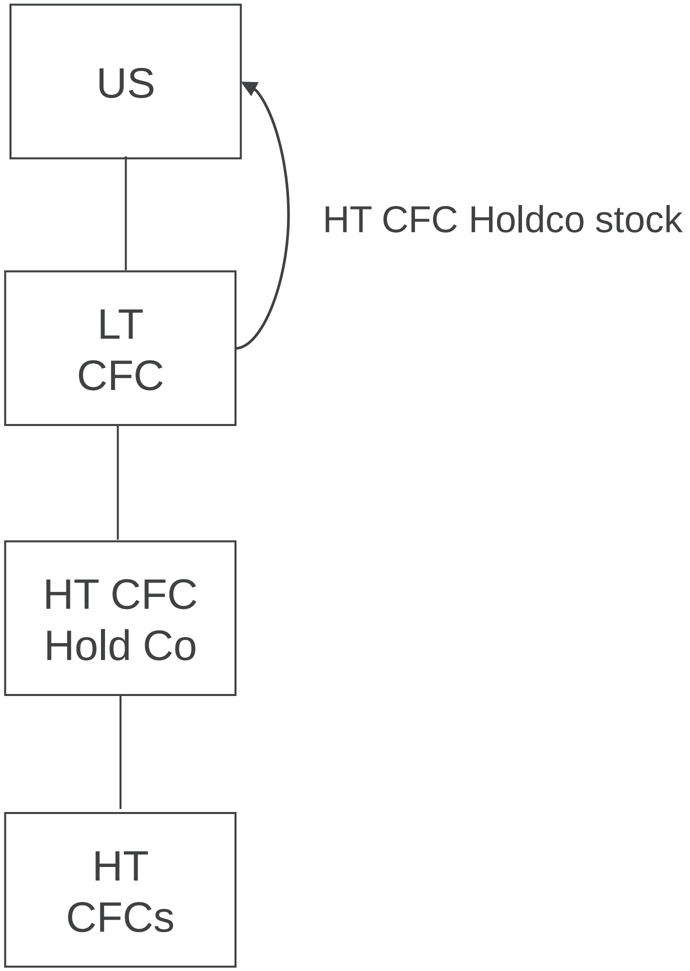
Restructuring to Avoid Anti-Hopscotch-Spin-off of High Tax Group

Steps

- LT CFC distributes stock of HT CFC Holdco to US

Key Points

- Can qualify as tax free section 355 spin-off
- Need business purpose
- No GRA and generally no E&P pick-up; but see §1.367(b) – 5(c) rules for possible adjustments to basis and E&P pick-up
- Most elegant long term solution



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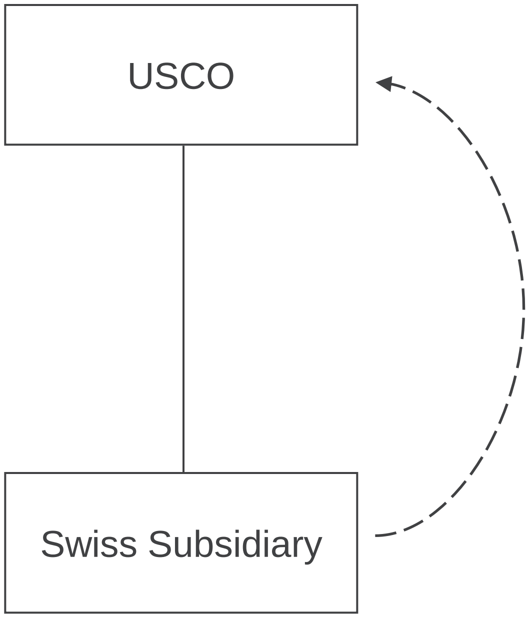
Prepayment Strategy

- Inventory Prepayment Transaction
  - Assumes U.S. group is selling inventory to foreign subsidiaries for distribution abroad or further manufacturing/assembly



Cash equal to two years' worth of inventory, discounted to reflect the fact that the money is advanced earlier than normal

Must be nonrefundable

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Prepayment Strategy
Broader Prepayment Issues

- Can be used for inventory, services, royalties and cost sharing payments
- Can USCO defer the income pursuant to Treas. Reg. 1.451-5 or Rev. Proc. 2004-34?
  - If deferral is possible, how long?
- Is the discount that foreign subsidiary receives subpart F income (e.g., “income equivalent to interest”) or is it a reduction in expense?
- Can you repeat?

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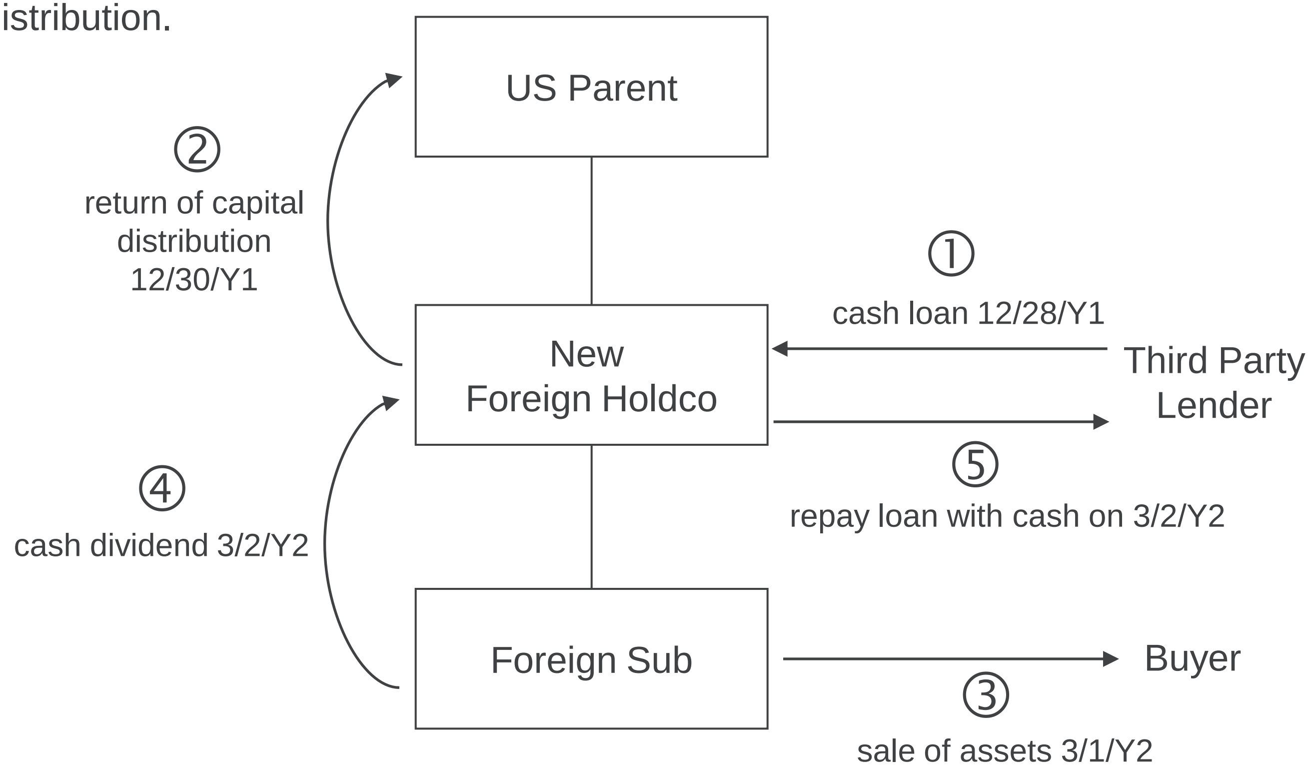
Return of Capital Distribution

Assume: USP contributes F Sub to new F Holdco in Year 1 before contemplated sale by F Sub of its assets in Year 2. Contribution creates stock basis in New Foreign Holdco. Transaction features a short-term loan from bank to fund distribution. New Foreign Holdco has no current or accumulated E&P at time of distribution.



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Return of Capital Distribution

- Can IRS assert that return of capital distribution funded with bank loan is really boot in the section 351 transaction in which new Foreign Holdco formed? Consider *Falkoff v Comm'r*, 604 F.2d 1045 (7th Cir. 1979)
- Could the return of capital distribution trigger any GRAs entered into on the set up?
- Will the bank demand a parent guarantee or pledge of subsidiary assets to support the loan?
- Other issues if Foreign Holdco is newly created:
  - 269
  - economic substance, business purpose

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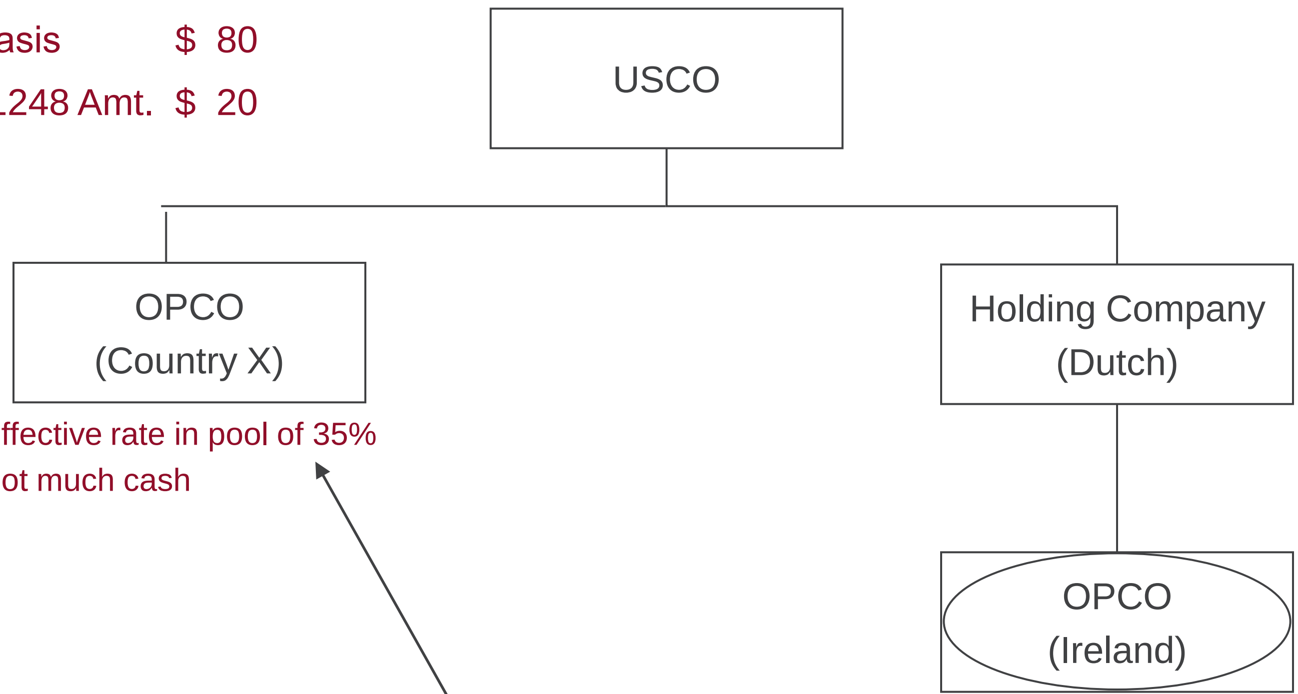
Foreign-to-Foreign All-Cash "D" Reorganization

Value of Opco	$100
Opco's stock Basis	$ 80
E&P / Section 1248 Amt.	$ 20



effective rate in pool of 35%
not much cash

low-tax earnings + cash

OPCO's attributes are key to ensuring
this transaction works <u>if</u> there is gain in the Opco stock

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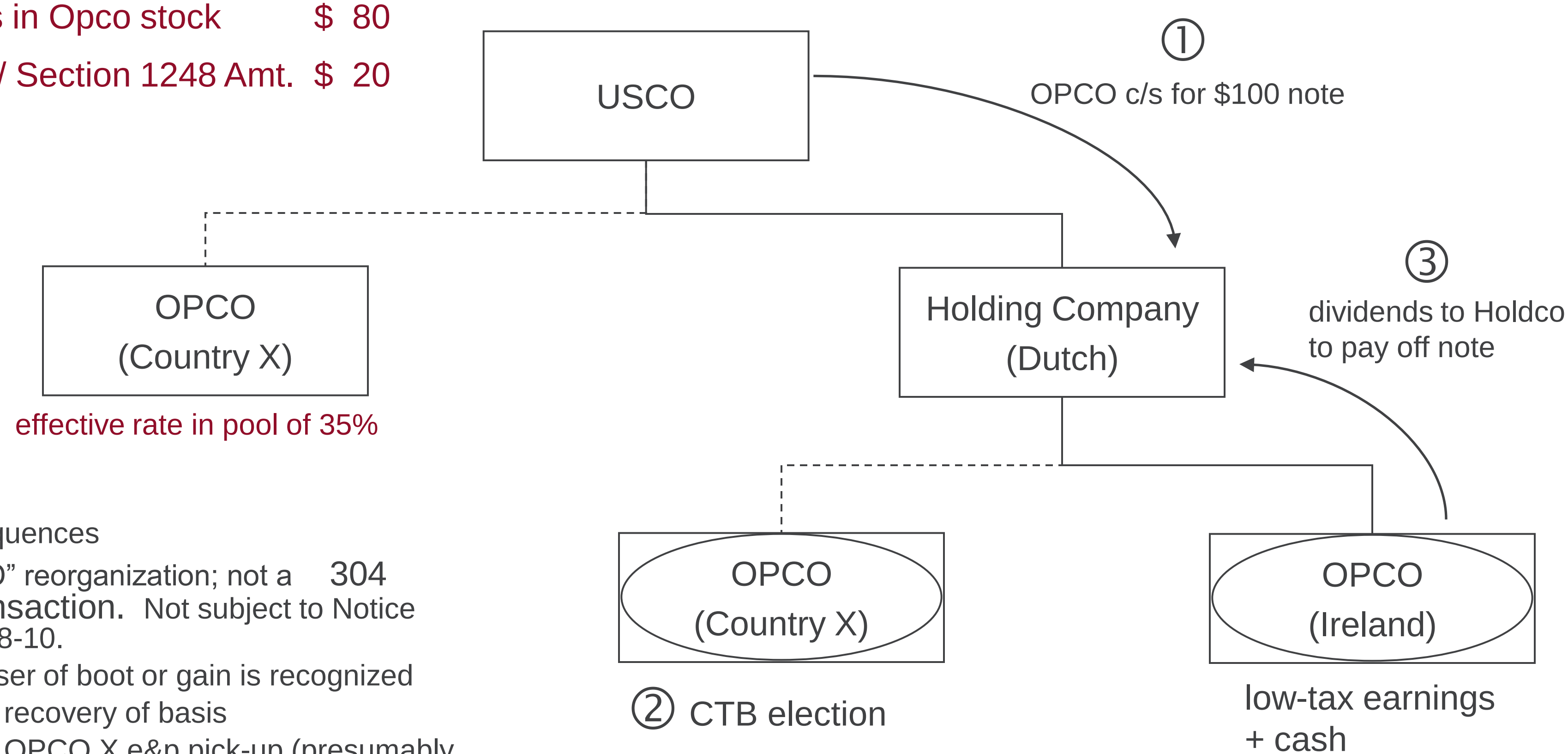
Foreign-to-Foreign All-Cash “D” Reorganization

Value of Opco	$100
Basis in Opco stock	$ 80
E&P / Section 1248 Amt.	$ 20



Consequences

- A “D” reorganization; not a 304 transaction. Not subject to Notice 2008-10.
- Lesser of boot or gain is recognized
- $80 recovery of basis
- $20 OPCO X e&p pick-up (presumably sheltered by FTCs)

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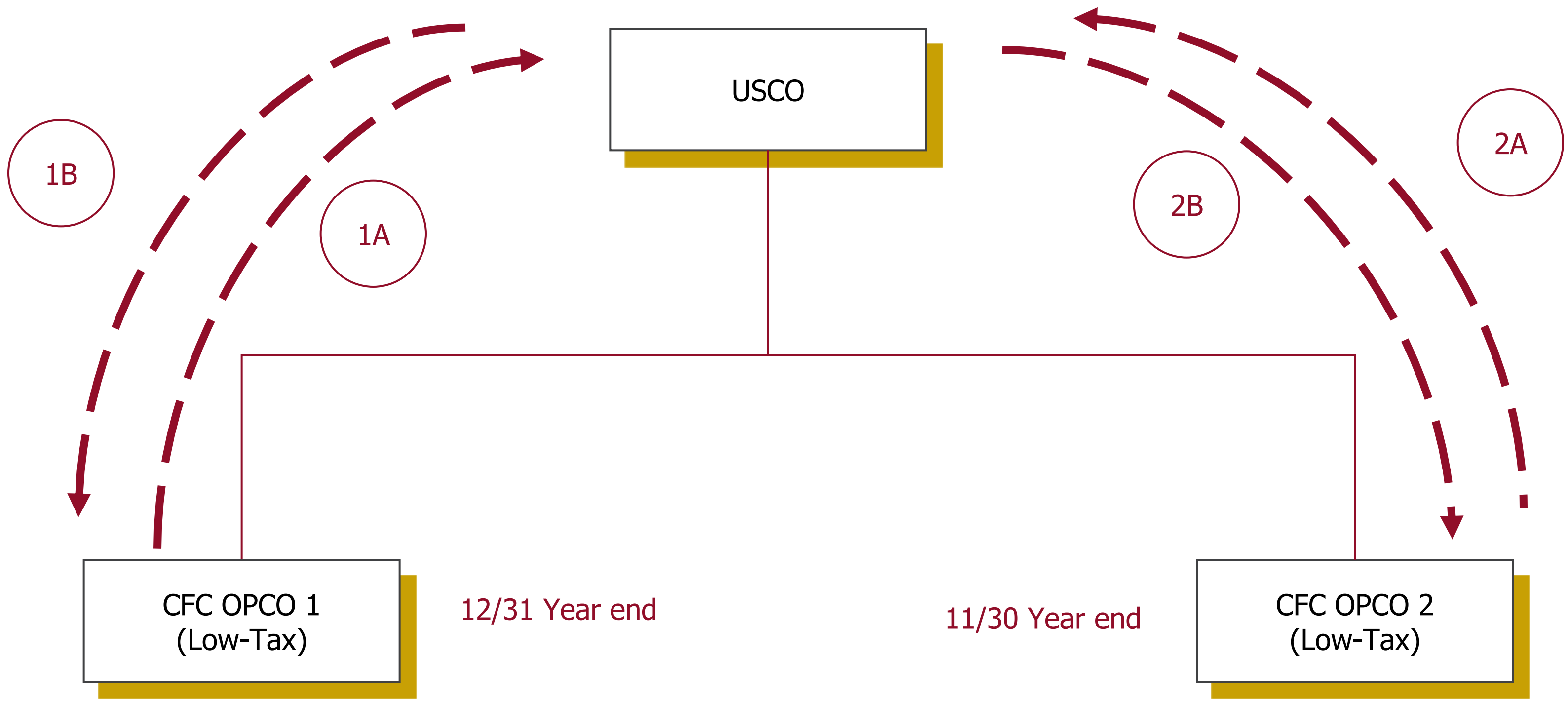
Dueling Loan Strategy



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Dueling Loan Strategy

– OPCO 2 will have an 11/30 year end, as permitted under section 898 of the Code. The low-tax CFC Opcos will lend all of their cash back to the United States parent at the following intervals:

	OPCO One	OPCO Two
➢ 12/01/03-01/14/04		X
➢ 01/15/04-02/28/04	X	
➢ 03/01/04-04/14/04		X
➢ 04/15/04-05/31/04	X	
➢ 06/01/04-07/14/04		X
➢ 07/15/04-08/30/04	X	
➢ 09/01/04-10/14/04		X
➢ 10/15/04-11/31/04	X	

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Dueling Loan Strategy

- Potential risks:
  - Change of Tax Year:
    - Normally need business purpose under section 442;
    - *But See*, Rev. Procs. 2006-45, 2006-45 I.R.B. 851 and 2007-64, 2007-42 I.R.B. 818.
      - Has the CFC changed the year previously?
      - Does the CFC own an interest in a pass-through entity or another CFC?
  - Treas. Reg. 1.956-1T (anti-abuse regulation).
  - Debt v. Equity – IRS challenge unlikely to be successful, provided loans are repaid on time and advances have the formal indicia of debt.
  - Constructive dividend as per *Tollefson v. Commissioner*, 52 T.C. 671 (1969), *aff'd.,* 431 F.2d 511 (2d Cir. 1970), *cert. den*., 401 U.S. 908 (1971).

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Dueling Loan Strategy

- Potential Risks (Cont’d):
  - Step-Transaction – at what point will a reviewing court step the advances together and treat them as one loan?
    - Rev. Rul. 89-73, 1989-1 C.B. 258 (comparison of time between loans to length of loans);
    - *Jacob’s Engineering v. Commissioner*, 97-1 USTC ¶50,340 (C.D. Cal. 1997), *aff’d* 99-1 USTC ¶50,335 (9th Cir. 1999); and
    - GLAM 2009-013 (Oct. 19, 2009) (confirming that disinvestment period and the U.S. taxpayer’s ability to borrow similar amounts between disinvestment periods are factors to analyze).
  - You must have at least two “pots” of cash, but you are not limited to two “pots” of cash.
  - The more pots you have, the more distance you can place between loans.

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Supply Chain Restructuring

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Supply Chain Changes

- Business driven to decrease costs and increase efficiencies
- Involve movement of personnel, functions and risk to a principal entity responsible for the global supply chain
- Require significant business changes to transaction flows, systems, and risk allocation
- May (but doesn't always) result in tax benefits if properly structured

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Common Supply Chain Structure

Principal Company

- Controls and manages supply chain—high value add
  - Manufacturing
  - Distribution
    - Buy-sell distributors
    - Commissionaires/commission agents
  - Routine returns for manufacturing / distribution
- Often owns and develops IP for use in the business
  - The options are licensing, contract R&D and cost sharing

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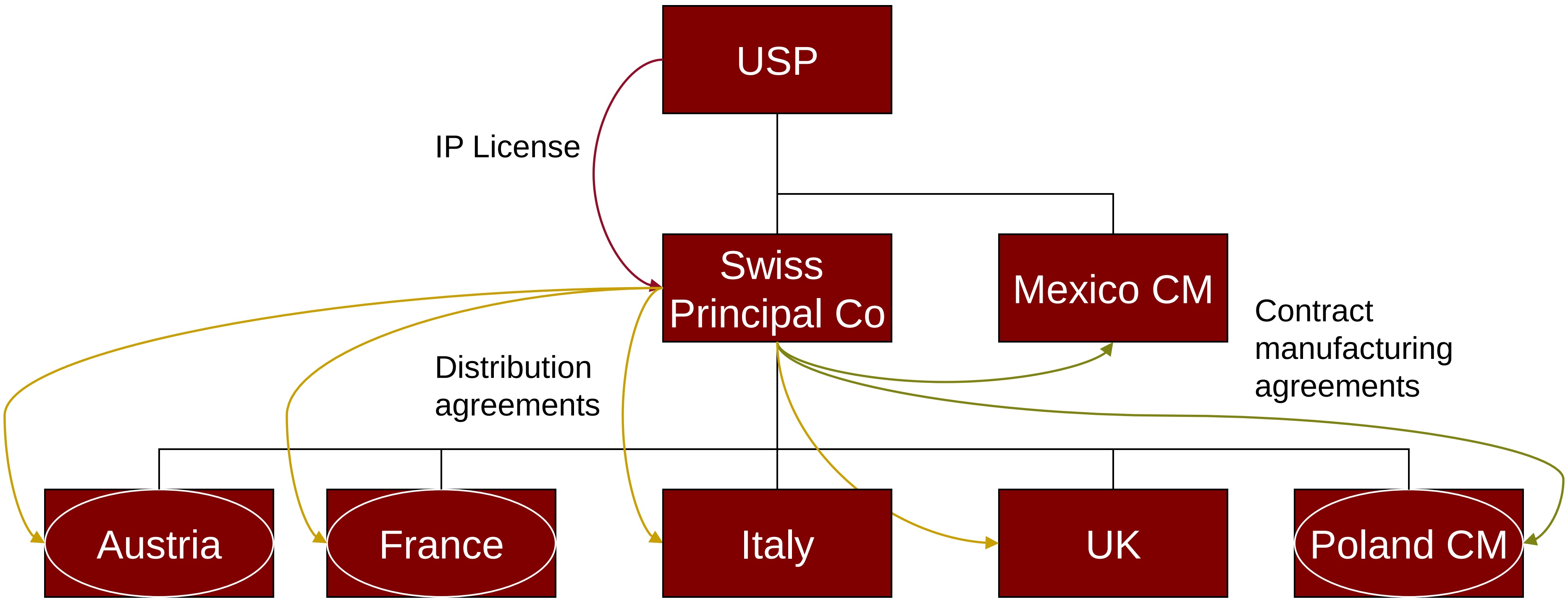
Common Supply Chain Structure



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Considerations

- Determine business efficiencies to be created by restructuring
  - Where and how does business want to operate?
- Consider global tax implications
  - Are there non-routine profits in the business?
  - Does the structure produce any tax benefits?
- Implementation Risk
- Cost of structure—Set up and maintenance
  - Defending transfer pricing
  - Restructuring issues

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US Tax Issues - Subpart F

Models for Sales of Goods

- Option 1: Structure for third party purchases and sales
  - On the purchase or manufacturing side:
    - use consignment, or
    - check the box to avoid a related party purchase
  - On the sale or distribution side:
    - use commissionaire, or
    - commission agent, or
    - check the box to avoid a related party sale
  - Check the box solutions raise potential branch rule issues

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US Tax Issues - Subpart F

- Option 2: Qualify for the manufacturing defense to subpart F
  - Physical manufacturing
  - Manufacturing via substantial contribution
- Option 3: Use of “same country” exception
  - Use of hybrid branch

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US Tax Issues - Subpart F

Models for licensing and service business

- For licensing there are two options:
  - active marketing, or
  - active development off shore
- For services, avoid the following:
  - service for a related party
  - service a related party was obligated to perform
  - services to secure sale of goods
  - substantial assistance

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US Tax Issues - ECI

- Avoid US source income because the US trade or business rules are unclear
- For foreign sales, rely on foreign material participation
- For US sales, foreign material participation not available

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US Tax Issues – Transfer Pricing

- Routine Returns
  - Manufacturing
  - Distribution
  - Contract R&D
- Non-Routine Returns
  - Intangible Property
    - Licensing, Contract R&D or Cost Sharing
  - Business Strategy/Management

Inversion Transactions

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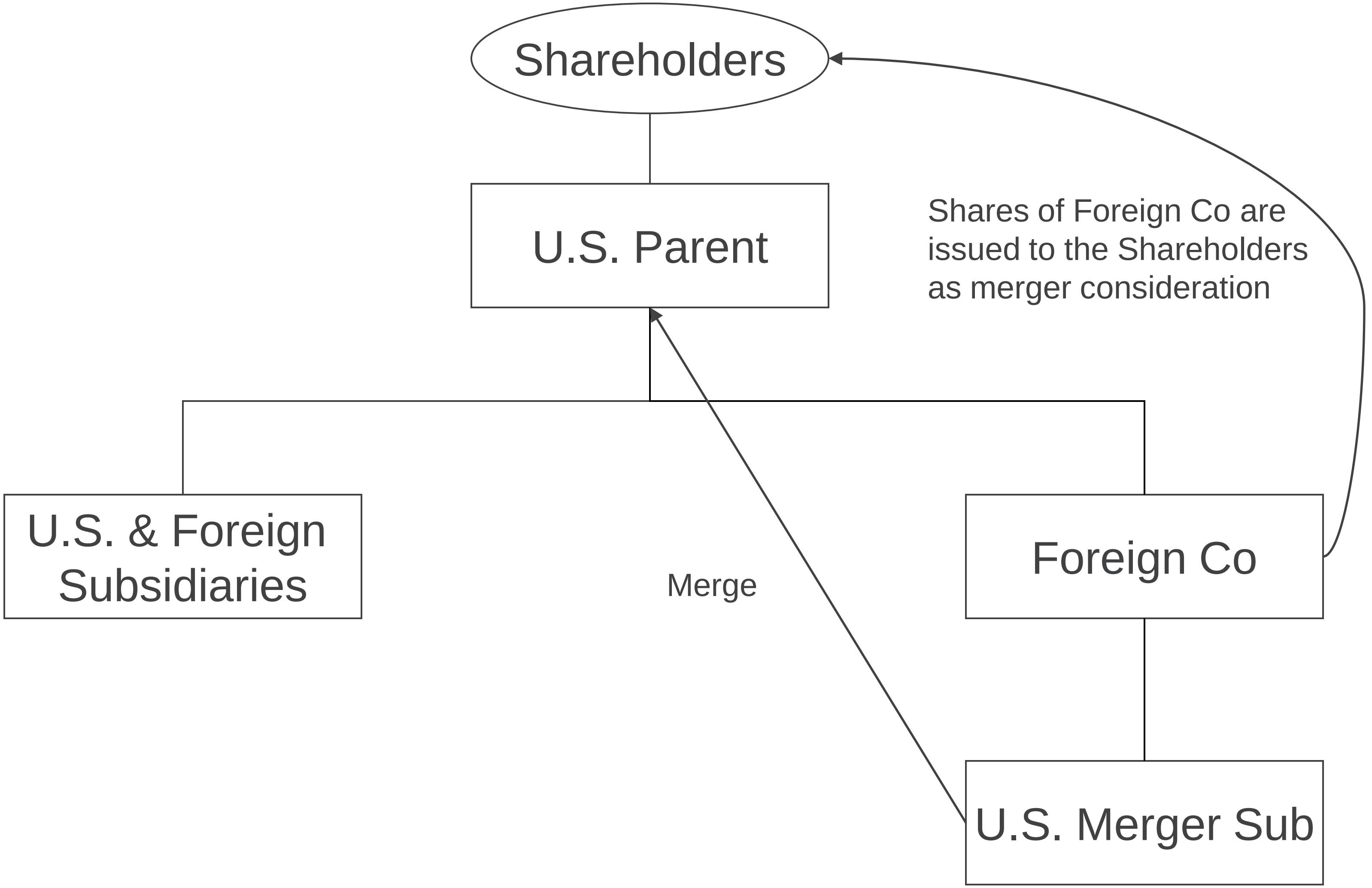
Stock Inversion



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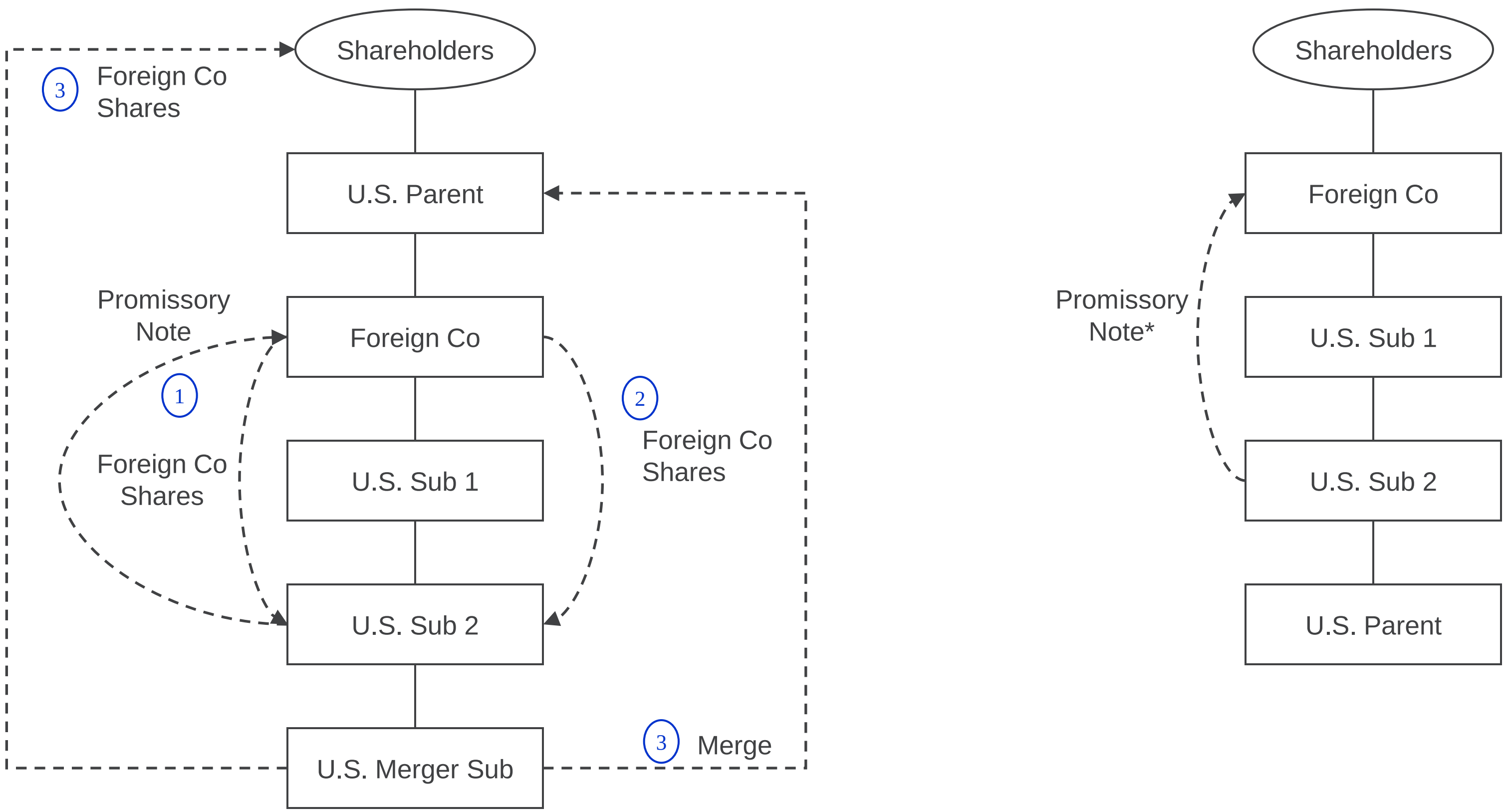
Stock Inversion with Debt Leverage



1. Foreign Co sells a portion of its stock to U.S. Sub 2 in exchange for a promissory note.
2. Foreign Co contributes a portion of its stock down the chain to U.S. Sub 2 as a capital contribution.
3. U.S. Merger Sub merges into U.S. Parent. Shareholders receive Foreign Co stock as merger consideration (must bust the reorganization).

•Promissory Note may be moved out of Foreign Co to a better financing structure.

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Section 7874

- If <u>80 percent</u> or more of the domestic corporation's historical shareholders remain the same after the inversion, the corporation will continue to be treated as a U.S. corporation.
  - Eliminates the benefits of inversion.
  - Therefore, new shareholders must own more than 20% of the new foreign parent's stock.
- If <u>60 percent</u> or more of the U.S. corporation's historical shareholders remain the same after the inversion, the U.S. group may not use its existing U.S. tax attributes to offset "inversion" gain for 10 years.
  - Primarily affects post-inversion planning involving U.S. assets.

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When does section 7874 not apply?

- Substantial business activities in destination (percentage of historical shareholder ownership of new foreign parent is irrelevant).
  - Facts and circumstances test.
- Merge with an unrelated foreign corporation.
  - 60% and 80% ownership overlap rules apply.
  - New 3rd country parent jurisdiction possible.

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Section 4985

- Section 4985 imposes a one-time, 15% excise tax on the "fair value" of any previously untaxed, stock-based compensation of directors, officers, and 10% or greater shareholders.
  - Only applies if greater than 60% but less than 80% ownership identity exists and substantial business activities test is not met.
  - This is a one-time exit tax on unexercised stock options, unvested RSUs and other stock-based compensation held by a limited category of corporate insiders.
  - Gross-up for tax is also subject to 15% excise tax.
  - Note that even underwater, unexercised options may be subject to the excise tax.

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Section 457A

- Recently enacted section 457A
  - prevents deferral of income with respect to otherwise valid deferred compensation if plan sponsor is “non-qualified” foreign entity and comp is paid to a U.S. taxpayer (e.g., a U.S.-resident board member or officer).
  - should not apply to deferred comp arrangements “sponsored” by a U.S. operating company for its U.S. employees even if its foreign parent is “non-qualified.”
    - Sponsor is entity entitled to deduction under U.S. tax principles.
  - Notice 2009-8 expands scope of section 457A.

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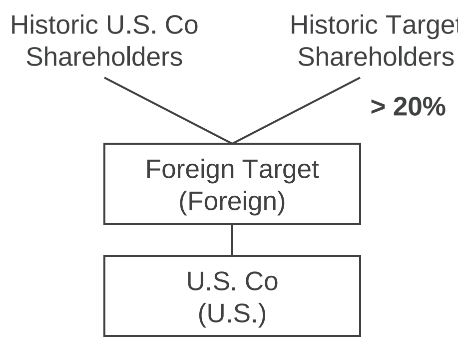
Merger with an Unrelated Foreign Corporation

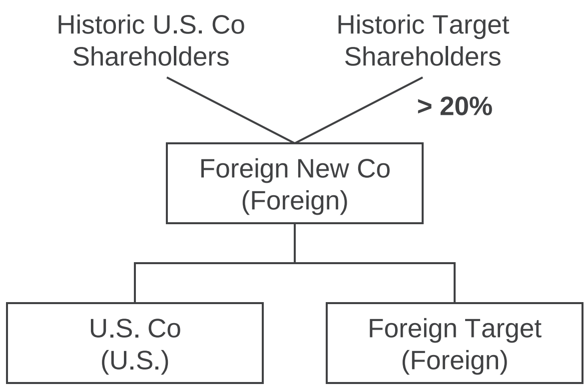
Alternative One:

Foreign Target as Parent



Alternative Two:

Foreign New Co (often a 3rd country) as Parent



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Migrating Intangible Property

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Goals of IP Migration Structure

– Reduce effective tax rate by earning profits from IP in a lower taxed jurisdiction
– Move existing rights at an appropriate transfer price
– “Do no harm” to IP legal ownership and right to protect IP

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Why Consider IP Migration in a Down Economy?

- Current and future value of existing IP has likely gone down under a variety of methodologies
- Brings home cash
- Creates opportunity for the ultimate turn-around (assuming it comes)
  - Have to balance possibility of potentially negative results if profits don't increase

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How can you migrate US-owned IP today?

- License IP
- Contract R&D
- Cost share (anyway)
- Two Phase Approach (License now – Cost share in a few years)
- R&D Partnerships

- Proposed Legislation

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Licensing

- Under -4, not -7
  - Best method analysis not biased towards income method
- Effective for technology if there is a CUT, especially if the IP has a long life
- Especially beneficial for marketing intangibles

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How can we make Licensing work?

- Need to avoid CPM
- Creative search for and use of CUTs
  - Co-marketing agreements
  - Joint ventures
  - Settlements
  - Supply agreements
- Careful examination of foreign related party's self-developed IP
  - Cost advantages over 3rd-party suppliers
  - Unusually good output/capital ratios

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Focus on Marketing IP

- Lower risk of failure than R&D investments
- Short lives and high rate of return
- Shift functions and risks to migrate profit
- Less visible than shifting technology income
- Does not require a change in IP ownership
- Third parties routinely split the excess (i.e., IP-related) profits

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Licensing Marketing Intangibles

- Move fair share of trademark profits offshore by shifting functions and risks under a license
- Divide income stream for trademarks
  - Licensor earns low-risk fixed annuity
  - Licensee earns residual profit for assuming risk of investing in advertising and marketing

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Contract R&D

- Still must license the pre-existing IP
  - Not subject to cost sharing regulations and new intangible valuation models (at least not yet)
- Allows migration of all IP, not just a portion of the rights
- Allows foreign participant to potentially capture the location savings on offshore R&D

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Contract R&D Risks

- What will the mark-up on R&D costs be?
  - The IRS may argue for a high mark-up based on “Crown Jewels” theory
- If rights divided, are the parties cost sharing “in substance?”

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Economic Slump and the Market Cap

- Can the historic lows in market caps be used to transfer the IP offshore and shift to contract R&D?
  - Cost sharing regs bless use of the market cap method
  - Contract manufacturing regs suggest we need more offshore substance to satisfy manufacturing exception to subpart F

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Cost Sharing

– Could consider cost sharing, regardless of the new -7 regs

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Avoid the Income Method

- Foreign intangibles will allow use of the RPSM
- Thorough factual development to identify value-drivers for the international business and contributions by the foreign entity
  - Foreign customer relationships
  - Sales and marketing teams
  - Efficient manufacturing and QA processes
- Exploit all possibilities for bringing in a foreign PCT
  - Foreign R&D team
  - Acquisition of a foreign company

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Coping with the Income Method

- Use truly realistic forecasts (probability-weighted outcome of different scenarios)
- Develop facts to support limited life for the platform contribution (no terminal value)
- Identify and benchmark returns for all ‘routine’ operations
- Determine risk-appropriate discount rates
- Apply the concept of arm’s-length range by running the model using different input parameters

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Two phase plan: Licensing & Cost sharing

PHASE 1

Foreign entrepreneur

- licenses technology intangibles from US
- incurs all territory specific sales and marketing expenses, develops the international market
- manages and funds offshore R&D, if any
- absorbs foreign acquired operations, if any

PHASE 2

US and Foreign entity engage in cost-sharing

- PCTs from both sides will allow use of RPSM

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Thank You!!

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Navigating the U.S. Withholding Regulations and Surviving IRS Examination

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Agenda

1. General Withholding Rules
2. IRS Focus
3. IRS Withholding Initiative
4. Withholding Becomes Tier I Issue
5. IRS Audit Plan
6. FATCA
7. IRS Guidance on FATCA
8. Future of FATCA

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Withholding – General Rule

- U.S. persons who make payments of certain types of U.S. sourced income to foreign persons generally must withhold tax at a rate of 30% on such payments.
- Exceptions to withholding, but not to reporting:
  - Treaty provisions allowing for a reduced rate (must have W-8BEN or 8233 and usually a U.S. TIN).
  - Income effectively connected with a trade or business (requires Form W-8ECI and a U.S. TIN).
- Payments should be reported on Forms 1042 and 1042-S.

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IRS Focus

- The quality of the overall reporting and withholding systems.
- The procedures of the withholding agents to ensure proper classification of payments, sourcing, and the validity of documentation of foreign persons.
  - Payments made to a foreign person
  - FDAP Income
  - U.S. source income

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How to Identify Foreign Persons

- The IRS is focused on, among other issues:
  - Payments to foreign vendors
  - Payments to foreign related parties
  - Payments of pension benefits to foreign persons
  - Payments of interest and dividends to foreign persons
- Agents are looking for people or entities that:
  - Have a foreign address
  - Have not furnished a Form W-9 or U.S. TIN (watch for EINs beginning with "98")
  - Are coded as foreign

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What is Considered U.S. Income?

- Interest, dividends and pension payments
- Other items that are typically reported on 1099-MISC such as:
  - Rents paid for the use of tangible or real property used in the U.S.
  - Royalties and licensing fees for the use of intangible property in the U.S.
  - Payments for services rendered (including payments to outside directors), speakers, legal or accounting services performed in the U.S.
  - Prizes and awards

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U.S. Source Income (cont)

- Watch out for services imbedded in contracts such as installation, training and maintenance services for computer software.

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IRS Withholding Initiative

- IRS audited 11 companies comparing the 5471's and 5472's and 10 had not filed any 1042's.
- On July 29, 2008, IRS issued a new Internal Revenue Manual (IRM) section 4.10.21 "U.S. Withholding Agent Examinations - Form 1042"
- Provides general guidance to examiners on withholding principles and the procedures for Form 1042 examinations.

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Audit Selection Factors

- Large Case Audits
- Tax Return Data (Forms 5471 & 5472)
- Voluntary Compliance Program

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Withholding – Tier I Issue

"U.S. Withholding Agents - 1441; Reporting and Withholding on U.S. Source FDAP Income"

IRS identified withholding as Tier I issue in January of 2009.

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Issue Tiering – LB&I

- **Tier I - High Strategic Importance**.
  - Tier I includes “high-risk” transactions and issues that represent LB&I’s highest compliance priorities.
  - See chart in handout
    - Some are mandatory; some are not.
    - Withholding is still listed as TBD.
    - Examiners should always consider Tier I issues as part of every examination.

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IRS Audit Plan to Audit U.S. Withholding Agents

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- 10 step audit plan

- The U.S. Withholding Agent has significant control over the audit process.
  - Significant focus on reducing time required to perform the audit by having the U.S. Withholding Agent direct the audit.
  - Opportunities will be discussed under each Audit Step

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Step 1 - Analyze the Withholding Agent's Withholding Tax System

- Internal controls
- Policy manual
- Review methods of processing new accounts including identification of payee
  - W-9
  - W-8 ECI
  - W-8 BEN
  - W-8 EXP
  - W-8 IMY

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Step 1 - Analyze the Withholding Agent's Withholding Tax System (cont)

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- U.S. Withholding Agent's systems should include:
  a) Beneficial Owner Processing
  b) Exempt Entity Processing
  c) "No Documentation" Requirements Processing
  d) Processing for Intermediary
  e) Interest Withholding and Exemptions
  f) Securitized Transactions
  g) REIT processing
  h) OID

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Step 1 - Analyze the Withholding Agent's Withholding Tax System (cont)

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- U.S. Withholding Agent's systems should include:
  - i) Eligible Securities
  - j) U.S. Branch processing
  - k) Affiliate Transactions
  - l) International Organizations
  - m) Exempt Recipients
  - n) Backup Withholding

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Step 1 - Analyze the Withholding Agent's Withholding Tax System (cont)

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- Preliminary evaluation of the adequacy of the U.S. Withholding Agent's systems.
- See general IDR in handout.
- Focus on "reducing time required to conduct audit" allows taxpayers to control process.

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Step 1 - Analyze the Withholding Agent's Withholding Tax System (cont)

In addition, the Audit Plan recommend that the following items are analyzed:

a) A summary of the withholding tax system process,

b) System flowcharts.

c) An explanation of how each or all of the systems.

described above is addressed within the taxpayer system.

d) Recommended breakdown into strata before the arrival

of the team for this process .

e) Internal Control Reports .

f) A policy manual that describes the overall system.

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Step 2 - Review the Account Opening Procedures / Identify Payee

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- The status of the payee must be determined in order to analyze the withholding tax treatment of a payment – Most critical step.
- Sufficient controls in place to determine status?

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Step 2 - Review the Account Opening Procedures / Identify Payee (cont)

- The examiner should consider the following:
  - Whether the U.S. withholding agent properly identifies appropriate account withholding treatment.
  - Whether the U.S. withholding agent ensures that proper separation of duties with respect to opening and processing of accounts is part of the internal control description.
  - For example, employees whose duties include opening accounts are not part of the retention, custody or accounting for records. Exceptions are immediately noted, and internal controls descriptions include written procedures on how to handle such exceptions.

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Step 2 - Review the Account Opening Procedures / Identify Payee (cont)

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- In order to reduce the time required to perform the audit, the examiner may request that the U.S. withholding agent
  - Document the processes and procedures utilized in determining proper opening account procedures and payee status. These processes and procedures may be described in a manual, internal audit report, training manual for account openings, or checklists for opening account procedures.
  - The examiner may request that the withholding agent provide specific recommendations for audit reviews or review of internal control.

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Step 3 – Reconcile Forms 1042-S to Form 1042

- Reconcile to ensure that all income paid to nonresident alien and foreign corporations subject to withholding has been considered.
- Reconciliation should be part of the U.S. Withholding Agent's standard procedure.

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Step 4 - Determine the Appropriate Strata

- Transactions should be categorized into strata before selecting a sample.
- In order to reduce the time required to perform the audit, the examiner may request that the U.S. withholding agent provide a recommended segregation or stratification at the beginning of the audit, and work with the audit team to develop the strata.
- The withholding agent may have concerns that may be accommodated in the sample design.

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Step 4 - Determine the Appropriate Strata (cont)

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- Strata may include:
  - Accounts grouped by withholding rate.
  - Accounts grouped by amount.
  - Accounts grouped by the recipient's country from Form 1042-S.
  - Accounts grouped by the recipient's code from Form 1042-S
  - Accounts grouped by the expected documentation to be reviewed such as W-8IMY, W-8BEN, and W-8EXP.
  - Accounts grouped by business unit.
  - Accounts grouped by cost center.
  - Accounts grouped by Margin Account, certain interest accounts etc.

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Step 5 – Determine the Appropriate Sample Size

- At least 100 accounts
- In order to reduce time required to perform the audit the examiner may request that the U.S. withholding agent provide recommended sample size, with appropriate statistical justifications for the sample size.

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Step 6 – Request Documentation of the Sample

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- The examiner will determine the sample and request the documentation information.
- For each account selected, the examiner should request the current account file for review of the documentation and calculation of the withholding.

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Step 7 – Verify Appropriate Identification/Classification of Payee

- Review information for appropriate documentation.
- Verify that documentation of payee status has been reviewed by the withholding agent for accuracy.
- Verify that the U.S. withholding agent has properly classified payees having foreign status.

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Step 8 - Review Documentation Requirements for Various Types of Income

- Consider the type and source of income in determining if the withholding is correct.
- Different types and sources of income may include the following:
  - Securities Lending
  - Interest Paid by U.S. Obligors
  - Sale of Property and Assumption of Bonds
  - Margin accounts
  - Interest Coupons in Default
  - Domestic Corporations Paying to Foreign Affiliates
  - Original Issue Discount
  - Bank Deposit Interest

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Step 8 - Review Documentation Requirements for Various Types of Income (cont)

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- Different types and sources of income may include the following:
  - Portfolio Interest
  - Interest and Real Property Mortgages
  - Interest Paid to CFC's
  - Notional Principal Contract Income
  - Dividends
  - Eligible Securities
  - Effectively Connected Income
  - U.S. Branch
  - REIT Distribution
  - International Organization

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Step 9 – Review for Proper Coding on Form 1042-S

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- Review the Explanation of Codes listed on the instructions to Form 1042-S and determine whether the codes reflected by the U.S. withholding agent are correct.

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Step 10 – Extrapolate and Calculate Penalties

- Failure to file or pay tax
- Determination of rate of interest
- Failure to obtain documentation timely or act in accordance with applicable presumptions
- Accuracy related – negligence
- Fraud penalty
- Failure to file correct information
- Failure to furnish correct payee statement

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Liability for Noncompliance

- Withholding agent has strict liability for withholding noncompliance as soon as an outbound payment is made that is unsupported by appropriate documentation.
- Strict liability will be imposed if the documentation is outdated.
- U.S. withholding agent will be held responsible for all taxes, interest and penalties on the foreign persons failure to pay U.S. taxes.
- Executives may have personal liability as well.

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"Curing" Before an Audit

- Penalties for failure to timely withhold can be cured retroactively.
- An analysis of all payments to foreign persons must be identified and appropriate documentation must be obtained.
- If a payment is not established as foreign source, it is presumed to be U.S. source.

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Additional Withholding Issues

- FIRPTA – Foreign Investment in Real Property Tax Act.
- Payments made by a U.S. or foreign partnership must withhold on income effectively connected to a U.S. trade or business that is allocable to foreign partners.
- Wages paid to non resident aliens.

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Withholding Tax Regime of the HIRE Act

- Signed into law March 18, 2010
- FATCA – Foreign Account Tax Compliance Act of 2009.
  - Effective January 1, 2013.
  - Intended to cut down on perceived tax avoidance by U.S. persons through the use of offshore accounts.
  - Intended to supplement the existing withholding and reporting rules.
  - Rules are far reaching

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What is FATCA?

- Requires foreign financial institutions to provide the IRS with information of U.S. persons invested outside the U.S.
  - The FFI must report worldwide income and not just U.S. source income to the U.S. Treasury.
- Requires foreign entities to provide information about U.S. owners to the withholding agent.

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How is FATCA Withholding Different from Current Withholding Rules?

- Applies to broader types of income than the current rules.
- Applies regardless of statutory or treaty exemptions or reductions.
  - Entities or individuals must be in compliance with FATCA in order to get treaty benefits.
  - Information provided by foreign persons to the U.S. Treasury is covered by the exchange of information treaties.

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Who Does FATCA Affect?

- Any entity that makes a payment of U.S. source income should review FATCA to determine if and how it affects their entity.
- Foreign entities receiving U.S. source income
  - Foreign Financial Institutions (FFI) - directly or indirectly; includes the gross proceeds from a sale or disposition of U.S. property.
- U.S. entities making payments of most U.S. source income to foreign persons.

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What is a FFI?

- Any non U.S. entity that :
  - Accepts deposits in the ordinary course of banking
  - Primarily holds financial assets for the account of others
  - Is engaged to a substantial degree in investing, trading in securities, commodities, etc.
  - Examples - banks, hedge funds, private equity funds, Broker/dealers and insurance companies.
  - $50,000 de minimis limit, but several banks will not respect this due to the difficulty in reprogramming their systems to account for it.

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How Can FFI's Avoid the Withholding Requirement?

- FFI can enter into an Agreement with the Department of the Treasury:
  - Obtain information to identify U.S. account holders.
  - Comply with Treasury verification and due diligence Procedures.
  - Withhold 30% tax on payments to account holders that refuse to provide information, FFI's that have elected to be taxed as a U.S. entity.
  - Report annually.
  - Comply with Treasury requests for additional information.
  - Close the account if foreign law prevents reporting or get a waiver of the secrecy law from the customer.

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How Can FFI's Avoid the Withholding Requirement (cont)?

- FFI's may elect to provide 1099's to U.S. account holders, but they must still enter into an agreement with the U.S. Treasury.

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Payments to Non Financial Foreign Entities

- Withholding agents must withhold tax of 30% unless:
  - The NFFE certifies to the withholding agent that they have no U.S. owners, or
  - The NFFE provides the names, addresses and U.S. TIN of the substantial U.S. owners to the withholding agent.

How Does the Withholding Agent Determine U.S. Ownership?

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- Look for "indicia of U.S. status":
  - Indication that the account holder is a U.S. resident or citizen.
  - Born in the U.S.
  - U.S. mailing or permanent address.
  - Accounts that have only P.O. boxes, in care of addresses or hold mail addresses.
  - A power of attorney signed by a person with a U.S. address
  - Instructions to send payments to an account in the U.S. or instructions received from the U.S.

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How Does the Withholding Agent Determine U.S. Ownership (cont)?

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- If these indicia of ownership exist, that is not proof that the individual is a U.S. citizen, but it does mean that further research is required.

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What Payments are Subject to Withholding?

- Any payment of interest (including portfolio interest and OID), dividends, rents, royalties, licensing fees, wages, annuities, FDAP income, gains and profits, if they are from sources within the U.S.
- Gross proceeds from the sale or disposition of U.S. property if it would produce interest or dividends.
- Interest paid by foreign branches of U.S. banks.
- Effectively connected income is usually exempt.

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What should companies be doing now to comply with FATCA?

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- Review systems to track foreign ownership.
- Review systems to track withholding requirements or exceptions.
- Update policy manual to reflect the new requirements.
- Review vendors in accounts payable.
- Review global entity structure to determine requirements.
- Update relevant employees of the additional requirements.

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Treasury Guidance

- Notice 2010 – 60 IRS issues preliminary guidance regarding priority issues for comment.
  - August 27, 2010
- Proposed Regulations regarding interest paid by U.S. bank to foreign person.
  - Issued January 6, 2011
- Notice 2011-34
  - Issued April 8, 2011
- Notice 2011-53
  - Issued July 14, 2011; Revised July 24, 2011

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Draft Form 8938

- "Statement of Specified Foreign Assets"
- Released in draft form in Oct/Nov of 2011
- Currently applies to individuals only.
- U.S. Treasury has announced that they plan to expand this form to include specific U.S. entities.
- Must be filed with 2011 Form 1040.

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Reaction of Foreign Countries

- Several countries are speaking with the U.S. Treasury about the implementation of FATCA.
- Several other countries are considering similar programs.

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What is the Future of FATCA?

?

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Thank you!

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713-986-7188

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Exhibit 1

Information Document Request Recommendation

The following requests are recommended to examiners of Forms 1042 in order to provide a base of knowledge on which to determine the adequacy and reliability of the withholding agent's systems. Such determination should precede sampling of accounts to ascertain the accuracy of the amounts reflected on Forms 1042 and 1042-S. The examiner should include the following questions in the first Information Document Request (Form 4564) served on the U.S. withholding agent.

Please provide the following preliminary information:

a. Copies of Forms 1042 and Forms 1042-S for each entity of the consolidated group for the year's ___________.

b. Work papers and other supporting documents used in preparing these Forms 1042 and Forms 1042-S.

c. Any internal audit reports for the years identified in a. above that pertain to each company's fiduciary operations, including but not limited to customer account opening and validation procedures and procedures for recording customer transactions.

d. Operating manuals and written procedures pertaining to the fiduciary activities of each entity, including but not limited to customer account opening and validation procedures and procedures for recording customer transactions and payments.

e. Flowcharts, diagrams and other material that describe how customer account information is incorporated into each company's EDP system for, among other things, withholding and tax reporting purposes.

f. Names and titles of all individuals familiar with the fiduciary operations of each entity.

g. Names and titles of all individuals familiar with the manuals and procedures and charts provided in response to items d. and e. above.

h. Customer ledgers or other records pertaining to each entity's fiduciary activities that record, report, identify or show information about all customers who have been classified as foreign residents for purposes of federal tax withholding and/or reporting purposes. Such records may be limited to those applicable to or used in connection with the years identified in item a. above.

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Tier I *High Risk* Active Issues At a Glance

Updated 5/24/10	§118 Abuse *(USF, BEP in Monitoring Status)*	Domestic Production Deduction IRC §199 *(Monitoring)*	Foreign Earnings Repat - IRC 965	Foreign Tax Credit Generators	Mixed Service Costs *(Phase I in Monitoring)*	Repairs vs Capitalization Change of Accounting Method	Research Credit Claims	Section 482 Cost Sharing	US Withholding Agents - Section 1441
Issue Owner Executive	Lavena Williams	Charlie Brantley	Michael Danilack	Walter Harris	Keith Jones	Sergio Arellano	Lavena Williams	Patricia Chaback	Lori Nichols Stuart Mann (Issue Champion)
Lead TA	Maria Montani	Sandra Frost	Linda Azen	Mark English	Marge Lopez	Laurie Schutter	Lee Keenan	Don McGinty	Robert Driscoll
	Dave Moser	Robert Schnuriger		Linda Azen	Doug Toney	David Boschetto		Jon Tamaki	
Lead Counsel	Laurel Robinson	Charles Buxbaum	Glenn McLoughlin	Marvis Knospe	John Duncan	Jim Lanning	Paul Colleran	Michelle Korbas	Victoria Kanrek
Risk Analysis	Audit Team makes risk analysis	Mandatory if material*	Mandatory if material*	Mandatory Exam	PHASE I - follow ASP PHASE II - contact IST	Audit Team makes risk analysis	Audit Team makes risk analysis	Audit Team makes risk analysis	TBD
Industry Director Directives	IDDs - # 1 through #8	IDD #1 - 12/6/06	IDD #1 - 10/2/07	IDD #1(rev)- 2/19/09	IDD #1 - 6/8/06	IDD #1 - 1/22/10	IDD #1 - 4/4/07	IDD #1 - 4/5/07	IDD on Exams of Form 1042 - 10/31/03
		IDD #2 - 8/24/07	IDD #2 - 4/21/08		IDD #2 - 5/1/07		IDD #2 - 1/15/09	IDD #2 - 3/21/08	
		IDD #3 - 3/4/09	IDD #3 - 5/26/09		IDD #3 - 5/2/07	IDD #2 - 1/22/10			
					IDD #4				
					IDD #5				
Key UIL Codes	118.01-03 118.01-05 61.40-01& 02	199.00-00 to 199.08-00	965.00-00 to 965.05-00	901.13-00	263A-07-00 263A.06-01	263.14-01	41.00-00 to 41.55.09	482.11-11 482.11-12	TBD
Guidance	USF ASG 2004	Final Regulations	Notice 2005-64	Appeals Coordinated Issue	Revenue Ruling 2005-53	Revenue Ruling 2001-4	Notice 2008 - 39	CIP - Buy-In Adjustments	Web Info on NRA Withholding
	Revenue Ruling 2007-31	Final TIPRA Regulations	Notice 2005-38:	Chief Counsel Advice	Proposed Regulations		Audit Techniques Guide	Temporary Regulations	
	CIP for SALT	Final & Temp Regs for Software	Notice 2005-10	Final & Temp Regulations				Checklist for Cost Sharing Arrangement	
	CIP - Ex Inc		GLAM						
	CIP for Bioenergy		Audit Guidelines	TAM					

* ***Contact IMT***

Caution: DRAFT FORM

This is an advance proof copy of an IRS tax form. It is subject to change and OMB approval before it is officially released.

If you have any comments on this draft form, you can submit them to us on our web site. Include the word DRAFT in your response. You may make comments anonymously, or you may include your name and e-mail address or phone number. We will be unable to respond to all comments due to the high volume we receive. However, we will carefully consider each suggestion. So that we can properly consider your comments, please send them to us within 30 days from the date the draft was posted.

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Form **8938** (November 2011) Department of the Treasury Internal Revenue Service

Statement of Specified Foreign Financial Assets

▶ See separate instructions ▶ Attach to your tax return

OMB No. 1545-2195

Attachment Sequence No. **175**

If you have attached additional sheets, check here ☐

Name(s) shown on return | Identifying number

Number, street, and room or suite no. (if a P.O. box, see instructions)

City or town, province or state, and country (including postal code)

For tax year beginning , 20 , and ending , 20

Note. All information must be in English. Show all amounts in U.S. dollars. Show currency conversion rates in Part I, line 6(2), or Part II, line 6(2).

Type of filer

a Specified individual **(1)** ☐ Married filing a joint return **(2)** ☐ Other individual

b Specified domestic entity **(1)** ☐ Partnership **(2)** ☐ Corporation **(3)** ☐ Trust **(4)** ☐ Estate

Check this box if this is an original, amended, or supplemental Form 8938 for attachment to a previously filed return . . . . . . ☐

Part I Foreign Deposit and Custodial Accounts (see instructions)

If you have more than one account to report, attach a continuation sheet with the same information for each additional account (see instructions).

1 Type of account ☐ Deposit ☐ Custodial | **2** Account number or other designation

3 Check all that apply **a** ☐ Account opened during tax year **b** ☐ Account closed during tax year
c ☐ Account jointly owned with spouse **d** ☐ No tax item reported in Part III with respect to this asset

4 Maximum value of account during tax year . . . . $

5 Did you use a foreign currency exchange rate to convert the value of the account into U.S. dollars? . . ☐ Yes ☐ No

6 If you answered "Yes" to line 5, complete all that apply.

(1) Foreign currency in which account is maintained	(2) Foreign currency exchange rate used to convert to U.S. dollars	(3) Source of exchange rate used if not from U.S. Treasury Financial Management Service

7 Name of financial institution in which account is maintained

8 Mailing address of financial institution in which account is maintained. Number, street, and room or suite no.

9 City or town, province or state, and country (including postal code)

Part II Other Foreign Assets (see instructions)

Note. *If you reported specified foreign financial assets on Forms 3520, 3520-A, 5471, 8621, or 8865, you do not have to include the assets on Form 8938. You must complete Part IV. See instructions.*

If you have more than one asset to report, attach a continuation sheet with the same information for each additional asset (see instructions).

1 Description of asset | **2** Identifying number or other designation

3 Complete all that apply

a Date asset acquired during tax year, if applicable . . . . ________

b Date asset disposed of during tax year, if applicable . . . . ________

c ☐ Check if asset jointly owned with spouse **d** ☐ Check if no tax item reported in Part III with respect to this asset

4 Maximum value of asset during tax year (check box that applies)

a ☐ $0 - $50,000 **b** ☐ $50,001 - $100,000 **c** ☐ $100,001 - $150,000 **d** ☐ $150,001 - $200,000

e If more than $200,000, list value . . . . $

5 Did you use a foreign currency exchange rate to convert the value of the asset into U.S. dollars? . . . ☐ Yes ☐ No

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Part II Other Foreign Assets *(continued)*

6 If you answered "Yes" to line 5, complete all that apply.

(1) Foreign currency in which asset is denominated	(2) Foreign currency exchange rate used to convert to U.S. dollars	(3) Source of exchange rate used if not from U.S. Treasury Financial Management Service

7 If asset reported in Part II, line 1, is stock of a foreign entity or an interest in a foreign entity, report the following information.

a Name of foreign entity

b Type of foreign entity **(1)** ☐ Partnership **(2)** ☐ Corporation **(3)** ☐ Trust **(4)** ☐ Estate

c ☐ Check if foreign entity is a PFIC

d Mailing address of foreign entity. Number, street, and room or suite no.

e City or town, province or state, and country (including postal code)

8 If asset reported in Part II, line 1, is not stock of a foreign entity or an interest in a foreign entity, enter the following information for the asset.

Note. If this asset has more than one issuer or counterparty, attach a continuation sheet with the same information for each additional issuer or counterparty (see instructions).

a Name of issuer or counterparty

Check if information is for ☐ Issuer ☐ Counterparty

b Type of issuer or counterparty

(1) ☐ Individual **(2)** ☐ Partnership **(3)** ☐ Corporation **(4)** ☐ Trust **(5)** ☐ Estate

c Check if issuer or counterparty is a ☐ U.S. person ☐ Foreign person

d Mailing address of issuer or counterparty. Number, street, and room or suite no.

e City or town, province or state, and country (including postal code)

Part III Summary of Tax Items Attributable to Specified Foreign Financial Assets (see instructions)

Asset Category	Tax item	Amount reported on form or schedule	Where reported: Form and line	Where reported: Schedule and line
I. Foreign Deposit and Custodial Accounts	**a** Interest	$		
	b Dividends	$		
	c Royalties	$		
	d Other income	$		
	e Gains (losses)	$		
	f Deductions	$		
	g Credits	$		
II. Other Foreign Assets	**a** Interest	$		
	b Dividends	$		
	c Royalties	$		
	d Other income	$		
	e Gains (losses)	$		
	f Deductions	$		
	g Credits	$		

Part IV Excepted Specified Foreign Financial Assets (see instructions)

If you reported specified foreign financial assets on the following forms, check the appropriate box(es). Indicate number of forms filed. You do not need to include these assets on Form 8938 for the tax year.

☐ 3520 Number of forms ______ ☐ 3520-A Number of forms ______ ☐ 5471 Number of forms ______

☐ 8621 Number of forms ______ ☐ 8865 Number of forms ______

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Transfer Pricing Update

Dallas, Texas
November 4, 2011

Dale Bond
Nick Raby
David Swenson

pwc

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Agenda

- Global Trends
- United States Update
- OECD Update
- Business Restructurings
- Xilinx and Veritas Transfer Pricing Cases
- Permanent Establishments
- Questions
- Appendices

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Global Trends

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Global trends

Fiscal deficits cast a long shadow – governments need to raise significant amounts of revenue

- Aggressive examinations and enforcement activities worldwide
- Move towards real time discussions, a risk assessment approach with a focus on materiality and complexity
- MNCs are facing increasing pressure from certain tax authorities adopting “unprincipled” and inconsistent positions (e.g., India, Brazil, Turkey)
- MNCs face significant uncertainty in cross-border transfer pricing and PE tax audits and controversies

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Global trends

Authorities becoming more aggressive in the transfer pricing and PE arena

- Greater focus on transfer pricing by jurisdictions
- More resources being allocated to transfer pricing examination and audit teams
- Increasing number of "desk top reviews" of transfer pricing documentation
- Authorities adopting inconsistent treatment of identical transactions and structures and inconsistent definitions of key concepts and terms
- Increased information sharing and cooperative interaction among tax authorities:
  - Exchange of information
  - Joint audits
  - Foreign site visits
  - Streamlined audits

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Global trends

Common areas of focus by tax authorities

- Transfers of tangible and intangible property
- Technical/management service fees
- “Guarantee fees” and application of the “passive association” concept - Australia, Canada, Germany
- Recharacterization as capital contributions – adjustments to COGS or to marketing expenses – Turkey
- In-country “loss operations”
- Recharacterization of business restructuring transactions

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Global trends

Significant strain is mounting on traditional dispute resolution alternatives – administrative appeals, mediation, APAs, MAP negotiations, arbitration and litigation

- Inventories of Competent Authority/MAP cases at record highs
- APA inventories are also at record highs
  - Unacceptable backlog of cases
  - Territorial fighting within the IRS over jurisdictional authority
  - Limiting the effectiveness of the US APA system

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United States Update

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United States

Development of a new IRS Transfer Pricing Practice

- Transfer Pricing Director and Chief Economist
- Triage of cases
- Move to "Permanent Transfer Pricing Cases" program
- Recent comments by Messrs. Danilack and Maruca
- Planned merger of APA and Competent Authority functions by January 2012

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United States

Recent trends in US transfer pricing examinations

- Case selection and breadth of coverage, scope, and intensity
- IRS audit tactics
  - Early identification and use of expert witnesses
  - Requests for functional analysis interview notes of advisors
  - Requests for extensive transfer pricing “background documents”
  - Threat of summons enforcement
  - Foreign travel requests
  - Recorded employee interviews
  - Plant and facility tours (US and non-US)

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United States

Importance of the emerging "Mandatory Binding Arbitration" option

- US tax treaties with Belgium, Canada, Germany, and France
- Switzerland (pending US Senate ratification)
- Japan (under consideration)
- Recent experience with US - Canada MAP cases

Alternative dispute resolution processes. See Appendix A.

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OECD Update

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OECD Update

Overview of new chapters I-III of the OECD guidelines

- Unanimous support of arm's length principle
- Key principles for undertaking a transfer pricing analysis
- Priority of transfer pricing methods
- Selection of the most appropriate method
- Conducting a comparability analysis
- Practical application of the TNMM
- Practical application of profit split methods

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OECD Update

Priority of transfer pricing methods - 2010 revisions

- Profits-based methods no longer methods of last resort
- Continuing preference for traditional transactional methods if equally reliable
- Emphasis on appropriateness of method to the circumstances of the case
  - Nature of transaction – functions/risks/assets
  - Availability and reliability of comparables
- Not precisely equivalent to US best method rule – not necessary to consider and reject the application of each alternative method

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OECD Update

The 9-step process

1. Determination of years to be covered
2. Broad analysis of taxpayer's circumstances
3. Understanding the controlled transactions under examination – functional analysis
4. Review of existing internal comparables, if any
5. Determination of available sources of information on external comparables
6. Selection of the most appropriate TPM and, depending on method, selecting the relevant financial indicator
7. Identification of potential comparables based on key characteristics and five comparability factors
8. Determination of and making comparability adjustments as needed
9. Interpretation of data and determination of arm's length remuneration

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Business Restructurings

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Business Restructurings

Typically involves the movement of functions, risks, intangible property rights, and services out of key territories (e.g., Japan, Germany, and the UK) and into strategic jurisdictions (e.g., Switzerland, Ireland, and Singapore)

Issues

- Allocations of risk
- Authorities disregarding taxpayer structures and transactions
- Indemnification of individual parties to a business restructuring
- Transfer pricing following a business restructuring

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Business Restructurings

Allocation of risks

- An analysis of allocations of risk starts with the contractual arrangements of the parties
- Contractual terms related to risk allocation generally respected unless:
    - The conduct of the related parties does not conform to the contractual allocation of risk
    - The contractual allocation of risk is not arm's length

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Business Restructurings

Arm's length allocation of risks

- Would the risk allocation have been agreed between unrelated parties?
  - Control of risk is an important but not an absolute indicator – some outsourcing of day to day risk management permitted
  - Financial capacity to assume risk (including capacity to assume and then insure or hedge risk) should be considered
- If allocation of risk is not "arm's length" tax authority should seek first to identify a pricing solution. If that cannot be done, tax authority has the ability to reallocate risks.

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Business Restructurings

Disregarding taxpayer structures and transactions

- Tax authorities can disregard or recharacterize taxpayer transactions in two situations
  - The economic substance of the transaction is not consistent with the contractual arrangements (i.e., the parties do not do what they say)
  - The transaction as structured is not commercially rational and the structure selected by the taxpayers impedes the ability to determine an arm's length price
- Transactions should be recharacterized only in exceptional circumstances

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Business Restructurings

Compensation for the restructuring

- Every change in profit potential or expected future profits does not require payment of arm's length compensation – must be a transfer of something of value or a situation calling for indemnification
- Must evaluate the reasonably available alternatives to each party and whether contractually a party would have been able to demand compensation
  - Termination provisions of intercompany agreements are important
  - Prior investment in operations is important (e.g., a distributor that invests in significant start up costs may have an expectation of a longer term arrangement)

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Update on Xilinx and Veritas Transfer Pricing Cases

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U.S. Update: Xilinx Case – Impact on Regulations

- **§1.482-9 services regulations:**

  "Total services costs include all costs in cash or in kind (including stock-based compensation) that, based on analysis of the facts and circumstances, are directly identified with, or reasonably allocated in accordance with the principles of paragraph (k)(2) of this section to, the services."

- **§ 1.482-7 cost sharing regulations:**

  "a controlled participant's operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term stock-based compensation means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to…equity instruments or stock options…"

- **§ 1.482-7T temporary cost sharing regulations:**

  "IDCs mean all costs, in cash or in kind (including stock-based compensation)…"

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U.S. Update: Veritas Case – Relevant Facts

- Veritas entered into a CSA with its Irish subsidiary to develop software.
- Veritas transferred pre-existing IP to Veritas-Ireland in exchange for a buy-in payment.
- The IRS challenged the buy-in payment, and proposed a $2.5 billion increase to value of pre-existing IP contributed by Veritas.
    - The IRS' $2.5 billion was based on a report that utilized the income method, acquisition price method, and market capitalization analysis. Before trial, the IRS abandoned this report and relied on a revised income method analysis yielding a $1.675 billion increase.
- At trial, the IRS contended that the transfer of pre-existing IP was "akin" to a sale because "the assets collectively possess synergies that imbue the whole with greater value than each asset standing alone."
- As such, the IRS argued that the income method appropriately aggregated the controlled transactions.

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U.S. Update Veritas Case – What did the courts decide?

- The Tax Court found that the IRS expert's valuation report utilized the wrong beta, wrong equity risk premium, and unrealistic growth rates in application of income method.

- The Tax Court also disagreed with the IRS' "akin to a sale theory." The Tax Court found that the pre-existing IP did not have a perpetual life, and that the IP developed during the CSA should not be classified as pre-existing. Therefore, the transactions should not have been aggregated.

- The Tax Court held that the CUT method proposed by Veritas (with adjustments) was the best method for determining the arm's-length buy-in payment.

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Veritas Case – Impact

- Similar to *Xilinx, Veritas* was decided under the prior cost sharing regulations (relevant transactions occurred in 1999). In *Veritas,* the Tax Court also based some of its decision on specific language included in the prior cost sharing regulations.

- The temporary cost sharing regulations include the income method as a specified method. In addition, a CIP issued by the IRS states that the income method is the preferred method for determining buy-in payments.

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Permanent Establishments

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Permanent Establishments

- When is a PE created?

- How are profits attributed to a PE?

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Permanent Establishments

Comparison of the Zimmer and Dell Cases

- In March 2010 the French Supreme Court held in the Zimmer case that a commissionaire did not constitute a PE of its UK parent under the dependent agent article of the UK/France tax treaty.
- In March 2011 the Norwegian Court of appeal ruled in Dell that a commissionaire did constitute a PE of its Irish parent under the equivalent article in the Ireland/Norway treaty

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Permanent Establishments

Comparison of the Zimmer and Dell Cases (cont.)

- Dependent agency – interpretation of "in the name of":
  - Article 5(5) of the OECD Model Tax Treaty – when a person…habitually exercises…the authority to conclude contracts "in the name of" …the enterprise…is deemed to have a PE…
  - Commentary para 32.1 – the meaning of "authority to conclude contracts" not limited to an agent who literally enters into contracts on the behalf of the principal – it applies even if those contracts are not in the principal's name.
- French Commercial Code Article L 132-1 – a commissionaire is a person who acts in his own name or under a business name for the account of a principal.

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Permanent Establishments

Zimmer Case

- Zimmer SAS sold orthopedic products in France under buy-sell arrangement until 1996.
- Converted to commissionaire structure acting in its own name on behalf of Zimmer Ltd.
- On audit the French authorities argued that Zimmer Ltd had a fixed place of business in France and Zimmer SAS was a dependent agent.
- Lower courts agreed Zimmer SAS could contractually bind parent.
- The French Supreme court found that Zimmer SAS acted in its own name and could not legally conclude contracts on behalf of Zimmer Ltd.

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Permanent Establishments

Dell Case

- Dell Products Ltd sold products through its Norwegian commissionaire, Dell AS.
- Major issue raised on audit was the same as Zimmer – whether the commissionaire had the authority to conclude contract binding the principal – court concluded that this was the case.
- Distinguished from Zimmer on the grounds that the French case predated Commentary para 32.1.
- Court determined that contribution by Dell Products was relatively small.
- Main value driver determined to be the sales activity performed by Dell AS.
- With very little analysis, 60% of the profit for Dell Products derived on sales to Norway was attributed to the Norwegian PE (including the commission fee for Dell AS)

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Permanent Establishments

Summary

- Potential for very large adjustments and substantial administrative angst in trying to identify and manage risks, respond to audits.
- Punitive effective tax rates.
- Existence or not of PE is a difficult issue for Competent Authorities to resolve since that would require one side or the other to back down completely, so the compromise often involves agreement that there is a PE but with the attribution of business profits negotiated down.
- Difficult to obtain certainty in advance – e.g. in many cases not possible to obtain a ruling such as an APA, and not easy to document defense in advance since difficult to identify all exposures.
- *...which all results in uncertainty.*

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Questions

Appendices

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Appendix A: Alternative Dispute Resolution Processes

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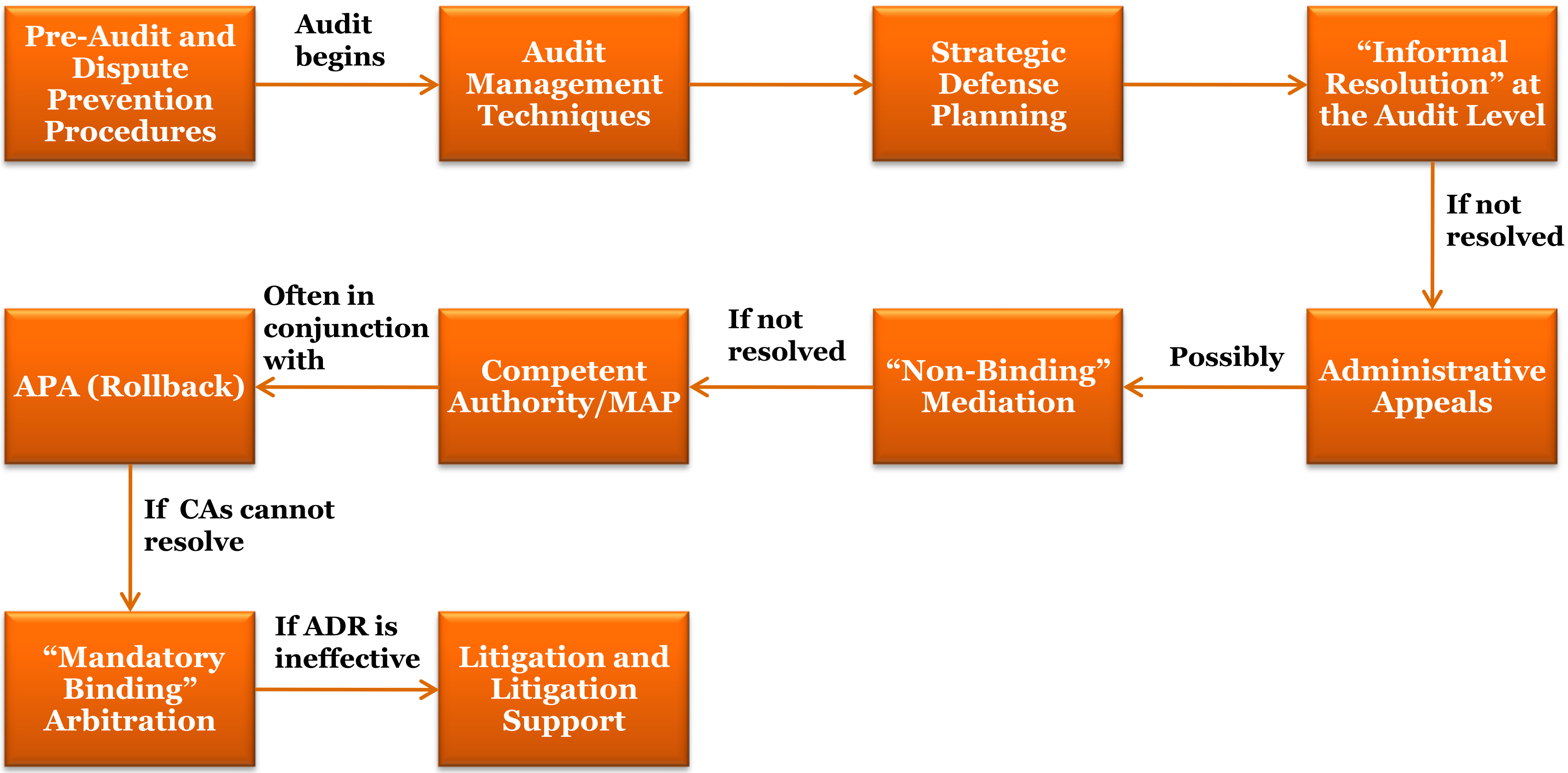
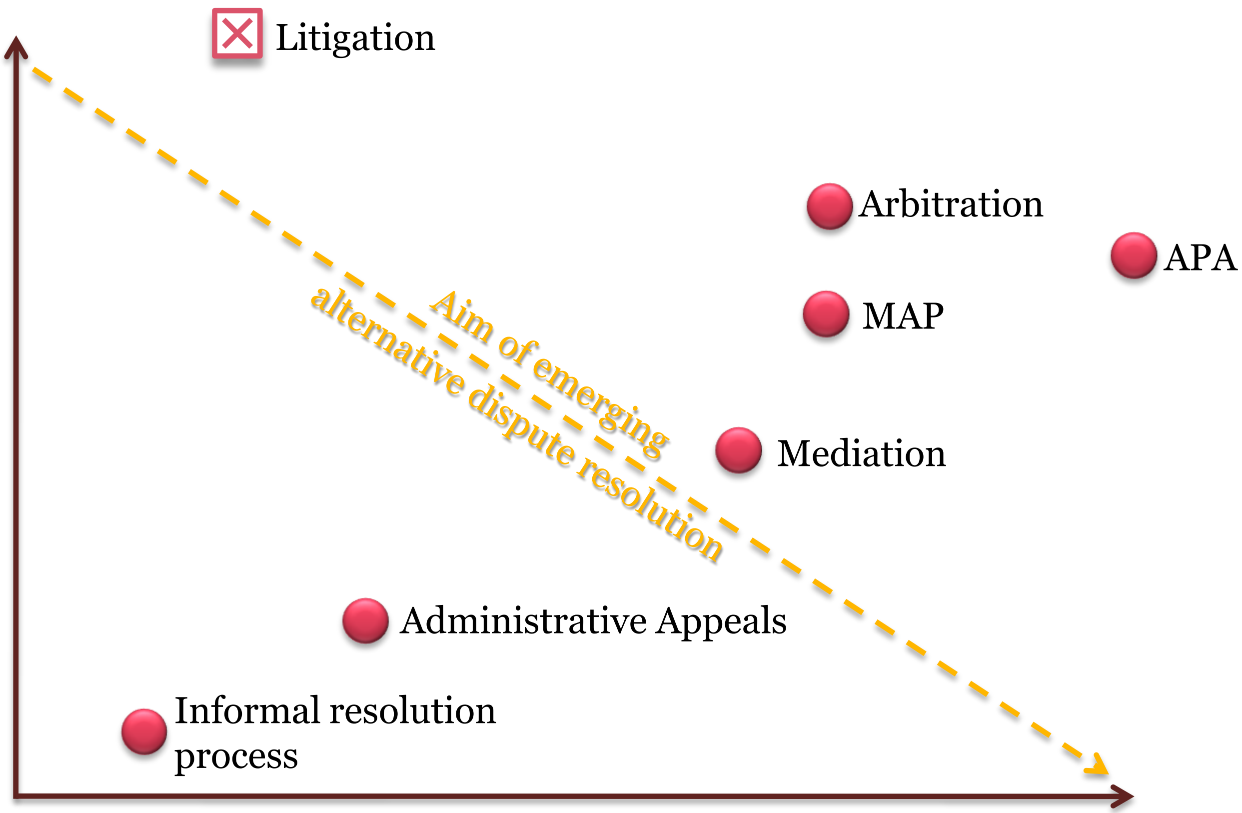
Alternative dispute resolution options

Dispute Resolution Lifecycle



Alternative dispute resolution options

Increasing cost to taxpayer
(time, resources, cost of ADR process itself)



Increasing benefit of outcome to taxpayer
(possibility of applying outcome to future transactions; significant reduction in assessment amount)

Appendix B: United Nations and European Union Initiatives

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INTERNATIONAL TAX UPDATE

by

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November 4, 2011

INTERNATIONAL TAX UPDATE

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I. Legislative Proposals

A. Ways & Means Participation Exemption Discussion Draft

1. The House Ways & Means Committee released a discussion draft addressing a participation exemption for certain foreign source income. It seeks feedback on how to improve the proposed set of rules. A summary document states that the Committee anticipates releasing future discussion drafts on other components of tax reform legislation, but has started with the participation exemption because it reforms one of the most complex and challenging areas of Federal tax law.

2. The top corporate tax rate is reduced to 25%.

3. The participation exemption is effectuated by means of a [95]% deduction for the foreign source portion of dividends received from CFCs by domestic corporations that are 10% shareholders of the CFCs. [Five] percent of a dividend from a CFC remains taxable. This taxation is intended to be a substitute for the disallowance of deductions for expenses incurred to generate exempt foreign income.

4. There is a one-year holding period requirement in respect of stock on which the dividend is paid. No deduction is allowed in respect of any dividend on any share of CFC stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. A deduction also is not permitted in respect of any dividend on any share of CFC stock to the extent the domestic corporation that owns the share is under an obligation (under a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property. These holding period requirements parallel the requirements of § 246(c)(1) for present-law DRDs. The U.S. shareholder must at all times during the relevant period be at least a 10-percent U.S. shareholder of the CFC.

5. Dividends paid by one CFC to another CFC are also generally exempted.

6. A domestic corporation is permitted to treat its ownership of 10/50 companies as CFC. The election applies to stock in all 10/50 companies held (or subsequently acquired) by the U.S. shareholder.

7. Foreign branches of domestic corporations are treated as a CFC for all purposes of the Code. Therefore, in addition to the [95]-percent DRD, the full range of rules applicable intercompany transactions--for example the transfer pricing rules of § 482 and the cross-border reorganization rules of § 367--apply to transactions between a foreign branch and its domestic parent corporation; and the only foreign tax credits in respect of foreign tax imposed on a foreign branch are the credits that are available in respect of foreign tax imposed on CFCs (that is, foreign tax on income included under subpart F).

8. If a U.S. shareholder sells stock of a “qualified foreign corporation” that the U.S. shareholder has held for at least one year, [95]% of any gain is excluded from income and no deduction is allowed for any loss. For purposes of this provision, a qualified foreign corporation is any CFC (an actual CFC or a noncontrolled 10/50 corporation treated as a CFC in respect of the selling shareholder as a result of an election) if at least [70] percent of the assets are active assets both (1) at the time of the sale or exchange and (2) at the close of each quarter of any taxable year of the selling shareholder if the quarter ends during the three-year period ending on the date of the sale or exchange. If a corporation has not been in existence for the entire three-year period, this calendar-quarter rule is applied on the basis of the period during which the corporation has been in existence. Whether a corporation is a qualified foreign corporation is determined by applying the rules just described to that corporation and to any predecessor of that corporation. An active asset is any asset of a kind that does not produce foreign personal holding company income under the subpart F rules. Section 1248 would not apply if the above rules apply.

9. Before the participation exemption takes effect, a 10-percent U.S. shareholder of a CFC or a noncontrolled 10/50 corporation must include in income its pro rata share of the undistributed, non-PTI of the foreign entity, subject to an [85]% DRD. A foreign tax credit is available in respect of the taxable portion of the included income. The Code rules in effect before enactment of the discussion draft ─ for example, the corporate tax rate and the separate foreign tax credit limitation rules of section 904 ─ apply in determining the increase in a 10-percent U.S. shareholder’s U.S. tax liability as a result of the

mandatory inclusion. The increased tax liability generally may be paid over an eight-year period (with interest).

10. Section 902 is repealed in respect of actual dividends received by a 10-percent United States shareholder of a foreign corporation. The repeal also applies to 10/50 corporations even if an election is not made to treat this entity as a CFC.

11. For purposes of computing the foreign tax credit limitation, only directly-allocable deductions are subtracted from gross foreign source income to compute foreign source taxable income. Taxpayers are not required to allocate other deductions against foreign source income for purposes of determining the foreign tax credit limitation. Directly allocable deductions are deductions that are directly incurred as a result of the activities that produce the related foreign-source income, e.g., salaries of sales personnel, supplies, and shipping expenses directly related to the production of foreign source income. Stewardship expenses, G&A expenses and interest are not considered as directly allocable.

12. Foreign tax credit baskets are eliminated. A single foreign tax credit limitation category applies to all foreign source income without regard to its present limitation category.

13. Section 956 is repealed. The repeal is due to the fact that E&P of a CFC are generally eligible foe the DRD without regard to whether the earnings are invested in the U.S. or abroad. The PTI and basis adjustment rules of §§ 959 and 961, respectively are also repealed.

14. Three alternatives are presented to address base erosion issues:

    (a) Option A provides that income attributable to use or exploitation of intangibles that has not been subject to a specified minimum income tax in any jurisdiction is included in U.S. income to the extent that such income exceeds 150 percent of costs attributable to such income. Under the provision, if a U.S. person transfers intangible property from the United States to a related CFC, certain excess income from transactions benefiting from or connected with the transferred intangible property is includible in income as a new category of subpart F income, foreign base company excess intangible income. This option was first outlined by the Obama Administration in its 2011 and 2012 budget recommendations.

(b) In Option B, income earned by a CFC that is neither derived from the conduct of an active trade or business in the home country of the CFC ("the home-country exception") nor subject to an effective rate of foreign tax of at least [10] percent is includible in subpart F income as low-taxed cross-border income. In order to qualify for the home-country exception and thus avoid inclusion of low-taxed cross-border income, a CFC must satisfy three tests. The income in question must arise from the conduct of a trade or business by the CFC within the jurisdiction in which the CFC is organized. The CFC must maintain an office or other fixed place of business within such country. With respect to a CFC located in a home country that is a party to an income tax treaty with the United States, this element is generally met if the offices or fixed place of business would satisfy the permanent establishment provisions of such treaty. Finally, the income must be derived from activities that serve the local market of the home country, either through transactions with respect to property used within the country or by performing services with respect to persons or property located in the country.

(c) Option 3 creates a new category of subpart F income for worldwide income derived by CFCs from intangibles and provides a deduction for a domestic corporation of [40] percent of its income from foreign exploitation of intangibles. As a result, the provision both increases the U.S. taxation of income derived from intangibles owned or licensed by a CFC and decreases the U.S. tax on the income of a U.S. corporation from its use of its intangibles in foreign markets.

15. The discussion draft limits the deductibility of "net interest expense" of a U.S. corporation that is a U.S. shareholder with respect to any CFC if both the CFC and U.S. corporation are part of a worldwide affiliated group. A portion of otherwise deductible interest is disallowed if the U.S. group fails to meet both a relative leverage test and a percentage of adjusted taxable income test. The lesser of the two amounts determined under these tests is the amount by which deductible interest is reduced. The new rule is inapplicable to a wholly domestic group. In the relative leverage test, all U.S. members of the worldwide affiliated group are treated as one member in order to determine whether the group has excess

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domestic indebtedness. Excess domestic indebtedness is the amount by which the total indebtedness of the U.S. members exceeds [100] percent of the debt those members would hold if their aggregate debt-to-equity ratio were proportionate to the ratio of debt-to-equity in the worldwide group. The percentage of aggregate domestic debt represented by excess domestic indebtedness is the debt-to-equity differential by which net interest expense is multiplied to determine the amount of interest that would be disallowed under the relative leverage test. The percentage of adjusted taxable income test first requires computation of adjusted taxable income, that is, taxable income increased by deductible losses, interest, depreciation and amortization, qualified production expenses and other items as prescribed in § 163(j)(6)(A). Whether interest expenses exceed the prescribed percentage of adjusted taxable income is determined company by company, as is the actual disallowance of deduction. Interest disallowed under this rule may be carried forward to subsequent taxable years. To the extent that application of this provision results in a disallowance of an interest deduction, the amount of that disallowance reduces the amount of interest disallowed under § 163(j).

B. Hagen-McCain Repatriation Bill

1. Sens. Kay Hagen (D-NC) and John McCain (R-AZ) introduced a bill to reduce the tax rate on repatriated earnings.

2. The corporate rate is reduced to an 8.75% effective rate on foreign earnings brought back dividends received to the United States. The rate is achieved through a temporary deduction (DRD) of 75 percent.

3. Companies can reduce their effective rate to 5.25% if the increase their U.S. payroll during 2012. The lowest repatriation rate can be achieved incrementally in accordance with expanding qualified payroll (all wages to employees that are subject to payroll tax)--through net job creation or higher employee pay. In order to receive the lowest repatriation rate, a company would have to increase its "qualified payroll" by 10%.

4. The proposal discourages firms from reducing employment by including in a company's gross income calculation $75,000 per full-time position that is eliminated.

C. Sen. Mike Lee (R-UT) introduced a bill that would permanently lower the tax rate for businesses from 35% to 5% on money earned overseas and brought back to the U.S.

II. Economic Substance

A. <u>LB&I-4-0711-015 (July 15, 2011)</u>

1. The LB&I directive follows up on LMSB-20-0910-024 (Sept. 14, 2010), which stated that to ensure consistent administration of the strict liability penalty related to the application of § 7701(o), any proposal to impose the doctrine, and thus the penalty, at the examination level must be reviewed and approved by the appropriate Director of Field Operations (DFO).

2. The purpose of the LB&I Directive is to instruct examiners and their managers how to determine when it is appropriate to seek the approval of the DFO in order to raise the economic substance doctrine. Once an examiner determines that raising the doctrine may be appropriate, this directive sets forth a series of inquiries the examiner must develop and analyze in order to seek approval for the ultimate application of the doctrine in the examination

3. In addition, the LB&I Directive provides that, until further guidance is issued, the penalties provided in sections 6662(b)(6) and (i) and 6676 are limited to the application of the economic substance doctrine and may not be imposed due to the application of any other "similar rule of law" or judicial doctrine (e.g., step transaction doctrine, substance over form or sham transaction).

4. The following facts and circumstances tend to show that application of the economic substance doctrine to a transaction is likely <u>not</u> appropriate. If some of the factors below apply to the transaction, and an examiner continues to believe that the application of the doctrine is appropriate, the examiner should continue to analyze the transaction as discussed below.

   (a) Transaction is not promoted/developed/administered by tax department or outside advisors

   (b) Transaction is not highly structured

   (c) Transaction contains no unnecessary steps

(d) Transaction that generates targeted tax incentives is, in form and substance, consistent with Congressional intent in providing the incentives

(e) Transaction is at arm's length with unrelated third parties

(f) Transaction creates a meaningful economic change on a present value basis (pre-tax)

(g) Taxpayer's potential for gain or loss is not artificially limited

(h) Transaction does not accelerate a loss or duplicate a deduction

(i) Transaction does not generate a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)

(j) Taxpayer does not hold offsetting positions that largely reduce or eliminate the economic risk of the transaction

(k) Transaction does not involve a tax-indifferent counterparty that recognizes substantial income

(l) Transaction does not result in the separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years

(m) Transaction has credible business purpose apart from federal tax benefits

(n) Transaction has meaningful potential for profit apart from tax benefits

(o) Transaction has significant risk of loss

(p) Tax benefit is not artificially generated by the transaction

(q) Transaction is not pre-packaged

(r) Transaction is not outside the taxpayer's ordinary business operations.

In addition, it is likely not appropriate to raise the economic substance doctrine if the transaction being considered is related to the following circumstances.

(s) The choice between capitalizing a business enterprise with debt or equity

(t) A U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment

(u) The choice to enter into a transaction or series of transactions that constitute a corporate organization or reorganization under subchapter C

(v) The choice to utilize a related-party entity in a transaction, provided that the arm's length standard of section 482 and other applicable concepts are satisfied.

5. The following facts and circumstances tend to show that application of the economic substance doctrine may be appropriate.

(a) Transaction is promoted/developed/administered by tax department or outside advisors

(b) Transaction is highly structured

(c) Transaction includes unnecessary steps

(d) Transaction is not at arm's length with unrelated third parties

(e) Transaction creates no meaningful economic change on a present value basis (pre-tax)

(f) Taxpayer's potential for gain or loss is artificially limited

(g) Transaction accelerates a loss or duplicates a deduction

(h) Transaction generates a deduction that is not matched by an equivalent economic loss or expense (including artificial creation or increase in basis of an asset)

(i) Taxpayer holds offsetting positions that largely reduce or eliminate the economic risk of the transaction

(j) Transaction involves a tax-indifferent counterparty that recognizes substantial income

(k) Transaction results in separation of income recognition from a related deduction either between different taxpayers or between the same taxpayer in different tax years

(l) Transaction has no credible business purpose apart from federal tax benefits

(m) Transaction has no meaningful potential for profit apart from tax benefits

(n) Transaction has no significant risk of loss

(o) Tax benefit is artificially generated by the transaction

(p) Transaction is pre-packaged

(q) Transaction is outside the taxpayer's ordinary business operations.

6. If after applying the guidance set forth above, an examiner believes that the application of the economic substance doctrine may be appropriate, the examiner must answer the following series of inquiries before seeking the approval of his or her appropriate DFO to apply the doctrine

(a) Is the transaction a statutory or regulatory election? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(b) Is the transaction subject to a detailed statutory or regulatory scheme? If so, and the transaction complies with this scheme, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(c) Does precedent exist (judicial or administrative) that either rejects the application of the economic substance doctrine to the type of transaction or a substantially similar transaction or upholds the transaction and makes no reference to the doctrine when considering the transaction? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(d) Does the transaction involve tax credits (e.g., low income housing credit, alternative energy credits) that are designed by Congress to encourage certain transactions that would not be undertaken but for the credits? If so, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(e) Does another judicial doctrine (e.g., substance over form or step transaction) more appropriately address the noncompliance that is being examined? If so, those doctrines should be applied and not the economic substance doctrine. To determine whether another judicial doctrine is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

(f) Does recharacterizing a transaction (e.g., recharacterizing debt as equity, recharacterizing someone as an agent of another, recharacterizing a partnership interest as another kind of interest, or recharacterizing a collection of financial products as another kind of interest) more appropriately address the noncompliance that is being examined? If so, recharacterization should be applied and not the economic substance doctrine. To determine whether recharacterization is more appropriate to challenge a transaction, an examiner should seek the advice of the examiner's manager in consultation with local counsel.

(g) In considering all the arguments available to challenge a claimed tax result, is the application of the doctrine among the strongest arguments available? If not, then the application of the doctrine should not be pursued without specific approval of the examiner's manager in consultation with local counsel.

(h) If an examiner seeks approval from the DFO, the DFO is instructed to consult with Counsel before a decision is made. If the DFO believes it is appropriate to approve the request, the DFO should provide the taxpayer an opportunity to explain its position, either in writing or in person (at the DFO's discretion), addressing whether the doctrine should be applied to a particular transaction.

B. *Merck & Co. v. U.S.*

1. A. U.S. appellate court, in a case named *Merck & Co V. U.S.*, ___. F. 3d ___ (CA-3 2011), affirmed the district court's decision in *Schering-Plough Corp. v. U.S.*, 651 F. Supp. 2d 219 (D. NJ 2009). (Schering-Plough was acquired by Merck between the time of the district court case and the time of appellate court case). The decision concerns § 956, but the appellate decision is more noteworthy for its impact on the recently codified economic substance doctrine.

2. The case concerned a promoted strategy to effect a repatriation from a CFC. The U.S. parent assigned future income streams from an interest rate swap with a third party to certain foreign subsidiaries in exchange for lump sum payments from those subsidiaries. The court

held that the transactions were in substance loans from the foreign subsidiaries. The taxpayer took the position that the lump sum payments from the foreign subsidiaries were includible in income ratably under Notice 89-21. The court was not swayed by the taxpayer's reliance on the Notice, focusing on substance over form and step transaction issues. An item of evidence relied on by the court was notes of the taxpayer's Director of Financial Reporting, which stated, "We are really accounting for the net deferred income as a loan, but tax could not have us record it as a loan." The court stated that, in substance, the transactions were loans, and that § 956 applied.

3. The District Court, in a footnote, also stated that as an alternate conclusion the transactions lacked economic substance. The Third Circuit did not adopt this conclusion, stating in a footnote that since it affirmed the Third Circuit's substance over form reasoning, it did not need to reach the economic substance issue.

C. *Superior Trading LLC v. Commissioner*

1. In Superior Trading LLC v. Commissioner, 137 T.C. No. 6 (2011), the Tax Court disallowed partnership deductions allocated to U.S. parters in respect of distressed Brazilian receivables transferred by a tax-indifferent Brazilian corporation. The court also imposed accuracy-related penalties, but did not hold that the transaction lacked economic substance.

2. The case involved a Brazilian entity in bankruptcy reorganization under Brazilian law. In a promoted transaction the Brazilian entity transferred distressed receivables to a partnership. Shortly after transferring its receivables, the Brazilian entity was redeemed out of the purported partnership. The partnership did not make a § 754 election, and the amendments to § 754 made by the 2004 Tax Act were not yet in effect. Thus, according to the petitioners, the basis of the receivables in the hands of the partnership remained unchanged at the receivables' face amount even after the redemption.

3. As the promoter found U.S. investors, the partnership transferred the receivables to a second partnership. The U.S. investors contributed substantial cash and other assets to the second partnership. Within a year of the above transactions, the second partnership sold the

distressed receivables through an “accommodating” party for the receivables’ fair market value. The resulting loss, equal to the spread between the face amount and the fair market value of the receivables and was allocated proportionately to the U.S. partners. The U.S. partners would eventually recognize gain on the wind up of the structure, but in the meantime there were significant timing benefits.

4. The court disallowed the losses holding, among other things, that the Brazilian entity did not contribute the distressed receivables to the partnership within the meaning of § 721 and that a partnership did not exist for U.S. federal tax purposes. It also imposed accuracy related penalties.

5. However, the court did not find a lack of economic substance. It stated that the mere fact that tax losses from a transaction exceed the accompanying economic losses does not render the transaction devoid of economic substance. It cited evidence that the servicing of distressed receivables was attracting the interest and investment of legitimate and sophisticated U.S. investors, and that the actual receivables that the purported partnerships acquired had, in fact, generated nontrivial revenues, although not necessarily profitability.

6. Further, the court distinguished this transaction from a Son-of-BOSS transaction which the court describes as creating a loss “manufactured out of whole cloth.” In a Son-of-Boss transaction, an encumbered asset which is not covered by section 752 is transferred to a partnership. The partner claims a high basis in its partnership interest, and recognizes a loss upon subsequently unwinding the contribution and settling the matching liability. Here, by contrast, the court stated that the loss is eventually offset by a matching gain, and the U.S. investors contribute substantial assets to the partnership to create basis. Therefore, according to the court, “unlike the stilted single-entity Son-of-BOSS transaction, [the instant transaction] requires a minimum of two parties, with one willing to give up something of substantive value. In an arm's-length world, this would happen only if adequate compensation changed hands.” As a result the court did not find economic substance lacking.

III. Splitter Rules

A. Section 909 was enacted into the Code as part of P.L. 111-226, signed into law on August 10, 2010. The provision is intended to prevent the claiming of foreign tax credits arising from "splitter" transactions, generally meaning transactions, often using hybrid entities, in which foreign taxes are separated from the underlying earnings that give rise to the foreign taxes.

B. The legislative history (JCX-46-10) states that it is not intended that differences in the timing as to when income is taken into account for U.S. and foreign income tax purposes (e.g., as a result of differences in accounting rules) should create a splitting event in the case where the same person pays the foreign taxes and takes into account the related income, but in different periods.

C. The legislative history also states that a splitting event does not occur where a CFC pays or accrues a foreign tax and takes the related income into account in the same year, even though the E&P to which the foreign income tax relates may be distributed to a covered person as a dividend or included under Subpart F.

D. The legislative history offers the case of a hybrid instrument as an example. In the example, US, a domestic corporation, owns all the shares of CFC-1, and CFC-1 owns all the shares of CFC-2. CFC-2 earns $100 from its regular business operations. CFC-2 issues a hybrid instrument to CFC-1 which is treated as equity for U.S tax purposes and as debt for foreign tax purposes. CFC-2 accrues (but does not pay currently) interest to CFC-1 equal to $100. As a result CFC-2 has no income for foreign tax purposes, while CFC-1 has $100 of income and pays $30 of foreign taxes. For U.S. purposes, CFC-2 has the $100 of income and CFC-1 has the $30 of taxes. Under the splitter rules the related income with respect to the $30 of foreign taxes paid by CFC-1 is the $100 of earnings and profits of CFC-2.

E. Late in 2010 the IRS released Notice 2010-92, 2010-15 I.R.B. 1, which the IRS anticipates is the first of several items of published guidance concerning § 909. The Notice focuses on the application of § 909 to split foreign income taxes of a § 902 corporation that were not deemed paid by a United States shareholder before 2011. The Notice refers to these as "pre-2011 splitter arrangements."

1. The first type of splitter transaction, a reverse hybrid structure, exists when a § 902 corporation owns an interest in a "reverse hybrid," meaning an entity that is treated a corporation for U.S. federal income tax purposes but is a pass-through entity or a branch under

foreign law. A pre-2011 splitter arrangement involving a reverse hybrid structure exists when pre-2011 taxes are paid or accrued by a § 902 corporation with respect to income of a reverse hybrid that is a covered person with respect to the § 902 corporation. The Notice provides that a pre-2011 splitter arrangement involving a reverse hybrid structure may exist even if the reverse hybrid has a deficit in earnings and profits for a particular year (for example, due to a timing difference). Such taxes paid or accrued by the § 902 corporation are pre-2011 split taxes. The related income is the earnings and profits (computed for U.S. federal income tax purposes) attributable to the activities of the reverse hybrid that gave rise to the income included in the foreign tax base with respect to which the pre-2011 split taxes were paid or accrued.

2. The second category of pre-2011 splitter arrangements is a foreign consolidated group, which exists when a foreign country imposes tax on the combined income of two or more entities. Tax is considered imposed on the combined income of two or more entities even if the combined income is computed under foreign law by attributing to one such entity the income of one or more other entities. A foreign consolidated group is a pre-2011 splitter arrangement to the extent that the taxpayer did not allocate the foreign consolidated tax liability among the members of the foreign consolidated group based on each member's share of the consolidated taxable income included in the foreign tax base under the principles of Treas. Reg. § 1.901-2(f)(3). A pre-2011 splitter arrangement involving a foreign consolidated group may exist even if one or more members has a deficit in earnings and profits for a particular year (for example, due to a timing difference). Pre-2011 taxes paid or accrued with respect to the income of a foreign consolidated group are pre-2011 split taxes to the extent that taxes paid or accrued by one member of the foreign consolidated group are imposed on a covered person's share of the consolidated taxable income included in the foreign tax base. The related income is the earnings and profits (computed for U.S. federal income tax purposes) of such other member attributable to the activities of that other member that gave rise to income included in the foreign tax base with respect to which the pre-2011 split taxes were paid or accrued.

3. The third category of pre-2011 splitter arrangements is a foreign group relief or other loss-sharing regime, which exists when one entity with a loss permits the loss to be used to offset the income of one or more other entities (a "shared loss"). A pre-2011 splitter arrangement involving a shared loss, however, exists only when all of the following three conditions are met:

   (a) There is an instrument that is treated as indebtedness under the laws of the jurisdiction in which the issuer is subject to tax and that is disregarded for U.S. federal income tax purposes (a "disregarded debt instrument").

   (b) The owner of the disregarded debt instrument pays a foreign income tax attributable to a payment or accrual on the instrument.

   (c) The payment or accrual on the disregarded debt instrument gives rise to a deduction for foreign tax purposes and the issuer of the instrument incurs a shared loss that is taken into account under foreign law by one or more entities that are covered persons with respect to the owner of the instrument.

4. The fourth category is a hybrid instrument, that is an instrument which is either (1) treated as equity for U.S. federal income tax purposes and as debt for foreign tax purposes ("U.S. Equity HI"), or (2) treated as debt for U.S. federal income tax purposes and as equity for foreign tax purposes ("U.S. Debt HI"). If the issuer of a U.S. Equity HI is a covered person with respect to a section 902 corporation that is the owner of the U.S. Equity HI, there is a pre-2011 splitter arrangement with respect to the portion of the pre-2011 taxes paid or accrued by the owner section 902 corporation with respect to the amounts on the instrument that are deductible by the issuer as interest under the laws of a foreign jurisdiction in which the issuer is subject to tax but that do not give rise to income for U.S. federal income tax purposes. Pre-2011 split taxes paid or accrued by the section 902 corporation equal the total amount of pre-2011 taxes paid by the section 902 corporation less the amount of pre-2011 taxes that would have been paid or accrued had the section 902 corporation not been subject to tax on income from the U.S. Equity HI. The related income of the issuer of the U.S. Equity HI is an amount equal to the amounts that are deductible by the issuer for

foreign tax purposes, determined without regard to the actual amount of the issuer's earnings and profits.

5. Other Rules

(a) Related income is considered taken into account by a § 902 shareholder to the extent the related income is recognized as gross income by the § 902 shareholder, or by an affiliated corporation upon a distribution, a deemed distribution or inclusion out of the E&P of the covered person attributable to the related person.

(b) In the case of partnerships, § 902 is applied at the partner level.

(c) Treasury and the IRS recognize that certain allocations of creditable foreign tax expenditures and income of a partnership can result in the separation of creditable foreign tax expenditures and the related income for purposes of § 909. See Treas. Reg. § 1.704-1(b)(5), Example 24. Partnership allocations that satisfy the substantial economic effect rules will not constitute pre-2011 splitter arrangements, except to the extent described in the Notice.

(d) The Notice states that § 909 does not alter the general rules for determining when a foreign tax is treated as paid or accrued. However, other than for purposes of of § 986, the suspended taxes are taken into account and treated as paid or accrued in the year the related income is taken into account.

(e) Comments are specifically requested on whether and to what extent the following transactions should be treated as giving rise to a splitting event: (i) covered asset acquisitions described in § 901(m); (ii) the incorporation of a disregarded entity or a hybrid partnership with respect to foreign income taxes paid in the year of the incorporation or attributable to a significant timing difference; (iii) certain transfer pricing adjustments; (iv) group relief structures not otherwise described in this notice; (v) sale and repurchase agreements in the related and unrelated counterparty contexts; (vi) foreign anti-deferral regimes; and (vii) foreign consolidated groups in which members have losses.

IV. Covered Asset Acquisitions

A. Section 901(m) denies foreign tax credits ("FTCs") with respect to foreign income not subject to U.S. taxation by reason of a covered asset acquisition. A "covered asset acquisition" is generally a qualified stock purchase to which § 338 applies, the acquisition of a partnership interest with a § 754 election in effect, a transaction that is treated as the purchase of an entity's assets for U.S. tax purposes but as a stock acquisition (or disregarded) for foreign tax purposes (for example, the acquisition of a disregarded entity), and any similar transaction.

B. The law prevents the claiming of foreign tax credits on foreign tax attributable to "income differential amounts." The disqualified portion of any foreign income tax is the ratio of the aggregate basis difference (but not below zero) allocable to the tax year for all relevant foreign assets divided by the income on which the foreign income tax is determined.

C. The foreign tax for which a credit is denied can be spread over a number of years due to different amortization rates and amounts as a result of the acquisition basis step up for U.S. tax purposes. Thus, determining the disallowed credits can be complex.

D. <u>Example</u>

1. Assume US, a domestic corporation, acquires 100% of the stock of FT, a foreign target organized in country F with a "u" functional currency, in a qualified stock purchase for which a § 338 election is made. The tax rate in country F is 25%. The aggregate basis difference in connection with the qualified stock purchase is 200u, including: (1) 150u that is attributable to asset A, with a 15 year recovery period for U.S. tax purposes (10u of annual amortization); and (2) 50u that is attributable to asset B, with a five year recovery period (10u of annual depreciation).

2. In each of years 1 and 2, FT's taxable income is 100u for local purposes and FT pays foreign income tax of 25u (equal to $25 when translated at the average exchange rate for the year). As a result, the disqualified portion of foreign income tax in each of years 1 and 2 is $5 (10u + 10u of allocable basis difference over 100u of foreign taxable income times $25 foreign tax paid).

3. In year 3, FT's taxable income is 140u, 40u of which is attributable to gain on the sale of asset B. FT's country F tax is 35u (equal to

$35 translated at the average exchange rate for the year). Accordingly, the disqualified portion of its foreign income taxes paid is $10 ((40u (10u of annual amortization on asset A plus 30u attributable to disposition of asset B) of allocable basis difference over 140u of foreign taxable income) times $35 foreign tax paid)).

4. If the taxpayer fails to substantiate the income, the income is determined by dividing the amount of the foreign tax by the highest marginal tax rate applicable to the income in the relevant jurisdiction.

E. As is typical with rules written to cure perceived abuses, the reach of § 901(m) is surely broader than intended. The scope of § 901(m) would seem to cover routine check-the-box elections (under the rule that a transaction treated as an asset acquisition for U.S. purposes and a stock acquisition (or disregarded transaction) for foreign purposes). Further, it would also seem to cover many transactions involving disregarded entities, such as sales, contributions or distributions.

1. Consider, for example, the sale of a disregarded entity by CFC1 to a brother/sister entity, CFC2. The sale is a covered asset acquisition because it is treated as an asset sale for U.S. tax purposes and as a stock sale for foreign tax purposes.

2. Therefore, the US parent's foreign tax credits on distributions from CFC2 are reduced because the basis step-up is not taken into account. However, CFC1's E&P are still increased as a result of the sale. Accordingly, double taxation results.

3. Consider, also, the § 909 splitter effects on such a transaction.

Reconstruction of a foreign target's tax basis will now be an important diligence item. This could significantly increase the time and expense of diligence. For example, items such as historic acquisitions, restructurings, and accounting methods will need to be investigated. Old and cold transactions will need to be unearthed and possibly translated into U.S. tax principles.

Section 901(m)also raises treaty issues. Most U.S. tax treaties allow a U.S. FTC for income taxes paid in the foreign country. Under the new rule, the foreign tax is permanently lost as a credit.

The provision applies to covered asset acquisitions after December 31, 2010, subject to a limited transition rule. Acquisitions are subject to the previous rule if they are covered by a written agreement binding on January 1, 2011, described in a ruling request filed with the IRS on or before July 29, 2010, or described in a public announcement or SEC filing on or before January 1, 2011.

Section 901(m) does not disallow the claiming of foreign taxes as a deduction. It also does not disallow a reduction to the foreign target's earnings and profits. Therefore, § 338 and §§ 754 elections, outside the foreign tax credit context, still can produce repatriation opportunities. For example, the elimination of E&P resulting from a § 338 election and subsequent reductions in E&P through amortization deductions can create opportunities for tax-free returns of capital under § 301(c)(2).

Note also that § 901(m) does not apply to transactions that are treated as asset acquisitions for foreign tax purposes. While an asset transaction is generally not preferable from the seller's perspective, this is an alternative that should be considered, especially when foreign law permits the tax-free disposition of assets.

Anti-Hopscotch Rules–§ 960(c)

Under § 960(c) foreign tax credits are limited when a lower-tier CFC with a higher effective tax rate than its CFC parent makes a § 956 loan to its U.S. shareholder.

The U.S. shareholder's foreign tax credit is limited to the amount of the foreign tax credit that would have resulted had the amount been distributed through the tiers of corporations between the lower-tier, high-ETR CFC and the U.S. parent.

The provision is effective with respect to § 956 inclusions attributable to U.S. property acquired by a CFC after December 31, 2010.

Caution should be exercised in respect of modifications to a debt instrument that could be treated as a significant modification under Treas. Reg. § 1001-3.

The JCT Technical Explanation states that no special rules apply in determining the hypothetical credit. The only exception is that, to the extent an actual distribution would be subject to any income or withholding taxes, those taxes that are not taken into account in determining the hypothetical credit. An example provides as follows:

USP, a U.S. parent company, owns all the vote and value of CFC1, a CFC organized in country A with post-1986 undistributed earnings of 200u and post-1986 foreign income taxes in the amount of $10. CFC-1 owns all of the vote and value of CFC2, a CFC organized in country B with post-1986 undistributed earnings of 100u, and post-1986 foreign income taxes in the amount of $50. If CFC-2 makes a loan to USP that results in a § 956 inclusion in the amount of 100u, the tentative credit is $50 (100u over 100u times $50).

The hypothetical distribution of 100u from CFC-2 to CFC-1 would increase CFC-1's current E&P by 100u, from 200u to 300u, and increase CFC-1's foreign income taxes from $10 to $60. The 100u hypothetical distribution results in a dividend of 100u that is not-Subpart F income of CFC-1 under the Subpart F look-through rules of § 954(c)(6). Although country B would impose a 10% withholding tax on an actual distribution of 100u to CFC-1, for a total withholding tax of 10u, this amount is not taken into account in determining the hypothetical credit.

Next, the 100u of hypothetical distribution from CFC-1 to US would result in a dividend of 100u, with respect to which US would be deemed to have paid $20 in taxes (100u over 300u times $60). Because the hypothetical credit of $20 is less than the tentative credit of $50, US's foreign taxes deemed paid with respect to its § 956 inclusion are limited to $20. US's § 78 gross up with respect to the § 956 inclusion is also $20.

If in the same taxable year CFC-1 were also to make an actual distribution of all of its accumulated E&P of 200u, the 100u hypothetical distribution from CFC-1 to US would have no impact on the calculation of US's actual deemed paid credit from CFC-1's actual dividend. The deemed paid credit on the 200u dividend would be $10 (200u over 200u times $10). In addition, the calculation of the hypothetical credit with respect to the hypothetical distribution of 100u from CFC-2 would be the same (100u over 300u times $60 equals $20) whether or not CFC-1 paid an actual dividend.

The Technical Explanation states that the treatment of any foreign taxes over the limit imposed under the new rule (the "excess taxes") is the same as the treatment of any other foreign taxes paid or accrued, but not yet deemed paid for purposes of the foreign tax credit rules. Thus, if a foreign corporation's excess taxes are in its general category post-1986 foreign income taxes pool, the foreign corporation's excess taxes are still considered general category post-1986 foreign income taxes. Accordingly, these taxes are included in the computation of foreign taxes deemed paid with respect to a subsequent distribution from, or income inclusion with respect to, that foreign corporation, subject to applicable limitations including the limitation of the new provision. In the example above, the excess taxes that remain at CFC-2 equal $30. The excess taxes equal the deemed paid foreign tax credit (determined without regard to the new provision) of $50 minus a hypothetical credit of $20.

Alternatively, if CFC-2's E&P also included 125u of previously taxed income, then the excess taxes remaining at CFC-2 would be $50, because the applicable ordering rules would prioritize the hypothetical distribution as coming first from the 125u in previously taxed income over the 100u in untaxed earnings. Thus, the new rule can have interesting applications in the context of previously taxed income.

VI. Other Foreign Tax Credit Issues

A. Excess Profits Tax--§ 903

1. The IRS, in ECC 201052017, stated that the Algeria's exceptional profit tax is not creditable as an in lieu of tax under § 903. Algeria imposes an excess profits tax. Its base is gross income. The taxpayer at issue was paying a regular income tax which is imposed on net income in addition to the excess profits tax.

2. Section 901 permits taxpayers to claim a credit for foreign income taxes. Reg.§ 1.901-2(a)(i) states that a foreign levy is an income tax if and only if it is a tax and the predominant character of that tax is that of an income tax in the U.S. sense.

3. Section 903 states that a creditable income tax includes a tax paid in lieu of an income tax otherwise generally imposed. Reg. § 1.903-1(b)(1) states that an in lieu of tax must operate as a tax imposed in

substitution for, and not in addition to, an income tax or a series of income taxes generally imposed.

4. As a preliminary matter, the IRS stated that the excess profits tax cannot be an income tax because it is not imposed on net income. The IRS concluded that since taxpayer is paying an income tax and the excess profits tax tax, the excess profits tax is in addition to, and not in lieu of, an income tax, and therefore it cannot qualify under § 903, as an in lieu of tax.

5. The IRS stated that some taxpayers have argued that an income tax and a non-income tax in combination can qualify as an alternative tax regime in lieu of the income tax imposed on other business sectors. Taxpayers cite Reg. § 1.903-1(b)(3), Example (4), which allows multiple levies to be combined. But in this example all such levies are non-income taxes. The IRS did not accept the taxpayer's argument that taxpayers can combine an income tax and a non-income tax.

6. Further the IRS stated that the taxpayer's argument is weakened by the fact that the excess profits tax was introduced at a later time, after the income tax had been in effect for some time. Plus, the income tax paid by the taxpayer is the generally applicable income tax. If the only difference in the generally applicable tax others pay and the tax the dual capacity taxpayer pays is the applicable rate, it's not a separate levy under the regulations, according to the IRS.

B. <u>Refund Claims</u>

1. In FAA 20105001F, addressing a foreign tax credit refund claim, the IRS stated that the limitations period for claiming the refund begins in the year when the underlying income is earned and not in the year when a dispute with the foreign government over the amount of tax owing is resolved.

2. The taxpayer is a domestic corporation. Its foreign subsidiary was liable as withholding agent for a 25% withholding tax on bond interest. The foreign subsidiary contested the liability, and it was agreed that the foreign subsidiary would pay withholding tax at a 15% rate.

3. The taxpayer did not claim any foreign tax credits for the withholding taxes on its originally filed returns. It claimed the

foreign tax credits on an amended return. The amended return reported the credits as resulting in an overpayment of U.S. tax for which the taxpayer requested a refund.

4. Under § 6511(d)(3)(A), taxpayers wishing to file a foreign tax credit refund are subject to a 10-year period of limitations. The statute provides that the period begins to run from the due date of the tax return for the year in which the foreign tax was actually paid or accrued.

5. The IRS contended that the ten-year period of limitations to file foreign-tax-credit-related refund claims for the taxable years at issue had expired. The taxpayer argued that it may claim the foreign tax credit because the statute of limitations tolled when it paid the withholding taxes and resolved the dispute with the foreign tax authorities. It also claimed that its refund claim was timely because the period of limitations began on the due date of its originally filed return, which had not expired as of the amended return's filing date.

6. The Service stated that as a preliminary matter, the taxpayer is an accrual basis taxpayer, and therefore the taxable year in which the taxpayer may claim the foreign tax credit hinges on the meaning of "accrue." When foreign taxes are contested, according to the Service, the timing of when they accrue for purposes of the credit does not follow traditional accrual accounting principles.

7. In general, under the “contested tax doctrine,” which has its basis in accrual tax accounting principles (embodied in § 461) when an accrual-basis taxpayer contests a deductible liability and that liability remains contingent, the taxpayer may only accrued the tax in the year when the liability is finally adjudicated. However, this result was disputed by the Supreme Court in Cuba Railroad Co. v. United States, holding that the credit may be taken in the year the foreign taxes accrued, even though the taxpayer contested the taxes, then resolved the dispute and paid the taxes in a later year. The IRS followed this holding in Rev. Rul. 58-55. As support for this view the IRS cited section 986(a)(1)(A),which states that for an accrual basis taxpayer, the amount of foreign income taxes paid within two years of the year in which the underlying income was earned is translated into dollars by using the average exchange rate for the taxable year to which such taxes relate.

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8. The IRS stated that in the instant situation that for the purposes of the foreign tax credit, the accrual related back to the years for which the taxes were assessed.

9. Among the arguments made by the taxpayer was that § 6511(d)(3)(A), which was amended in 1997, states that the limitations period begins in "the year in which such taxes were actually paid or accrued." However, according to the Service this phrase refers to § 901, which provides that a foreign tax credit is allowed against U.S. income tax for foreign taxes paid or accrued during the taxable year to a foreign country. It also cited to the legislative history of the change to § 6511(d)(3)(A), claiming that Congress adopted the Service's position in Rev. Rul. 84-125 which states that the limitations period begins to run on the due date of the return for the year in which the taxes were paid or accrued.

C. Partnership Audit Issues

1. CCA 2011020412155037 (March 4, 2011), states that the failure of partners to properly compute their foreign tax credit deriving from partnership income would be an affected item. It states that following the partnership proceeding the Service would have one year to assess the under-reported tax, probably through an affected item notice of deficiency unless the deficiency is purely computational from the face of the partner returns.

2. The issues of what constitutes a "partnership item" and an "affected item" in respect of foreign tax credits are not straightforward but essential in the context of an audit. The partnership provisions in Title IV of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, sec. 401-407, 96 Stat. 324, 648-71, established a unified audit and litigation process under §§ 6221 through 6233 of the Code for determining the tax treatment of partnership items at the partnership level. The TEFRA audit rules and procedures call for a separate audit of the partnership return and the separate administrative and judicial resolution of disputes in respect of "partnership items". § 6221

3. Because § 6226 makes the issuance of a Notice of Final Partnership Administrative Adjustment ("FPAA") a condition precedent to the exercise of its jurisdiction over a partnership action, the Tax Court has no jurisdiction over partnership items until an FPAA is issued

for the partnership. Neither the Service nor the taxpayer is permitted to raise non-partnership items in the course of a partnership proceeding, nor may partnership items be raised in proceedings relating to non-partnership items of a partner unless the partnership items are converted to non-partnership items. Failure to conduct a partnership level TEFRA proceeding would bind the Service on any item or items on the partnership Form 1065 and books and records of the partnership that were required to be taken into account by the partnership under subtitle A of the Code, and which are also partnership items as defined under the regulations. The Service, however, may adjust non-partnership items, including affected items, under the deficiency procedures of § 6211 through 6215. Therefore, the determination of whether an item is a partnership item is the threshold question in determining the applicable deficiency procedures

4. A “partnership item” means, with respect to a partnership, any item required to be taken into account for the partnership's taxable year under any provision of subtitle A of the Code to the extent regulations provide that such item is more appropriately determined at the partnership level. § 6231(a)(3). An “affected item” means any item to the extent it is affected by a partnership item. § 6231(a)(4).

5. Treas. Reg. § 301.6231(a)(3)-1 provides additional rules on what constitutes a partnership item, including partnership income, gain, loss, deduction, or credit. The regulations, however, are silent as to whether foreign taxes specifically constitute a partnership item.

6. Proposed regulations under § 6231 provided that foreign taxes were a partnership item. Prop. Treas. Reg. § 301.6231(a)(3)-1(a)(1)(ii). When the regulations were finalized, however, reference to foreign taxes was eliminated. In an FSA the Service expressed the view that whether foreign taxes are a partner item or a partnership item depends on whether, under foreign law, the taxes are imposed on the partners in their individual capacities (partner item) or on the partnership as an entity (partnership item). 1995 FSA Lexis 65 (Oct. 18, 1995).

7. In the CCA it appears the partnership’s income was a key input necessary to correctly determine the amount of the partner’s foreign tax credit. The partner’s foreign taxes were presumably imposed on

the partner in its individual capacity, and therefore were a partner item. However, the amount of the foreign tax credit depended on the correct determination of the partner's share of the partnership's income, and therefore was an affected item.

8. Issues related to foreign tax credits can get more complicated in respect of deemed paid credits claimed by partners. See FSA 200144006 (July 30, 2001), which describes two domestic partners who own interests in a U.K. entity (UK JV) that made a check-the-box election to be treated as a partnership and received dividends from its foreign subsidiaries.

9. The partners claimed credits related to the dividends. The Form 1065 reported total dividend income and subdivided the dividend income into general limitation income, passive income, and dividends received from a certain § 902 corporation. The reported dividend income included the "gross-up" amounts under § 78 of the Code.

10. USPartner1 filed a Form 8082, "Notice of Inconsistent Treatment or Administrative Adjustment Request", with respect to the Form 1065. The Form 8082 requested that it be treated as an Administrative Adjustment Request ("AAR"), and requested substitute return treatment for the entire partnership. The AAR substitute return reported several changes to the amounts reported on the Form 1065. The AAR substitute return reported a revised amount of foreign taxes accrued, which was less than the amount originally reported. The AAR states that the amount was adjusted "to reflect the actual tax liability of the foreign corporations". The amount is described as the total foreign taxes deemed paid under § 902 of the Code with regard to the dividends by a U.K. subsidiary (UK Sub) of UK JV.

11. The AAR substitute return also reduced the amount of reported dividend income from because of changes made to UK Sub's earnings and profits and a correction to the amount of cash distributed and section 78 gross-up amounts with respect to the dividends from UK Sub. The revised dividend income was classified as general limitation income. Also, the Schedule M-1 amounts were adjusted to report that UK JV received a distribution of previously taxed income from a subsidiary of UK Sub. The revised dividend income amount did not include the previously taxed income

12. UK Sub paid U.K. windfall tax, and UK JV did not include this amount as a foreign tax paid or accrued on either its Form 1065 or on the AAR substitute return. USPartner2 filed a Notice of Inconsistent Treatment, Form 8082, claiming additional foreign tax credit for its share of that amount since it asserts that the U.K. windfall tax is, contrary to the position taken by HybridJV, a creditable foreign income tax.

13. Section 702(a)(6) of the Code provides that each partner shall take into account separately his distributive share of the foreign taxes described in § 901 paid or accrued by the partnership. Section 703(a)(1) requires the partnership to separately state these amounts on the partnership return. Thus, according to the FSA, the amount and eligibility for credit under § 901 and the separate limitation classification under § 904 of taxes paid or accrued by a partnership are items the partnership is required to take into account under subtitle A of the Code, and therefore are partnership items.

14. However, under the facts at issue UK JV did not pay or accrue any foreign income taxes. Taxes deemed paid by UK JV’s domestic corporate partners USPartner1 and USPartner2 under section 902 or 960 attributable to taxes paid or accrued by subsidiaries of UK JV in which the partners owned the required amount of voting stock under section 902(a) or 960(a)(1) are not credits "of the partnership" and need not be separately stated on UK JV’s return. Therefore, they are not partnership items.

15. Further, according to the Service, the amount of the foreign subsidiaries’ earnings and foreign income taxes, and whether the taxes paid by the foreign subsidiaries’ are creditable taxes in the first instance (such as the UK windfall profits tax), are not determined at the partnership level, and therefore are not partnership items.

16. However, USPartner1's and USPartner2's entitlement to the deemed paid foreign tax is dependent, in part, upon establishing ownership of the requisite amount of voting stock in the subsidiaries of UK JV. To the extent the amount of UK JV’s stock ownership in UKHolding is relevant to this determination, the amount of the deemed paid credit under section 902 or 960 and corresponding section 78 "gross-up" are affected items. Presumably the Service based this conclusion on Treas. Reg. § 301.6231(a)(3)-1(a)(1)(vi), which provides that a partnership item includes amounts in respect of the

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partnership's assets, investments, transactions, and operations necessary to enable the partnership or the partners to determine certain items; however one of these items is not whether and the extent to which partners may claim indirect foreign tax credits. Cf. Olsen-Smith, Ltd. et. al. v. Commissioner, T.C. Memo 2005-174 (the determination of the identity of indirect partners of a partnership is not a partnership item that a court may determine in a partnership-level proceeding).

17. USPartner2 has filed a Notice of Inconsistent Treatment claiming additional foreign tax credit for its share of the UK windfall tax since it asserts that the U.K. windfall tax is, contrary to the position taken by UK JV, a creditable foreign income tax. Since, as discussed above, the item for which USPartner2 has filed the Form 8082 is not a partnership item, the FSA concludes that TEFRA proceedings are inapplicable

18. Under the bifurcated approach to foreign tax credits, in general, it would appear that the resolution of disputes involving § 902 credits could require the resolution of a partnership-level audit followed by the resolution of a partner-level audit.

D. Statute of Limitations--Carryback of Foreign Tax Credits

1. In *R.H. Donnelley Corp. v. U.S.*, ___ F. 3d ___ (4th Cir. 2011), the Fourth Circuit affirmed a district court decision holding that the IRS can recalculate tax liability for a year beyond the statute of limitations in order to determine whether excess tax credits can be carried back to previous years to support a refund.

2. Two days before the statute of limitations ran for the 1994 taxable year, the taxpayer claimed refunds for 1991 and 1992 based on tax credits carried back from 1994. The statute of limitations then expired. After an investigation revealed that the taxpayer had so underreported its 1994 income that there was sufficient tax liability to use up all of the credits in that year, the IRS denied the refund claim.

3. The Fourth Circuit found the taxpayer's claim that the IRS may not recalculate its 1994 taxes to defeat a 1991-1992 refund claim untenable in light of the Supreme Court's long-standing recognition that the IRS may recompute tax liabilities in response to a refund claim. See Lewis v. Reynolds, 284 U.S. 281 (1932). In Lewis, the

Supreme Court stated "[w]hile no new assessment can be made, after the bar of the statute [of limitations] has fallen, the taxpayer, nevertheless, is not entitled to a refund unless he has overpaid his tax."

4. The Taxpayer contended that Lewis is distinguishable because it only permits the IRS to raise "issues arising in that same tax year as an offset to the refund claimed." The court found this argument unpersuasive reasoning that under this theory, the IRS could challenge a deduction from 1991 or 1992, the years for which Donnelley claims a refund, but could not re-examine whether there were excess credits in 1994 to be carried back to 1991 and 1992. It noted that the Tax Court has found that the IRS has authority to recalculate all tax years necessary to determine whether there was an overpayment in the year of the claimed refund, so long as it does not assess additional taxes as a prelude to collecting them.

5. The court stated that the IRS is properly using Lewis as a "shield" rather than a "sword." “It seeks to collect not one additional penny from Donnelley. Instead it seeks to defend the fisc against Donnelley's bold claim for an $11 million refund.” Estate of Michael, which recognized again that the IRS may "retain payments already received when they do not exceed the amount which might have been properly assessed and demanded," id. at 509 n.8 (quoting Lewis, 284 U.S. at 283), validates the government's approach in this case.

6. The court also rejected the taxpayer’s argument that the text of § 904(a) prevents the IRS from recalculating the foreign tax credit limitation in response to a refund suit. The taxpayer contended that in § 904(a)'s phrase for U.S. tax liability "the tax against which such credit is taken," refers solely to the tax that the IRS could actually collect before the statute of limitations expired, because a "credit can only be taken against a real tax that exists." The court stated that on this view, Donnelley's foreign tax credit limitation for 1994 was forever fixed at an artificially low level, and that Congress has given no indication that there is anything unusual about § 904(a) such that the foreign tax credit limitation is to be computed using only the timely assessed tax.

7. The court concluded by stating, “[i]t takes real chutzpah for Donnelley to demand a refund under these circumstances.

Donnelley, by claiming a large deduction in 1994 to which it was not entitled, substantially understated its pre-credit income tax. It then received one sort of windfall when the statute of limitations expired, preventing the IRS from collecting any of the tax that Donnelley would have owed if it had properly reported its net income . . . [and while] the statue of limitations may protect Donnelley from additional collection . . . it does not give Donnelley license to claim a second windfall in the form of a refund. To claim otherwise is almost beyond belief."

E. Creditability of Puerto Rican Excise Tax

1. The IRS announced, in Notice 2011-29, that it is evaluating whether a new Puerto Rican excise tax is a creditable foreign income tax under U.S. law, but would not challenge the creditability of the excise tax in the meantime. The Puerto Rican excise tax applies to purchases made by non-Puerto Rican corporations from affiliated entities that manufacture in Puerto Rico if their gross receipts exceed $75 million. The tax is imposed on the purchasing corporation at a 4% rate on the value of purchases made and is collected and remitted by the Seller.

2. The excise tax applies in lieu of a tax imposed when a non-Puerto Rican corporation purchases goods from an affiliate that manufactures in Puerto Rico, and such purchases account for at least 10% of the total gross receipts of the manufacturer or at least 10% of the total cost of the property acquired by the Purchaser. When it applies, a portion of the income of the purchaser from the sale outside of Puerto Rico of the products manufactured in Puerto Rico is treated as Puerto Rican source income that is effectively connected with the conduct of a Puerto Rican trade or business.

3. The Notice treats the excise tax as an "in lieu of" tax that, for now, is creditable under IRC § 903 (pending resolution of a number of factual and legal issues). Therefore, a final determination has not been made on the creditability of the excise tax.

4. Further, the tax itself raises issues under the U.S. Constitution, to which Puerto Rico is subject. The issue are similar to the ability of U.S. states to tax out-of-state taxpayers that have no or minimal contacts with that state.

VII. Transfer Pricing

A. Buy-In payments

1. In ECC 201111013 the IRS addressed the following question: If one party (call it D for donor) gives a related party (call it R for recipient) something valuable, which R must further develop at its own expense before any exploitation (or at least before full exploitation is possible), how can one determine the compensation that R owes to D?

2. In the IRS's view, this issue presents difficult problems, because "The [Treas. Reg. § 1.482]-4 regulations generally address a license of rights to exploit an intangible 'as is.'"

3. Instead the IRS stated that the residual profit split method in Treas. Reg. § 1.482-6 addresses the question "to some extent." The IRS reasoned that, "[u]nder that method, routine activities are given a return determined by comparables, and any residual profit is split according to each party's relative intangible contributions." However, according to the IRS, the approach of splitting capitalized costs "tends to be unreliable when one party's investment period entirely precedes another party's investment period."

4. Therefore, the IRS concluded, that none of the traditional specified methods tend to work well in the instant situation, and one needs to resort to unspecified methods. Further, according to the IRS, "one needs a new approach to valuation, relying less on comparables and more on fundamental financial principles." The IRS attached three economic papers for further consideration.

5. It concluded by stating that, "the IRS position is that the economic result should control: there is in general no legal loophole to avoid full economic compensation, and methods that deny full compensation should be rejected."

B. Action on Decision in *Veritas*

1. The Service announced in an Action On Decision that it will not acquiesce in the result or reasoning in the Tax Court's opinion in *Veritas Software Corp. v. Commissioner*, 133 T.C. No. 14 (2009). The AOD states that the court's factual findings and legal assertions are erroneous.

2. The factual findings disputed by the AOD are that technological advances in the industry made existing products continually obsolete, that pre-existing technology had no ongoing R&D value, and that the Irish subsidiary was responsible for its marketing success largely independent of U.S. assistance. Similarly the court found that the marketing contributions that Veritas U.S. made to Veritas Ireland did not contribute value, but that Veritas Ireland's marketing success was attributable to its newly-hired sales manager, aggressive salesmanship, and savvy marketing. The AOD states that these facts would remove the underpinning of the Service's valuation.

3. The AOD states the Service also sees no legal basis for the court's inference that a "change in the law" is signified by the revenue estimate associated with the Administration's 2010 Budget proposal regarding the intangible status of workforce-in-place, goodwill, and going concern value.

4. The AOD states that the Service will continue to apply an aggregate valuation to interrelated transactions related to a cost sharing agreement where, under the facts and circumstances, such a valuation provides a most reliable measure of an arm's length result.

VIII. Dual Consolidated Loss Issues

A. <u>Application of SRLY Rules to DCLs</u>

1. The Service in AM 2011-002 applied the SRLY rules to a dual consolidated loss (DCL) in respect of which the taxpayer did not file a domestic use election.

2. USP is a domestic corporation that owns all the shares of USS, also a domestic corporation. USP and USS constitute an affiliated group ("the USP group") and file a consolidated federal income tax return.

3. USS owns 100% of the interests in FEX, a resident of Country X for Country X income tax purposes. FEX is treated as disregarded from USS for federal tax purposes. FEX carries on a business operation in Country X that, if carried on by a U.S. person, would constitute a foreign branch within the meaning of Reg. § 1.367(a)-6T(g)(1).

4. USS's interest in FEX constitutes a hybrid entity separate unit within the meaning of Reg. § 1.1503(d)-1(b)(4)(i)(B), and USS's indirect

interest in its share of the business operations conducted by FEX constitutes a foreign branch separate unit within the meaning of Reg. § 1.1503(d)-1(b)(4)(i)(A). These two individual separate units are combined and treated as a single separate unit under Reg. § 1.1503(d)- 1(b)(4)(ii) ("FEX Separate Unit").

5. In Year 1, USS generates $120x of net income that is attributable to the FEX Separate Unit pursuant to Reg. § 1.1503(d)-5. In Year 2, USS incurs a net loss of ($100x) that is attributable to the FEX Separate Unit. USS has no other items of income or loss for Years 1 and 2. The taxable income attributable to the USP group (without taking into account those items of income or loss attributable to the FEX Separate Unit) for Year 1 and Year 2 is $300x and $150x, respectively.

6. The ($100x) net loss attributable to the FEX Separate Unit in Year 2 is a dual consolidated loss ("DCL"). The USP group does not make a domestic use election with respect to the FEX Separate Unit's DCL ("the FEX DCL") under Reg. § 1.1503(d)-6(d), and no other exceptions in Reg. § 1.1503(d)-6 apply. Accordingly, the FEX DCL is subject to the domestic use limitation rule of Reg. § 1.1503(d)-4.

7. The Service also posited an alternative fact pattern in which the facts are the same as above, except that in Year 1 USS generates only $60x of net income that is attributable to the FEX Separate Unit.

8. A DCL is a net operating loss of a dual resident corporation or the net loss attributable to a separate unit (including a foreign branch) Subject to certain exceptions, § 1503(d) and the regulations thereunder prevent the "domestic use" of a DCL. A domestic use of a DCL is deemed to occur when the DCL is made available to offset, directly or indirectly, the income of a domestic affiliate in the year in which the DCL is recognized or in any other taxable year. In addition, a domestic use occurs in the taxable year when the DCL is included in the computation of taxable income of a consolidated group, even if no tax benefit results from such inclusion in that year. Reg. § 1.1503(d)-2.

9. Reg. § 1.1503(d)-4(a) provides that when the domestic use limitation applies, a DCL is subject to the separate return limitation year (SRLY) provisions of Reg. § 1.1502-21(c), as modified by Reg. § 1.1503(d)-4. The SRLY limitation of Reg. § 1.1502-21(c)

incorporates a concept known as the "cumulative register" (or "SRLY register"). Under this rule, the consolidated group may use a SRLYd NOL (subject to several limitations) to offset CTI to the extent that the SRLY member has contributed to the cumulative CTI of the group during consolidated return years.

10. The DCL regulations do not explicitly adopt the cumulative register concept. However, the Service stated that because the DCL regulations fully incorporate the SRLY limitation (except for certain modifications not applicable here), and because the cumulative register concept predates the DCL regulations, the cumulative register concept applies in respect of DCLs subject to the domestic use limitation.

11. Outside of the DCL context, a SRLYd NOL generally cannot be used to offset CTI in the year incurred because, by definition, the loss would have arisen in a separate return limitation year. This practical limitation, however, does not exist in the DCL context since a DCL can arise in any year, including those years when the member is included in a consolidated group.

12. The Service stated that the DCL regulations presume that a domestic use first occurs in the year the DCL is recognized. (Reg. § 1.1503(d)-2 provides that a domestic use is deemed to occur when the DCL is "made available to offset ... the income of a domestic affiliate ... in the taxable year in which the dual consolidated loss is recognized, or in any other taxable year.") This presumption, according to the Service, supports a similar construction of Reg. § 1.1503(d)-4(c). Thus, the language in Reg. § 1.1503(d)-4(c)(2) allowing carryovers or carrybacks of a DCL subject to the domestic use limitation may be interpreted as providing that a DCL may be carried back or forward to the extent that it is not used in the current year. In other words, under the SRLY rules, if a member incurs a DCL after having contributed to CTI in prior years, the DCL may be absorbed currently as an offset to income of domestic affiliates in the year of the DCL (limited by the amount of the member's prior CTI contributions).

13. The Service also stated that allowing the USP group to offset Year 2 CTI with the FEX DCL is consistent with the policies underlying § 1503(d). In general, the DCL provisions are intended to prevent a "double-dip," in which a single economic loss is used to offset two

streams of income —one reported on a U.S. tax return, and one reported on a foreign tax return and not subject to tax in the U.S. Here, this concern is not present because the FEX DCL is in effect only offsetting the FEX Separate Unit's "own" income. That is, the FEX Separate Unit's positive cumulative register ensures that the FEX DCL will only be available to offset CTI to the extent the FEX Separate Unit has contributed to aggregate CTI in previous years. Thus, according to the Service, the policies underlying the rules of Reg. § 1.1503(d)-4 (and the rules of Reg. § 1.1502-21(c)) are satisfied to the extent that, at the time the FEX DCL is absorbed, the FEX Separate Unit has made a corresponding positive cumulative contribution to CTI.

14. Accordingly, the Service stated that the USP group may use the FEX Separate Unit's $100x DCL in determining CTI in Year 2. It is not necessary for the USP group to make a domestic use election under Treas. Reg. § 1.1503(d)-6(d) in order to utilize the FEX DCL . Thus, for Year 2, the USP group has $50x CTI, and the FEX Separate Unit has $20x cumulative register remaining.

15. Under the alternative fact pattern (FEX has $60x of income in Year 1), the USP group may utilize the FEX DCL in Year 2 to the extent of the FEX Separate Unit's cumulative register. Because the FEX DCL exceeds FEX's cumulative register of $60x, only $60x of the $100x DCL may be utilized by the USP group. The remaining $40x of the FEX DCL remains subject to the domestic use limitation rule.

16. Alternatively, the USP group may file a domestic use election for the entire FEX DCL in Year 2, provided that the USP group is otherwise eligible to make the election and the requirements of Treas. Reg. § 1.1503(d)-6(d) are satisfied. However, USP may not file a domestic use election for a portion of the FEX DCL in addition to utilizing the FEX Separate Unit's cumulative register (i.e., by filing the domestic use election only for the remaining $40x of the DCL). The Service stated that domestic use elections apply to the whole DCL and not just a portion thereof. Accordingly, the USP group may utilize the FEX Separate Unit's cumulative register or file a domestic use election for the entire FEX DCL, but not both. The Service further stated that in the event USP filed a domestic use election and was later required to recapture the FEX DCL under

Treas. Reg. § 1.1503(d)-6(h), USP may be entitled to offset the recapture amount by the FEX Separate Unit's cumulative register. Treas. Reg. §§ 1.1503(d)-6(h)(2)(i) and 1.1503(d)-7(c), Example 40.

IX. Subpart F Issues

A. Factoring Income

1. In LTR 201131023 the Service ruled that income from the factoring of receivables is not subpart F income since the receivables themselves would not have produced subpart F income.

2. Taxpayer is a domestic corporation that has a Country B affiliate, Supplier. Supplier’s business receipts are derived from the sales of Products and associated services.

3. Supplier's contracts provide for payment at contractually based “milestones.” For example, a contract may require the customer to pay E% when the contract is signed; F% when Supplier has completed G Amount of the work; H% when Supplier has completed J Amount of the work; and the final K% when title passes to the customer. Upon reaching a milestone, Supplier sends an invoice to the customer, creating a Type L receivable, which is paid by the customer at a later date.

4. Supplier recognizes revenue on the accrual method for financial accounting, in accordance with GAAP. Supplier also uses accrual accounting for tax purposes, and has further elected to defer advance payments under Revenue Procedure 2004-34, 2004-1 C.B. 991. As a result, Supplier's revenue recognition for U.S. tax purposes is largely independent of its contractually based milestones or when its Type L receivables arise.

5. Whenever Supplier's Type L receivables arise before revenue is recognized for U.S. tax purposes, Supplier's Type L receivables will have zero basis for U.S. tax purposes.

6. In order to accelerate the receipt of cash, Supplier often factors its receivables, including its Type L receivables. This factoring is generally done with a related party, as described below, and may result in an acceleration of income to Supplier.

7. Supplier owns Factor, which is treated as a disregarded entity for U.S. tax purposes. Factor factors Supplier's Type L receivables.

Currently, this factoring program has no U.S. tax consequences because of Factor's U.S. tax status as a disregarded entity wholly owned by Supplier.

8. Taxpayer is considering transferring either the Factor business (by way of asset transfer or business migration) or the Factor stock into a separate ownership chain. Whichever form of transfer takes place, the Factor-Supplier factoring activity would cease to be disregarded for U.S. tax purposes as occurring entirely within one entity. Taxpayer nonetheless would like Supplier to continue the factoring program with Factor or its successor.

9. The contracts from which the Type L receivables arise would neither produce foreign base company sales income under § 954(d) nor foreign base company services income under § 954(e). The Type L receivables do not bear interest by their terms, and interest would not be imputed under sections 483 or 1274. The factoring transaction is properly treated for U.S. income tax purposes as a sale of the Type L receivables and not a borrowing.

10. The issue is whether the sale of the Type L receivables to Factor would give rise to foreign personal holding company income under § 954(c). Section 954(c)(1)(B)(iii) provides that FPHCI includes the excess of gains over losses from the sale or exchange of property that does not give rise to any income. "Sale or exchange" is not defined for purposes of section 954(c)(1)(B). Under Reg. §1.954-2(e)(3), the term "property that does not give rise to income" includes all rights and interests in property (whether or not a capital asset) including, for example, forwards, futures and options.

11. The Service framed the issue as whether the factoring of the receivables converts into foreign personal holding company income otherwise non-subpart F income earned by Supplier. It stated that it did not believe that such factoring converts Supplier's income into FPHCI.

12. Rather, according to the Service, any accelerated income received by Supplier as a result of factoring Type L receivables is a substitute for the income it would have collected under the relevant contracts, and should retain the same (non-subpart F) character. *See, e.g.*, *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 265, 78 S.Ct. 691, 694 (1958); and *Prebola v. Commissioner*, 482 F.3d 610, 611 (2d.

Cir. 2007), citing *Watkins v. Commissioner,* 447 F.3d 1269, 1272 (10th Cir. 2006)(the "basic lesson" of the substitute-for-ordinary-income line of cases following P.G. Lake is that "when a party exchanges for a lump sum the right to receive in the future ordinary income already earned or obtained, the amount received serves as a substitute for the ordinary income the party had the right to receive over time" and the lump sum is ordinary income).

B. Section 956

1. In CCA 201106007 the IRS stated that the sale of software by a CFC to U.S. end-user customers does not cause the CFC to hold an investment in U.S. property for purposes of § 956(c)(1)(D). The CFC, pursuant to a cost sharing arrangement with its U.S. parent, held the right to exploit copyrights in the U.S. The U.S. parent developed the software product and transferred the final version, in the form of a "gold master" disc, to the CFC. The CFC reproduced and sold copies of the software to end-user customers in the U.S.

2. "U.S. property" for purposes of § 956(c)(1)(D) includes the right to use intangible property in the U.S. that is acquired and developed by a CFC for use in the U.S. The CCA interprets this provision as defining U.S. property in relation to whether a CFC develops intangible property intended for use in the U.S. or acquires a right to use intangible property in the U.S. It does not interpret this provision as defining U.S. property in relation to whether that right is actually exercised. Accordingly, an investment in U.S. property arises upon the actual acquisition or development of rights to use intangible property in the U.S., not upon the actual use of that intangible in the U.S.

3. The CCA states that the CFC is treated as making an investment in U.S. property under § 956 when it acquires or develops the rights to use copyright rights in the U.S. pursuant to the cost sharing agreement. However, the actual sales of the computer software copies from a CFC to end-user customers in the U.S. do not in themselves give rise to an investment in U.S. property within the meaning of § 956(c)(1)(D). Furthermore, the actual transfer of copies of the software by CFC to the end-user U.S. customers does not affect the calculation of the CFC § 956 inclusion amount, because the CFC does not acquire or develop additional rights (or

relinquish any rights) to use the software in the U.S. as a result of the sale of copies to a U.S. person.

C. CFC/PFIC Status

1. In LTR 201106003 the Service addressed the treatment of a foreign corporation, which was held by a domestic partnership (Partnership X) , as either a controlled foreign corporation (CFC) within the meaning of § 958 of the Code or as a passive foreign investment company (PFIC) within the meaning of § 1287 of the Code. In the ruling the Service respected Partnership X as an entity, and accordingly, the foreign corporation was treated as a CFC, and none of its direct or indirect owners was treated as holding shares in a PFIC.

2. The ruling describes Partnership X, a domestic limited liability company treated as a partnership for U.S. federal tax purposes. Partnership X's members include U.S. individuals and a domestic corporation (collectively, Non-Partnership Members) that each own less than 10 percent of Partnership X. In addition, domestic partnerships (Partnership Members) each own more than 10 percent of Partnership X.

3. Partnership X, through a disregarded entity, owns all of the shares of Corporation B, a foreign entity that is treated as a corporation for U.S. federal tax purposes. Corporation B will earn income that is expected to be passive income within the meaning of Internal Revenue Code ("Code") section 1297(a).

4. Section 1297(d)(1) provides sets forth a PFIC/CFC overlap rule, stating that a corporation is not treated with respect to a shareholder as a PFIC during the qualified portion of such shareholder's holding period with respect to the stock in such corporation. Code section 1297(d)(2) defines "qualified portion" to mean the portion of a shareholder's holding period which is after December 31, 1997 and during which the shareholder is a U.S. Shareholder of the corporation and the corporation is a CFC.

5. The legislative history of Code section 1297(d) provides that the overlap rule was enacted because of a concern about the unnecessary complexity caused by the application of the subpart F and PFIC regimes to the same shareholders. To address this concern, the legislative history to Code section 1297(d) states that "a shareholder

that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally is not subject also to the PFIC provisions with respect to the same stock."

6. As a result of the overlap rule, there can be some flexibility in determining whether the subpart F or PFIC regime applies to shareholdings in a foreign corporation. In the ruling, it appears that the shareholders preferred the CFC regime to apply and sought a ruling on that basis.

7. The facts of the ruling state that Corporation B expects to qualify as a PFIC before application of the overlap rule, presumably because either at least 50% of its assets were expected to be passive or at least 75% of its income was expected to be passive.

8. Despite this the Service gave due regard to Partnership X, the sole owner of Corporation B. Section 957(c) states that, subject to certain exceptions not applicable here, for purposes of subpart F, the term “United States person” has the meaning assigned to it by Code section 7701(a)(30). A domestic partnership is treated as a United States person under Code section 7701(a)(30). Accordingly, Partnership X, the sole owner of Corporation B. is treated as a United States shareholder of Corporation B under Code section 951(b). And because 100% of Corporation B’s voting power and value is owned by Partnership X, Corporation B is treated as a CFC under Code section 957.

9. The Service treated Partnership X as an entity and therefore ruled that Corporation B will not be treated as a PFIC with respect to Partnership X, the Non-Partnership Members or any direct or indirect owner of a Partnership Member pursuant to Code section 1297(d). It stated that Partnership X, a domestic partnership, is a U.S. person within the meaning of Code section 7701(a)(30), and thus as sole owner of Corporation B, is a United States shareholder with respect to Corporation B. Accordingly, Partnership X is subject to the subpart F rules with respect to Corporation B, and neither Partnership X nor any of its members will be subject to the PFIC regime with respect to Corporation B. Accordingly, the Service ruled, Partnership X is subject to the subpart F rules with respect to Corporation B, and will not be subject to the PFIC regime with respect to Corporation B pursuant to the overlap rule.

10. The Service further ruled that the Non-Partnership Members will take into account their distributive shares of Partnership X's income, including any section 951 inclusion with respect to Corporation B. The partners in the Partnership Members will take into account their distributive share of their respective Partnership Member's distributive share of Partnership X's income, including any section 951 inclusion with respect to Corporation B.

11. Therefore, as a result of Partnership X owning 100% of the shares of Corporation B, none of the direct or indirect shareholders of Corporation B were subject to the PFIC regime.

12. The treatment of a domestic partnership as an entity for purposes of determining CFC status is a well established principle in the Code and Regulations. For example, Treas. Reg. § 1.701-2(e) provides that the Commissioner can treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder. However, this rule does not apply if a provision of the Code or Regulations prescribes the treatment o f a partnership as an entity, and this treatment and the ultimate tax results, taking in account all the relevant facts and circumstances, are clearly contemplated by that provision.

13. An example illustrating the operation of this regulation addresses a situation similar to LTR 201106003. In the example, X, a domestic corporation, and Y, a foreign corporation, intend to conduct a joint venture in foreign Country A. They form PRS, a bona fide domestic general partnership in which X owns a 40% interest and Y owns a 60% interest. PRS holds 100% of the voting stock of Z, a Country A entity that is classified as an association taxable as a corporation for federal tax purposes. The example, written before changes in the foreign tax credit rules, states that by investing in Z through a domestic partnership, X seeks to obtain the benefit of the look-through rules of section 904(d)(3) and, as a result, maximize its ability to claim credits for its proper share of Country A taxes expected to be incurred by Z.

14. The example, conducting a similar analysis as LTR 201106003, treats PRS as a United States person under § 7701(a)(30), and therefore as a § 951(b) United States shareholder of Z. Accordingly, the example concludes that Z is a CFC. It states that under the

relevant authorities it is clearly contemplated that taxpayers could use a bona fide domestic partnership to subject themselves to the CFC regime, and the resulting application of the look-through rules of section 904(d)(3). Accordingly, the example states, the Commissioner cannot treat PRS as an aggregate of its partners for purposes of determining X's foreign tax credit limitation.

D. <u>CFC Ownership</u>

1. In ECC 201104034, the IRS outlined considerations for determining whether a holder of foreign corporate stock is a U.S. shareholder under subpart F, referring to rules for construing informal voting power in terms of CFCs. The question was whether a person that transfers nominal or mere title ownership of stock in a foreign corporation could nevertheless be considered under the provisions of subpart F to be a U.S. shareholder of that foreign corporation (which would then be a CFC).

2. The Service, citing the regulations, stated that mere title ownership is not determinative of who holds the voting power of the stock; any arrangement to shift formal voting power away from U.S. shareholders will not be given effect if, in reality, voting power is retained. Treas. Reg. § 1.957-1(b)(2). It cited Treas. Reg. § 1.957-1(c), Example 5, which describes N, a U.S. person owns 50% of the outstanding shares of foreign corporation R, foreign corporation S owns 48% of the outstanding shares, and the remaining 2% are nominally owned by a non-resident alien. However, because the non-resident alien regularly acts as an attorney for N, reduces fees in conjunction with dividends received on the shares, and permits N to borrow against the shares, the example finds an implied agreement for N to "hold dominion" over the stock and the corporation is determined to be a controlled foreign corporation because N "owns" a total of 52% of the stock. This is the case despite the fact that the non-resident alien actually votes his shares at shareholder meetings.

3. The IRS also cited *Garlock v. Commissioner*, 489 F.2d 197 (2d Cir. 1973) and *Koehring Co. v. Commissioner*, 583 F.2d 313 (7th Cir. 1978), in which the courts held that actual, and not formal, voting power is the relevant consideration for determining CFC status.

4. The Service also stated that the Form 5471 filing requirements apply to all U.S. shareholders of a CFC. There is no exception for a person

who is a U.S. shareholder as a result of informal voting power arrangements. Consequently, the statute of limitations and penalty provisions that apply when a U.S. shareholder of a CFC fails to file Form 5471 will apply to an individual who, though not the nominal title owner of shares, is a U.S. shareholder as a result of an informal voting power arrangement.

X. OECD Discussion Draft on Permanent Establishments

A. On October 12, 2011 the OECD issued a discussion draft regarding the interpretation and application of Article 5 (Permanent Establishment) on the OECD Model Income Tax Convention. The draft covers 25 different topics that are not clear in the current Treaty and commentary. Certain of these topics are discussed below.

B. <u>Meaning of “At the Disposal”</u>

1. Paragraphs 4 to 4.2 of the Commentary on Article 5 explain that a place of business may constitute a permanent establishment of an enterprise if that place is “at the disposal” of the enterprise.

2. The main purpose of the PE concept of Art. 5, MTC is to grant taxation rights to the source state with respect to a foreign enterprise which is performing substantive activities and functions requiring a permanent physical presence. Art. 5, par. 1, MTC has always properly been interpreted to require some degree of physical presence, some type of fixed place of business at its disposal. For example, a general contractor subcontracting all of its work never has this kind of physical presence at its disposal.

3. The case of a company buying goods under a toll manufacturing agreement or contracting services, for example, could become problematical if the definition of “at disposal of” includes “at the direction of.” The drat states that if this were the rule, the existence of a permanent establishment would, in most business arrangements, become the rule instead of the exception. The Committee, instead, suggests that “at the disposal of” requires that an enterprise can make use of a place to the extent and for the duration it chooses to pursue its own business plan and activities and at the exclusion of the resident enterprise if necessary.

4. The Working Group concluded that it cannot be considered that a plant that is owned and used exclusively by a supplier or contract-

manufacturer is at the disposal of an enterprise that will receive the goods produced at that plant merely because all these goods will be used in the business of that enterprise

5. The following example was treated as constituting a permanent establishment. CLIENTCO, a resident of State S, has concluded a contract with Peter under which Peter provides training to CLIENTCO‘s staff in State S over a 20 month-long period. During that period, the work is undertaken at CLIENTCO‘s headquarters located in a series of office buildings located in a large estate in State S. In these buildings, Peter meets employees in their respective offices and is allowed to use 10 various training rooms, located throughout the complex, where group training sessions take place. When these rooms are not in use, Peter is allowed to use them for preparing his courses (the rooms have internet connection). Peter is given a security card allowing him unrestricted access to the buildings located in the estate during business hours. His contract requires him to use CLIENTCO‘s facilities exclusively for the purposes of the contract.

C. Home Office

1. This issue is whether an individual‘s home office (i.e. an office located in an individual‘s own home) would constitute a permanent establishment of the enterprise for which the individual works.

2. The Working Group states that even though part of the business of an enterprise may be carried on at a location such as an individual's home office, that should not lead to the automatic conclusion that that location is at the disposal of that enterprise simply because that location is at the disposal of an individual (e.g. an employee) who works for the enterprise.

3. Instead, whether or not a home office constitutes a location at the disposal of the enterprise will depend on the facts and circumstances of each case. In many cases, the carrying on of business activities at the home of an individual (e.g. an employee) will be so intermittent or incidental that the home will not be considered to be a location at the disposal of the enterprise.

4. Where, however, a home office is used on a regular and continuous basis for carrying on business activities for an enterprise and it is clear from the facts and circumstances that the enterprise has

required the individual to work from home (e.g. by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office), the home office may be considered to be at the disposal of the enterprise.

5. A clear example, according to the Working Group, is that of a non-resident consultant who is present for an extended period in a given State where she carries on most of the business activities of her own consulting enterprise from an office set up in her home in that State; in that case, that home office constitutes a location at the disposal of the enterprise. Where, however, a cross-frontier worker performs most of his work from his home situated in one State rather than from the office made available to him in the other State, one should not consider that the home is at the disposal of the enterprise.

D. <u>Duration of Activity</u>

1. The Working Group did not come to a definitive conclusion, but stated that that experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months).

2. One exception to this general practice has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). That exception is illustrated by the following example. An individual resident of State R rents a stand at a commercial fair in State S for 15 consecutive years where he sells sculptures during a period of five weeks each year. In that case, it could be considered that the time requirement for a permanent establishment is met due to the recurring nature of the activity regardless of the fact that any consecutive presence lasts less than 6 months.

3. Another exception to this general practice has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration

because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. Examples are as follows:

(a) An individual resident of State R has learned that a television documentary will be shot in a 17 remote village in State S where her parents still own a large house. Since the documentary will require the presence of a number of actors and technicians in that village during a period of four months, she decides to transform the house of her parents into a small restaurant which she will operate as sole proprietor during that period. These are the only business activities that she has carried on and she does not intend to carry on such activities in the future; the restaurant will therefore be the location where the business of that enterprise will be wholly carried on. In that case, it could be considered that the time requirement for a permanent establishment is met since the restaurant is operated during the whole existence of that particular business.

(b) This would not be the situation, however, where a company resident of State R which operates various catering facilities in State R would operate a cafeteria in State S during a four week international sports event. In that case, the company's business, which is permanently carried on in State R, is only temporarily carried on in State S.

E. Secondment Arrangements

1. The discussion draft provides some helpful commentary regarding situations where the foreign enterprise's personnel are present in the host country.

2. The drat states that there may be cases where individuals who are formally employed by an enterprise will actually be carrying on the business of another enterprise and where, therefore, the first enterprise should not be considered to be carrying on its own business at the location where these individuals will perform that work. Within a multinational group, it is relatively frequent for employees of one company to be temporarily seconded to another company of the group and to perform business activities that clearly belong to the business of that other company. In such cases,

administrative reasons (e.g. the need to preserve seniority or pension rights) often prevent a change in the employment contract.

3. The practical situation in which this issue was most likely to occur is the case where an employee of a company that belonged to a multinational group is temporarily seconded to work for another company of the group. In many cases, the secondment would be done without a formal contract between the two enterprises but, to avoid transfer pricing issues, a cost-plus charge might be paid to the first company. This, according to the working group, could have the "unfortunate consequence" that the services rendered by the employee might be considered to be provided by the first company to the second company, which would create the risk that the first company would be found to have a PE in the premises of the second company. The working group believed that this case should be distinguished from other cases where employees of a foreign enterprise perform that enterprise's own business activities.

F. Meaning of "to Conclude Contracts in the Name of the Enterprise"

1. The working group addressed the following issue: Does the phrase "to conclude contracts in the name of the enterprise" only refer to cases where the principal is legally bound vis-à-vis the third party, under agency law, by reason of the contract concluded by the agent, or is it sufficient that the foreign principal is economically bound by the contracts concluded by the person acting for it in order for a permanent establishment to exist (provided the other conditions are met)?

2. The working group addressed "commissionnaire" situations based on recent court decisions on in France (*Zimmer Ltd*., no PE) and Norway (*Dell DUF*, yes PE). The group, consistent with the divergent opinions of the above cases, did not reach a common view as to whether a commissionnaire situation constituted a PE.

3. The working group also examined comments the following three situations: (i) when a multinational group's contracting policies require multiple personnel in an organization to approve contracts, not all of whom may be employees of the enterprise being bound; (ii) when contracts are in a standard form for all customers (e.g., online contracts) so that no negotiation occurs when the contracts are formed; (iii) when sales are governed by a framework contract

applicable to all group companies and there follows specific purchase orders in which various personnel are able to conclude contracts for specific entities within the framework agreement.

(a) It was suggested that in cases (i) and (ii), as long as sales contracts were concluded in the name of a foreign enterprise, the extent to which the person concluding these contracts (e.g. by accepting an order) was using standard contracts or was constrained by a framework contract would not seem to matter.

(b) With reference to case (iii), one delegate indicated that his administration had dealt with a similar situation and had concluded that the acceptance of the order was the conclusion of the contract. It was clarified that this was done when the final nature and quantity to be delivered under the framework agreement was determined under a specific purchase order.

(c) As regards case (i), it was suggested that the Treaty (Article 5(5)) referred to the level of approval that was decisive for the contract to be legally concluded, subject to the comments in paragraphs 32.1 to 33.1 of the Commentary.

(d) The working group agreed that these three cases raised questions of facts and that the Commentary already provided enough guidance to deal with them

G. The working group recommended that the types of contracts referred to in Art. 5(5) not be restricted, to contracts for the sale of goods: the paragraph would cover, for example, a situation where a person has and habitually exercises an authority to conclude leasing contracts or contracts for services.

XI. Source and Character of Services and Royalty Income--*Goosen v. Commissioner*

A. In *Goosen v. Commissioner*, 136 T.C. No. 27 (2011), the Tax Court addressed a number of important source and character issues involving endorsement income of a professional golfer. The case also demonstrates the importance of allocation of consideration in the underlying contract.

B. The Petitioner, a professional golfer entered into a number of endorsement agreements with sponsors. Some endorsements involved Petitioner’s on-course activities and required him to play in a minimum number of tournaments. Other endorsements were contractually unrelated to his on-course play. The Petitioner allocated his fees between two corporations, one of which represented his U.K-source income and the other of which represented other income.

C. Character of Income

1. The court only examined the character of endorsement income from the on-course endorsement agreements since the parties agreed that off-course endorsement income was a royalty.

2. The on-course endorsement agreements granted sponsors the right to use petitioner's name and likeness for advertising and promotional materials worldwide. Petitioner also agreed to wear or use the sponsors' products, make promotional appearances and participate in photo and filming days. The sponsors stated that they valued the petitioner's character and persona and also his play at tournaments. The endorsement agreements failed to allocate the endorsement income between services and the right to use petitioner's name and likeness. The court found that that 50 percent of the endorsement fees petitioner received represented royalty income and 50 percent represented personal services income.

D. Source of Royalty Income

1. Here, petitioner granted his sponsors the right to use his name and likeness worldwide. The contracting parties agreed to source 25 percent to the United Kingdom and 75 percent to rest of the world. Because they didn't specify how the income should be sourced to the United States, the court could not accept their their sourcing allocation for purposes of determining U.S.-source royalty income.

2. Courts have generally allocated all the royalty income to the United States if the contracting parties failed to make a reasonable allocation, unless the taxpayer can show there is a sufficient basis for allocating the income between U.S. and foreign sources. A sufficient basis exists when a taxpayer establishes that he or she has property rights outside the United States and furnishes evidence on the value of those rights.

3. Petitioner established that he owns the rights to his name and likeness outside the United States and that those rights have value.

Accordingly, the Court determined the value of those rights by examining where the sponsors actually used petitioner's name and likeness. Petitioner's name and likeness were used in magazine and newspaper advertisements, commercials, websites and other promotional materials. The parties presented little statistical evidence on the use of petitioner's name and likeness. The court therefore looked at all the facts and due to Petitioner's global profile concluded that it would be unreasonable to source all the royalties to the United States. Taking into account all the evidence, including the fact that the U.S. is the largest golf market in the world, the court stated that it was in its best judgment that 50 percent of the royalty income petitioner received was U.S.-source income.

E. Whether Income Was ECI

1. Because Petitioner did not maintain an office or fixed place of business in the U.S., the court concluded that Petitioner was not subject to U.S. income tax on his foreign source income. The parties agreed that petitioner's personal services were effectively connected with petitioner's golf play, and that the U.S.-source income earned playing golf is taxed at regular graduated rates.

2. As for royalties from on-course endorsement agreements, the court stated that petitioner's income was ECI since his participation in a golf tournament was material to receiving income for the use of his name and likeness. It therefore found that such income is effectively connected with a U.S. trade or business, and petitioner will be subject to the graduated tax rates applicable to U.S. residents.

3. Royalties from off-course endorsement agreements were not ECI since they did not require petitioner to be physically present in the United States. Accordingly, the court held that a flat 30-percent tax is imposed on petitioner's gross U.S.-source royalty income from the off-course endorsement agreements.

F. Application of US-UK Treaty

1. The U.S.-U.K. Tax Treaty provides that the United Kingdom will tax a U.K. resident, non-domiciliary on non-U.K. source income only to the extent the income is remitted to or received in the United Kingdom.

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2. Petitioner's sponsors wired their payments to ESP's (U.K. income) bank account in Liechtenstein. In addition to his endorsement income, ESP (U.K. income) received on petitioner's behalf significant amounts of prize money, bonuses, non-U.S. royalties and appearance fees. ESP (U.K. income) paid petitioner a salary and a bonus that were based on the total amount deposited into the ESP (U.K. income) bank account in Liechtenstein. Petitioner submitted statements from his U.K. bank account showing transfers from ESP (U.K. income) into his U.K. bank account of £495,206 in 2002 and £12,500 in 2003. Petitioner did not establish, however, whether these salary and bonus payments constitute endorsement income or another type of income.

3. Accordingly, the court held that Petitioner failed to meet his burden of proving that endorsement income ESP (U.K. income) received on his behalf has been remitted to or received in the United Kingdom. As such, the court held that petitioner is not eligible for benefits under the U.S.-U.K. tax treaties

XII. Worthless Stock Loss/Bad Debt Deduction

A. In AM 2001-003, the Service took the curious position that the conversion of an insolvent corporation into a partnership did not give rise to a bad debt deduction under § 166 despite decades of precedent to the contrary.

B. The AM posits two fact patterns. In Situation 1, X, a domestic corporation owns all of the stock of Y, a foreign corporation. X owns 80% of Z, a foreign corporation, and Y owns 20% of Z. The fair market value of Z’s assets is $100; the basis of Z’s assets is $120; Z has $110 of liabilities, all of which are owed to X; X’s basis in its Z stock is $100; Y’s basis in its Z stock is $30. Z makes a check-the-box election to be treated as a partnership. The facts of Situation 2 are the same as Situation 1, except that all of Z’s liabilities are owed to a third party.

C. The Service, citing, among other authorities, Rev. Rul. 2003-125, concluded that X and Y are entitled to § 165(g) worthless stock losses because the assets of Z were insufficient to cover its liabilities, leaving nothing to distribute in respect of its stock.

D. However, in a departure from its longstanding position, the Service did not conclude that X could claim a bad debt deduction under § 166. Its sole line of reasoning was that the full amount of the liability is treated as surviving the liquidation and being contributed to the newly formed partnership.

E. This view contradicts the decades-long position of the Service and caselaw, which hold that a § 166 deduction is available under these circumstances. See, e.g., Rev. Rul. 2003-125; Rev. Rul. 70-489; Rev. Rul. 59-296; CCA 200706011; LTRs 9425024 and 8801028; and *Glenmore Distilleries Co. v. Commissioner*, 47 BTA 123 (1942), acq. 1942-2 C.B. 8.

F. The Service seemed to indicate that a bad debt deduction would be available had the worthless subsidiary elected to be treated as a disregarded entity as opposed to a partnership.

XIII. Miscellaneous

A. *Crack-Down on GRA Compliance*. An IRS official was reported as stating that inaccurate reporting by companies on gain recognition agreements is akin to turning in a blank sheet of paper. According to Jeffrey Johnson, international technical adviser, IRS Large Business and International Division, although there is some leniency on the accuracy of figures related to fair market value in a GRA, there is no excuse for having inaccurate basis figures. Further, the Service treats a GRA as not filed if figures are "available upon request." LMSB-04-0510-017, issued in July 2010 provides temporary procedures to amend a GRA that that IRS deems deficient. See 2011 TNT 15-17.

B. *Final Regulations under § 904(d)*. Final regulations were issued addressing the reduction in § 904(d) categories to two (general and passive) baskets, general and passive. The final regulations largely match the previous temporary regulations.

C. *Final Killer B Regulations*. The temporary regulations shutting down repatriations when a foreign subsidiary paid cash for stock of the U.S. parent to effect a triangular reorganization were finalized. The final regulations are at Treas. Reg. § 1.367(b)-10 (the temp regs had been at § 1.367(b)-14.

D. *Validity of Regulations*. In *Mayo Foundation for Medical Foundation and Research v. United States*, ___U.S. ___ (2011), the Supreme Court, among other things addressed, whether it should apply *Chevron* deference to a government agency's regulation or rather the multi-factor analysis used to review a tax regulation set forth in *National Muffler. Chevron* recognized that an agency's power "to administer a congressionally created …program necessarily requires the formulation of policy and the making of rules to fill any gap left … by Congress." The court held that absent justification to do so, "[t]his court is not inclined to apply a less deferential framework to evaluate Treasury Department regulations than it uses to review rules adopted by any other agency." Accordingly, the ruling confirms that *Chevron* deference applies to tax regulations.