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TO MOVE DIRECTLY TO AN ARTICLE CLICK ON THE TITLE

TABLE OF CONTENTS

PART 2
PRACTITIONER'S CORNER:

Part 3
Committee on Government Submissions:

- Comments Pertaining to The Texas Comptroller's Proposed Rule 3.13 Relating to Timely Filing and Payment
  January 29, 2015
  Charolette Noel, Jones Day
  Ira Lipstet, Dubois, Bryant & Campbell, LLP

- Comments on Texas Department of Insurance Draft Rules Regarding Professional Employer Organizations and Self-Funded Health Benefit Plans
  January 7, 20115
  James Griffin, Jackson Walker LLP
  Henry Talavera, Polsinelli PC

- Comments on Proposed Texas Comptroller Rule 3.286 (Sales & Use Tax Responsibilities and Nexus)
  December 19, 2014
  Charolette Noel, Jones Day
  Alyson Outenreath, Texas Tech University School of Law

- Comments on Proposed Texas Comptroller Rules 3.280 (Aircraft) and 3.285 (Sale for Resale)
  December 3, 2014
  Charolette Noel, Jones Day
  Alyson Outenreath, Texas Tech University School of Law

<u>Nuts and Bolts of Representing Taxpayers Facing Trust Fund Recovery Penalty Assessments</u>[1]

Rachael E. Rubenstein[2]

I. Background

a. What are Trust Fund Recovery Penalty Assessments?

- Under IRC 6672, individuals involved in a business can be held **personally liable** for the **entity's failure** to properly **collect and remit employment taxes**.
- This individual assessment takes the form of a penalty equal to **100% of the unpaid trust fund taxes** for each quarter.
- Several persons may be held jointly and severally liable.

b. Trust Fund Taxes Defined

- Employers are generally required to withhold **Federal Income taxes** and Federal Income Contributions Act (**FICA**) **taxes** from their employees' wages, match the FICA withholding and remit the aggregate amount to the Service quarterly. IRC § 6157.
- The **FICA taxes**, also known as "**employment taxes**," are credited towards future **Social Security** and **Medicare** benefits for employees.
- The **employees' portion of these taxes** as well as any **withheld Federal Income Taxes** are termed "**trust fund taxes,**" as the employer is required by law to hold the taxes "in trust" for the United States until it remits them quarterly.

c. IRC § 6672 Statutory Requirements

- In order for an individual involved in the business to be held liable under section 6672, she must be "**responsible**," having the duty to withhold and remit the trust fund taxes, and she must have "**willfully**" failed to collect and pay over the tax due. *Godfrey v. United States*, 748 F.2d 1568 (Fed. Cir. 1984).

d. Who May be Deemed a <u>Responsible Person</u> for Purposes of IRC § 6672 Liability?

- Any officer, employee, or member of an entity who had a duty to withhold and remit the taxes. *See* IRC § 6671(b).

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[1] In addition to the author's litigation experience, much of the material for this presentation came from Chapter 16, *Defending the Trust Fund Recovery Penalty— Section 6672* by Larry A. Campagna, Heather M. Pesikoff, and Susan M. Earley from the 5th and 6th (unpublished) editions of EFFECTIVELY REPRESENTING YOUR CLIENT BEFORE THE IRS, an ABA Section of Taxation publication edited by Keith Fogg. Additional resources used were published cases, materials from the State Bar of Texas Tax Section's 2014 Advanced Tax Law CLE*,* Chapter 17*, Collection From Nontaxpayers—Transferee Liability, Part B Collection of Taxes from Withholding Agents* in IRS PRACTICE & PROCEDURE by Michael I. Saltzman and Leslie Book (2013), and Part 5 Collecting Process, Chapter 7 Trust Fund Compliance of the Internal Revenue Manual (IRM).

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- Essentially, a responsible person is one who had the "status, duty, and authority" to control company decision making and the disbursement of company funds. *See Godfrey,* 748 F.2d at 1576.
- It's a test of substance, not form; meaning title alone is not determinative of status, duty, and authority. *Cook v. United States*, 52 Fed. Cl. 62 (2002).

Responsible Person Factors

Fact intensive inquiry – Courts have developed many factors to determine whether someone is deemed "responsible" under IRC 6672, including whether the person:

- made financial decisions regarding the company;
- signed company checks;
- prevented the issuance of checks by denying a necessary signature
- controlled disbursement of payroll;
- prepared payroll tax returns/made tax deposits;
- was active in the management of the day-to-day affairs of the company;
- made decisions regarding which debts were paid first;
- was an officer or member of the board of directors;
- owned a share of the company;
- controlled voting stock; and
- had the ability to hire and fire employees. **List is not exhaustive**

e. Willfulness Element

- Liability under IRC § 6672 <u>also requires</u> a "willful fail[ure] to collect such tax, or truthfully account for and pay over such tax."
- A responsible person acts willfully by making a "voluntary, intentional, and conscious decision" not to collect or pay the trust fund taxes. *Godfrey*, 748 F.2d at 1577.
- Does not require malicious intent to defraud government.
- Reckless disregard of duty to collect and remit taxes can satisfy willful prong.
    - More than mere negligence.

Willfulness Tests

- 1) Was a responsible person aware that the taxes were unpaid, possessed the power to pay them with company funds and instead used these funds to pay another creditor before the IRS? <u>or</u>

- 2) Was a responsible person's actions (or inactions) "grossly negligent" or in "reckless disregard" of the fact that the taxes were due and would not be paid?

II. TFRP Assessments, Small Businesses & The Great Recession

- From 2007 through 2009, the number of businesses with employees declined from 6,050,000 to 5,904,000—**a loss of 146,000 employer businesses**. Virtually all of the disappearing companies were small businesses because, according to the SBA, small businesses make up 99.7 percent of all employers in this country.[3]
- Small businesses disproportionately felt the effects of the recession, which negatively impacted their viability, growth, employment, and access to credit. These measurable effects lasted through 2012, well into the economic recovery period.[4]
- When businesses experience financial hardship, their creditors often go unpaid. Accordingly, many struggling companies fail to pay employment taxes, perhaps not fully understanding that such failures, unlike defaulting on other types of business debts, often result in personal liability for unpaid trust fund taxes officers or members of the business, regardless of the structure of the business with respect to limited liability.
- From 2006 – 2011, TFRP assessments were at their highest levels, over 4 million for each of these years.[5]

Example from Construction Industry

- Bob's Home Rehab established by a married couple, Bob and Nancy Smith in 2005 purchased distressed properties, renovated them, and then sold them to individuals or investors. Bob handled the purchasing decisions and oversaw the construction crews. Nancy managed the office with the help of her niece, Liz, who was responsible for most of the business bookkeeping responsibilities, including payroll. All three had check signing authority on the company bank account, but Bob and, sometimes, Nancy made the big financial decisions for the business. In addition, they had a small staff of 5-7 full-time employees as well as numerous independent subcontractors hired for each renovation job.
- When the recession hit, Bob struggled to maintain stable financing for purchasing homes and remodeling supplies. Buyers for the properties they did manage to renovate were scarce. Bob's Home Rehab continued to withhold employment taxes as required but by the time the quarterly payments were due, there was never enough money in the bank account to pay IRS. Other creditors also went unpaid and the business rapidly declined. Hot checks were written to several suppliers and

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[3] Scott Shane, *The Great Recession's Effect on Entrepreneurship*, FEDERAL RESERVE BANK OF CLEVELAND (Mar. 24, 2011), http://www.clevelandfed.org/research/commentary/2011/2011-04.cfm

[4] Elizabeth Laderman, *Small Businesses Hit Hard by Weak Job Gains*, FEDERAL RESERVE BANK OF SAN FRANCISCO (Sep. 9, 2013), http://www.frbsf.org/economic-research/publications/economic-letter/2013/september/small-business-job-growth-employment-rate/

[5] Internal Revenue Service, *SOI Tax Stats - Civil Penalties Assessed and Abated, by Type of Tax and Type of Penalty - IRS Tax Stats Table 17*, http://www.irs.gov/uac/SOI-Tax-Stats-Civil-Penalties-Assessed-and-Abated-by-Type-of-Tax-and-Type-of-Penalty-IRS-Tax-Stats-Table-17 (last visited Nov. 8, 2014).

contractors went unpaid, eventually contractors foreclosed materialmen's liens on the remaining homes.

- Bob and Nancy shut down the business in late 2008. The couple was left with no savings and only a few personal assets jointly owned. Bob went to work as a manger for a large retail supply store, and Nancy found a part-time job as a receptionist. Liz went back to community college full-time. The stress resulted in a separation for Bob and Nancy. By this point, almost a year had passed since any employment taxes were paid and the IRS was sending threatening letters. In early 2009, after each was interviewed, the IRS proposed individual TFRP assessments against Bob, Nancy, and Liz of approximately $23,000 each.

- Who should be held liable for the TFRP?

III. <u>General Advocacy Tips for Challenging TFRP Assessments</u>

a. Case Planning *(each will be discussed in separate paragraph)*

- ***Gather Evidence***
- ***Look at Controlling Case Law in Jurisdiction***
- ***Analyze Law & Facts***

Evidence Gathering

- Entity Formation Documents
- Written Agreements Among Principals
- Records of Business Income and Expenses (Electronic & Paper)
- Bank Statements
- Federal and State Employee/Payroll Records
- Tax Returns and Other Tax Filings/Records (Personal & Business)
- Loan Documents
- Public Filings with Secretary of State or County
- Filings with any Licensing Agencies
- Credit Reports
- Emails and Other Written Communications Among Principals
- Complete a Preliminary IRS Collection Information Statement
- If Post Assessment Representation, Request all Information Related to Assessment of Client and Other Responsible Persons via a FOIA.

Research Precedent in Various Jurisdictions

- There are almost 4,000 cases that reference IRC § 6672.

- Cases are extremely fact intensive and therefore case law varies greatly – sometimes even within the same jurisdiction.
- Various appellate jurisdictions do not give equal weight to the factors mentioned above.
    - Ex: Under Fifth Circuit precedent, check signing authority alone is essentially dispositive as to the question of whether someone is a "responsible person." *See, e.g.*, *Howard v. United States*, 711 F.2d 729 (5th Cir. 1983).
- Some jurisdictions permit the taxpayer to utilize reasonable cause arguments as a way to avoid liability, others do not.

Analyze Law & Facts

- Develop Case Theory & Arguments
- Ex: Liz was not a responsible person as defined in IRC § 6672. She was simply the bookkeeper for Bob's Home Rehab. She has a high school degree and has completed only one year or community college. Her bookkeeping knowledge comes from her training with Nancy. She trusted her aunt and uncle with regard to their business decisions and respected their authority at the office. Despite her ability to sign checks and her responsibility to keep company records and handle payroll, she never exercised any independent judgment over which creditors to pay over others. Liz did what she was told and had no authority to pay any bill, including IRS bills, unless directed to do so. She had no ownership interest in Bob's Home Rehab and was not involved in hiring, nor firing, employees or contractors.
    - **Practice tip**: Even if main argument is that the taxpayer is not a responsible person, it's still a good idea to include fact and argument related to willfulness element.
        - Example: *Assuming arguendo* Liz is a responsible person, her actions/inactions were not willful because she had no control over decisions regarding the order in which creditors were paid. Bob as the owner of the business made all such decisions.

b. Potential Arguments Against Client's Status as "Responsible Person"

- Although client may have paid creditors, handled payroll, and dealt with tax returns/deposits, he/she acted under the direction of a boss or principal decision maker.
- Client was a minority shareholder and did not control voting stock/rights.
- Client was an investor/partner etc. but had no involvement in day-to-day operations.
- Client was not a key player in ultimate financial decisions of the company.
- Client did not control the finances.
- Client may have had check signing authority but never exercised it.
- At the time period at issue, client had lower level of responsibilities/duties.

Return to Table of Contents

- Client was consulted about strengths and weaknesses of applicants but did not actually make any hiring or firing decisions.

c. Potential Arguments Against Client's Status as "Willful"

- Client had no knowledge that the taxes were owed/not paid.
- Client's actions or inactions were negligent, not reckless.
- Client did not make decisions about which creditors to pay over others.
- There was no money available to pay the IRS when the quarterly employment taxes were due.

IV. <u>TFRP Service Level Procedures & Challenges to Assessment</u>[6]

a. IRS Assessment Procedures & Pre-Assessment Strategies *(each will be discussed in separate paragraph)*

- ***Notices to Business***
- ***Revenue Office (RO) Investigation of Individuals***
- ***Proposed Assessment Letter (60 Day)***
- ***IRS Appeal Rights***
- ***Assessment***

Notices to Business

- Federal Tax Deposit (FTD) Alerts & Notice: Service has a program to identify businesses delinquent on employment tax deposits or filing requirements and refers the business names to local offices for follow-up.
  - Local office sends the business FTD Alter Notice.
- If unanswered, Revenue Officer (RO) is assigned to business for full investigation into compliance problems. RO attempts to get company into compliance.
  - Form 930 Possibly Sent to Business: directs employer to set-up special trust account for deposit of employment taxes.
  - If business cannot get into compliance, next step is investigation of potentially responsible persons for assessment of individual liability.

RO Investigation of Potentially Responsible Individuals

- RO will examine bank records and other records of the company.
  - May use administrative summons power to get needed records.
- Letter 3586 from RO sent to potential responsible persons (or witnesses) setting a meeting.

[6] *See generally* I.R.M. 5.7.

- Informs individual that purpose of meeting is to discuss duties and responsibilities as an officer or employee of business in default for specified tax periods.
- Informs individual that he/she may bring representative.
- Requests individual bring records such as:
  - bank/signature cards
  - Cancelled checks
  - Bank Statements
  - Meeting minutes
  - Other company records
- Included with letter is Notice 784, *Could You Be Personally Liable for Certain Unpaid Federal Taxes* and directs individual where he/she may obtain a copy of IRC 6672.

- Interview of Officers and/or Employees
  - RO will use Form 4181, *Questionnaire Relating to Federal Trust Fund Tax Matters of Employer*, for potential witnesses who have information against parties likely to be assessed TFRP(s).
  - RO will use Form 4180, *Report of Interview with Individual Relative to Trust Fund Recovery Penalty*, during interview of person likely to be assessed a TFRP.
    - This form is very important for both the taxpayer and the government in these cases, thus **great care should be exercised regarding completing the form during the interview, and signing it at the conclusion of the interview**.
    - Representative may advise the taxpayer not to complete the Form 4180 during an interview at IRS office.
      - Depends on the facts of case, relationship with appeals officer, and likely perceptions regarding the specific taxpayer.
    - Representative can offer to complete form with the taxpayer outside presence of RO, although RO may not accept this suggested approach.
    - If completed during interview, the taxpayer will be asked to sign interview form under penalties of perjury.
      - **No requirement to sign**.
  - An authorized representative can attend the interview along with the taxpayer, **or on behalf of the taxpayer**.
    - RO cannot compel client attendance unless administrative summons.

        - Representative can provide necessary documents and other information as requested.
    - After conclusion of investigation RO will decide whether to proceed with proposed assessment, which requires manager approval.

Proposed Assessment Letter

- RO sends Letter 1153, which proposes assessment of penalty under IRC 6672 for specified tax periods. The letter contains the following information:
    - Individual may agree to assessment by signing an enclosed Form 2751.
    - Individual has IRS Appeal rights if a protest (formal or informal) is filed within **60 days**.
    - Individual has right to have an authorized representative participate in the appeal process.
    - Individual has right to court review with and without a special bond in the event the individual disagrees with the decision reached by IRS Appeals.

IRS Appeal Rights: Challenging the TFRP Pre-Assessment

- **File a protest within the 60 day period** challenging the assessment, which sets out factual and legal arguments against the imposition of the TFRP.
- Include any relevant **documentary evidence that supports your case**, including records and affidavits as warranted.
    - Letter 1153 will have specific directions regarding what information the IRS is looking for in the TFRP protest.
    - **Practice tip:** since the vast majority of these type of assessments will exceed $25,000, pay special attention that the protest contains all the <u>necessary statements needed in a formal written protest</u>.
- <u>Conference will occur with Appeals Officer</u>
    - Appeals Officer will send Letter 4141 explaining appeals process, which will be followed by another letter setting time, date, and location of conference.
    - Second appeals letter may contain a statement of preliminary findings in response to the protest containing law and fact analysis.
    - Any additional materials for appeals to consider should be sent at least 5 days before the scheduled conference.
    - **Conference is informal** and representative may again decide with taxpayer **whether the taxpayer's presence is a good idea**.
    - During the conference, or soon after, may be an appropriate time to consider submitting a **qualified settlement offer** under IRC § 7430.
- After the conference, appeals will send a letter **either sustaining the original proposed TFRP, accepting the proposed settlement, or offering a hazards of litigation settlement**.

Return to Table of Contents

    - Usually given approximately one week to decide whether to accept appeals settlement offer.
    - If Appeals does not receive a response or no agreement can be reached, the case will be returned to the Collection Area Director for assessment.
    - Appeals Officer will send a final letter informing the taxpayer of the assessment decision and advising full payment.
        - The letter also outlines claim for refund procedures and options for court review (with or without payment of bond).

- **Practice Tip:** Mediation may be available while case is still in Appeals if settlement discussions are unsuccessful. *See* Rev. Proc. 2014-63. A written request for mediation must be sent to the appropriate Appeals Team Manager. *Id.*
- Note – interest will not begin to accrue on any TFRP amounts until the formal assessment occurs, so exercising appeal rights has the benefit of postponing interest charges.

Assessment

- The taxpayer is notified of the assessment when he/she receives the first bill for the unpaid penalty, which indicates the Employer Identification Number (EIN) associated with the unpaid taxes, tax form (941), tax period, and amount due.
- If more than one tax period is assessed, a separate bill will likely be sent for each tax period.
- If the bill goes unpaid after approximately 20 days, interest will begin to accrue.

b. **Challenging the TFRP Post-Assessment** *(each will be discussed in separate paragraph)*

- ***IRS Appeals***
- ***Traditional Collection Alternatives***
- ***Administrative Refund Claims***

IRS Appeals

- If appeals rights were not exercised pre-assessment, taxpayer will still likely have opportunity to go to IRS Appeals post-assessment by filing a refund claim.
- Appeals is an important step for exhausting administrative remedies.

Traditional Collection Alternatives

- **Offers In Compromise (OICs)**, **Installment Agreements (IAs)**, **Partial Payment Installment Agreements (PPIAs)** and even **Currently Not Collectible (CNC)** may be suitable in certain cases.
    - Most appropriate if taxpayer is low-moderate income with limited to no assets.

- o Ultimately, these options be most time/cost efficient method for handling TFRP assessments.

- If taxpayer still wishes to address issue of underlying liability but appeal rights have passed, consider the option of an **OIC Doubt as to Liability**.
  - o If unsuccessful, taxpayer does have administrative appeal rights and, also, may generally still file a refund claim/suit.
  - o But keep in mind that the passage of time tends to have a negative effect on the preservation of evidence and availability of witnesses.

Administrative Refund Claims[7]

- Administrative refund claim is a prerequisite to court review. **Two step process for taxpayer:**
  - o 1) Taxpayer must first pay a "divisible" amount of the penalty for each assessed quarter to IRS.
  - o 2) Taxpayer requests a refund of amount(s) paid and abatement of the TFRP assessment(s).
- Service may either respond with a Notice of Disallowance or take no action.
- Upon receipt of Notice of Disallowance or the passage of 6 months with no response, refund suit can filed.
- Refund SOL requires the refund suit to be filed within 2 years of payment.
- **Practice Tip**: Any payments made should include specific instructions to the IRS regarding how the payment(s) should be credited.

d. Divisible Tax Doctrine

- A TFRP assessment represents a cumulation of separate employee assessments, thus any portion of the TRFP assessment attributable to the failed remittance for a single employee is considered a divisible tax.
- Under this doctrine, taxpayer may pay a **portion of the withholding taxes attributed to a single employee** to form the basis of a refund suit. *See Steele v. United States*, 280 F.2d 89 (8th Cir. 1960); *Boynton v. United States*, 566 F.2d 50 (9th Cir. 1977).
- Exception to the *Flora* full payment rule for refund suits.
- **Practice Tip**: This divisible portion should be paid for each quarter assessed to mitigate potential challenges later to jurisdiction and forum choice.

V. TFRP Refund Litigation

a. Where to File the Suit

- Two options for refund litigation: [8]

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[7] *See generally* I.R.C. § 7422 (Civil Actions for Refund); Treas. Reg. § 301.6402–2 (Claims for Refund).

- 1) Local **United States District Court** where taxpayer resides, or
- 2) **United States Court of Federal Claims**

- Precedent in this area of the law in local appellate jurisdiction vs. federal circuit should be the guiding factor for this decision.

b. **Pretrial Issues** *(each will be discussed in separate paragraph)*

- ***Jurisdiction***
- ***Maintaining Choice of Forum***
- ***Discovery***
- ***Pretrial Briefing***

Jurisdiction

- Government may file Rule 12(b)(1) Motion and challenge subject matter jurisdiction for failure to pay a sufficient divisible tax payment equal to one employee's assessment for the quarters at issue.
- Plaintiff should try and avoid such a challenge by making payments large enough to cover at least one employee's portion of employment taxes and federal income tax withholding for all quarters assessed.
  - Payroll or other evidentiary records
- If, despite diligent attempts, the taxpayer is unable to secure records to establish whether a precise figure paid is sufficient to cover the TFRP assessment(s) attributable to one employee, a court may permit the payment(s) to stand as a representative amount of the divisible tax. *See, e.g., Kaplan v. United States*, 115 Fed. Cl. 491 (2014).
- Challenges to jurisdiction may come at any time.

Maintaining Choice of Forum

- Plaintiff's choice of forum may be challenged, particularly if other responsible persons are assessed and case is filed in the United States Court of Federal Claims.
- The government's most popular vehicle to challenge venue is to move to suspend the proceedings in the court plaintiff filed suit and simultaneously file a separate lawsuit to reduce the TFRP assessments to judgments against plaintiff and another assessed party in the federal district court where the business operated.
  - Main argument is judicial economy.
- Plaintiff may oppose this motion and move for an injunction against this later-filed suit by utilizing IRC § 6331(i)(4)(A). *See Beard v. United States*, 99 Fed. Cl. 147 (Fed. Cl. 2011).

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[8] *See* 28 U.S.C. § 1346.

Return to Table of Contents

- Based on recent district court cases in various jurisdictions, plaintiff's chances of success are high, although no appellate circuit has yet weighed in on interpretation of this code provision.

- Taxpayer will also have to file a Rule 12 motion in the second federal district court to prevent litigation from moving forward in that forum.

Discovery

- Once the taxpayer files a complaint, settlement with the Tax Division of the DOJ is not likely until the discovery process is complete.
- Plaintiff should be prepared to respond to, and request, the following:
  - **Rule 26 Disclosures**
  - **Requests for Production**
    - In TFRP cases, an exception to IRC 6103 (disclosure statute) permits all parties assessed to have information pertaining to the assessment and collection of the tax for all individuals deemed responsible as a result of the company's failure to withhold/remit employment taxes.
    - If not previously secured via a FOIA request, plaintiff should request all documents relating to any liability of [names of all persons assessed] under IRC 6672 with respect to any business or entity, including but not limited to [name of entity and EIN].
    - This request should include language similar to the following, "such documents to include any records of IRS investigation, assessment, collection, and specifically to include all records of any payments by or on behalf of [names of all persons assessed] with respect to any such liability."
  - **Interrogatories**
- The government will also likely **depose** plaintiff and others deemed responsible persons for the same TFRP assessments.
  - Plaintiff will have an opportunity to ask the government's deponents questions.
  - Plaintiff might consider deposing the Revenue Officer (RO).
  - **Practice Tip**: Plaintiff should be mindful of the high costs of depositions when deciding whether to depose potential witnesses. Plaintiff is entitled to a copy of his or her own deposition at no cost but not deposition transcripts of other government deponents.

Pretrial Briefing

- Lots of briefing in refund suits!
- Be prepared to **fully brief challenges** to **venue** and, potentially, **jurisdiction** or **summary judgment** motions.

Return to Table of Contents

- If trial is scheduled, briefing will include the following pleadings:
    - Joint Stipulation of Facts
    - Joint List of Exhibits
    - Plaintiff's Contested Factual Issues and Contentions of Facts
    - Plaintiff's Proposed Conclusions of Law
    - Plaintiff's Witness List
    - Plaintiff's Exhibit List
    - Objections to Defendant's Witnesses and Exhibits
- **Practice Tip**: If you wish to have example pleadings/briefs, find leading cases in jurisdiction through traditional research and then get on PACER and pull copies of the relevant pleadings filed in the case.
    - Only works for more recent cases, generally 7-10 years back depending on jurisdiction.

c. **Settlement vs. Trial**

- As with most tax litigation, the chances of settlement are fairly high, however; settlement will not likely come until late in the pre-trial litigation process, and DOJ Tax has several levels of bureaucracy concerning approval of settlement offers.
    - Consider filing a qualified settlement offer under IRC § 7430.
- Because TFRP cases are very fact-intensive, a trial before a judge (or jury if case is filed in local U.S. District Court vs. U.S. Court of Federal Claims) may be a more likely avenue for suitable relief than in other types of tax cases.

VI. Pyramiding & Potential Criminal TFRP Cases

a. Pyramiding

- Term for fraudulent practice where businesses withhold employment taxes from their employees but consistently fail to remit the taxes to the IRS.
- Persons involved in pyramiding businesses may shut down entities owing TFRP liabilities (possibly also file for bankruptcy) and then start new businesses under different names/type of entities and repeat the practice.
- DOJ Tax is filing more enforcement injunctions pursuant to IRC § 7402(a) in these types of cases to force compliance with employment tax laws.

Example Pyramiding Case

U.S. v. Sifuentes, d/b/a Simpson TV-VCR Repair, 2005 WL 3627339 (W.D. Tex).

In 2005, in San Antonio Texas, the government filed suit against Sifuentes, a sole proprietor (d/b/a Simpson TV-VCR Repair) requesting the issuance of a permanent injunction to require the defendant to: "(1) make timely employment tax deposits, (2) file timely federal employment and unemployment tax returns; [and] (3) file delinquent employment tax returns and pay the taxes, interest, and penalties due on the liabilities shown on those returns. At the time the suit was filed, the Defendant had been delinquent on his quarterly payments of employment taxes since June of 1985, when he first began his business. Prior to this suit, the IRS has used at least five administrative collection and monitoring remedies in an attempt to collect past due taxes and enforce withholding requirements to no avail. The injunction was granted on summary judgment.

b. Criminal TFRP Cases

- Under IRC § 7202, willful failure to collect or pay over trust fund taxes tax can result in a felony charge, and, if convicted, imprisonment and a fine of up to $10,000.
- Egregious violations of duty to withhold and remit employment taxes.
- Statutory elements are essentially same as IRC § 6702, but government's has to prove case under criminal burden of proof.

Criminal Case Example

U.S. v. Montemayor, 2013 WL 4459056 (S.D. Tex).

In 2013, in Laredo Texas, two owners of a home health care businesses (one a registered nurse) were indicted for failure to pay over to the IRS federal tax withholdings and FICA taxes allegedly withheld from employees' wages in violation of IRC § 7202. Both defendants were also charged with aiding and abetting the failure to pay over federal employment tax in violation of 18 U.S.C. § 2.

The indictment alleges, among other things, that "[d]uring the time period from about 2006 through at least 2011, the defendants . . . [diverted] corporate funds to cover nonbusiness expenses, including trips, entertainment, and the purchase of real estate, while, at the same time failing to pay over to the IRS payroll taxes withheld from . . . [their] employees."

Return to Table of Contents

Transfer Pricing Litigation Update; Amazon, Medtronic, Other Recent Cases and New IRS Guidance

State Bar of Texas

17th ANNUAL INTERNATIONAL TAX SYMPOSIUM NOVEMBER 6 & 7, 2014

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Return to Table of Contents

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Return to Table of Contents

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Themes of the Transfer Pricing Cases

1. Valuation of Intangibles
2. Evolving IRS Approaches to Transfer Pricing
3. Weakening of the Arm's-Length Standard

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Return to Table of Contents

Revenue Problems Among OECD Countries

- A tension exists between tax administrators' notion of realistic alternatives/sound economics and taxpayers' rights to arrange their business affairs to minimize taxes. The gap in the statutory rate and the effective rate of more than 20% is driving OECD countries, including the United States, to look for other ways to close the revenue gaps. This tension has resulted in a movement away from the arm's length standard and becomes readily apparent in the intangible area, particularly in light of the concept of "realistic alternatives" in the 2009 section 482 regulations.

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Revenue Problems Among OECD Countries (cont'd)

- Although the arm's length principle is universally accepted among OECD countries, there are differences in the way members view arm's length. The United States has traditionally respected contracts as written as long as they were followed. Internationally, the arm's-length principle is stretched to include the idea of whether parties operating at arm's-length would ever even enter into the contract.

- Base Erosion Profit Shifting ("BEPS") effort underway at the OECD. Action 8 involves special considerations for intangibles and addresses the lack of distinction between ex-ante (forecast) and ex-post returns (actual). There are divergent views among most OECD members and the United States on this issue. The United States takes the view that only the ex-ante is relevant whereas other members think both are relevant for hard to value intangibles. However, based on our experience with IRS exam teams on this issue, the difference may be more academic than real.

U.S. Approach to Platform Contributions or "Buy-In" Payments

- In the U.S. context, there is disagreement between the IRS and taxpayers as to how to evaluate intangibles for purposes of the buy-in payment for cost sharing agreements.

- For example, the IRS asserts that in certain cases the following may be intangibles within the meaning of section 936(h)(3)(B) and thus be valued separately for purposes of the buy in payment:
  - Workforce in place
  - Goodwill
  - Value of the head start afforded by the pre-existing intangibles (R&D rights)
  - Make or sell rights

- The IRS view is that an experienced team in place may contribute value in excess of the compensation paid to individual team members, and therefore may constitute an intangible within the meaning of section 936(h)(3)(B). Taxpayers, on the other hand view it as a part of services for which there are established comparables available to determine the proper pricing.

New IRS Guidance on Transfer Pricing Audits

The IRS released an audit "Roadmap" on February 14, 2014. The Roadmap, also called a "Quality Examination Process" (QEP), envisions a standard 24 month process (which may vary depending on the facts of the circumstances of an audit) for the audit process from start to finish. The IRS will spend an additional four months prior to the audit to become familiar with the taxpayer's business, operations, and market.

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Pre-Examination Analysis

- The first phase of the Roadmap is the "pre-examination analysis"
- To last about six (6) months.
- The Opening Conference and Transfer Pricing Orientation marks the beginning of this phase. During the pre-examination analysis stage, the IRS is to do the following:

1. Review tax returns for controlled transactions.
   - The IRS is supposed to learn the taxpayer's business including background, history, core business operations, IP, geographic and organizational structure, and segmented operational profitability.
   - Note that background analysis may include obtaining information from Treaty partners using requests for information pursuant to treaties or pursuant to simultaneous examination program.

2. Section 6662(e) documentation review.
   - IRS economist along with the International Examiner ("IE") and Transfer Pricing Practice member ("TPP") will begin to evaluate the taxpayer's best method and the potential applicability of various methods.

3. Planning meetings. Conduct a preliminary meeting with the taxpayer. In the meeting, the IRS is to
   - Identify key taxpayer personnel.
   - Request accounting data and records
   - Discuss need for interviews of operations personnel
   - Discuss Information Document Request ("IDR") process

4. Preparation of Initial Risk Analysis- a preliminary risk analysis is performed to help the IRS determine if the case is worthy of further examination or whether a survey would be more appropriate.

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Execution Phase

- The second phase of the roadmap is the "Execution Phase." Primary task for the execution phase is fact finding.
- Ideally to last between twelve (12) and fifteen (15) months.
- Send Information Document Requests ("IDR's")
- Consistent with the new directive (LB&I-04-1113-009), the IRS will perform what's called a comparability and functional analysis (outlined in IRM 4.61.3.5.1) during the execution phase. To do this analysis, the IRS is to interview key personnel, perform site tours, and review and analyze key accounting data.
  - Functional analysis primarily looks at the price charged and the profits earned on transfer pricing transactions to ensure they are at arm's length.
  - The functional analysis is performed with all IRS hands-on-deck (IE, TC (Team Coordinator), TPP (Transfer Pricing Practice member), Economist, Engineer, and Field Counsel).

Resolution Phase

- The third and final phase of the roadmap is the "Resolution Phase."
- This is to occur in the last six (6) months of the audit.
- The final Notice of Proposed Adjustment (NOPA) is to be provided to the taxpayer and a meeting should be held to understand the taxpayer's position.
- If the taxpayer disagrees with the IRS's NOPA, the IRS is supposed to explore pre-Appeals resolution opportunities, including fast track resolution.
- If issues remain unagreed, the IRS is to issue a Revenue Agent's Report (RAR) and a thirty-day letter along with case closing workpapers. After it receives the taxpayer's 30-day letter protest, the IRS is to address and rebut the taxpayer's positions.
- If an appeals conference is necessary, it ideally should occur within this phase.

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The IRS Seeks an Escape from *Veritas*

- One cannot preview the *Amazon* transfer pricing litigation without first discussing *Veritas v. Comm'r*, 133 T.C. 14 Docket No. 12075-0, December 10, 2009.

- *Veritas* was a case in which the IRS lost on a challenge to a buy-in payment relating to a software intangible. The Tax Court held that the IRS discounted cash flow method used the wrong useful life, the wrong discount rate, and an unrealistic growth rate to calculate the requisite buy-in payment.

- The IRS made things difficult for itself during the litigation. For example, more than a year after the Petition was filed, the IRS changed its transfer pricing method and discarded its expert.

- The Tax Court found that the IRS's discounted cash flow method yielded a growth rate that would have required a buy-in payment from Veritas's Irish subsidiary equal to 100 percent of its actual and projected income to Veritas U.S. through 2009 (transaction was in 1999), which would have resulted in $1.9 billion in losses over that period.

- Rather than appeal, the IRS filed an action on decision (AOD) that it would not acquiesce in either the result or the reasoning of the *Veritas* decision.

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The IRS Seeks an Escape from *VERITAS* (cont'd)

- The IRS AOD stated as follows: "[t]he court construes the buy-in to exclude any consideration of the future income value or value attributable to intangibles to be developed under a CSA apparently on the theory that such future income stream is already paid for through the participants' cost shares of ongoing R&D."

- In the IRS's view, the ongoing cost sharing payments only account for a portion of the value of the intangibles to be developed under the cost sharing arrangement. The balance of that value is attributable to the head start afforded by the pre-existing intangibles.

- The IRS contended the Tax Court's interpretation reads "for purposes of research in the intangible development area" out of the regulation. That is, by ignoring the contribution of pre-existing intangibles to the value of intangibles developed under a cost sharing arrangement, the Tax Court limits the value of pre-existing intangibles to their make or sell rights, and does not include any value related to R&D rights.

- The IRS argued that its interpretation that R&D rights must be compensated is anchored in the regulations in effect for the years at issue, not just in the 2009 cost sharing regulations.

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Amazon.com Inc. et al. v. Commissioner, T.C. Memo. 2014-149; Docket No. 31197-12

Presiding Judge: Judge Albert Lauber of the U.S. Tax Court (Appointed 2013).

Trial began November 3rd in Seattle.

Facts:

- Amazon did not receive a 30 day letter which means that the IRS did not give it an opportunity to go to IRS appeals or perhaps the parties agreed that appeals was not worthwhile.
- Amazon filed its Petition Dec. 28, 2012 for a redetermination of a $2.2 billion income adjustment related to a cost sharing arrangement with its subsidiary in Luxembourg.
- IRS increased Amazon's European subsidiary's "buy in" payment to Amazon for pre-existing technologies related to the operation of its European websites. The IRS took issue with the Amazon's transfer of intangible property to its European subsidiary as part of a 2004-06 restructuring and its formula and method for allocating costs for ongoing research and development under the cost share agreement.
- The cost sharing arrangement included a buy-in for preexisting technology and marketing intangibles that the IRS valued at more than 20 times the amount negotiated by Amazon and its subsidiary.
- Pre-existing intangibles included domain names, trade names, trademarks, website software, and fulfillment systems.

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Dueling Buy-In Payment Valuations

- Amazon engaged Deloitte Tax LLP (Deloitte) to conduct a transfer pricing study and value the pre-existing intangible property. The transfer pricing study concluded that the present value of the buy-in payment on behalf of the Luxembourg affiliate to Amazon was $217 million as of January 1, 2005.
- Amazon's Deloitte valuation was based on a useful life for the pre-existing intangibles of no more than seven years.
- Assumed the value of the intangibles would decay over the seven-year useful life.
- Amazon did not separately value the items of pre-existing intangible property subject to the buy-in and instead valued the property in the aggregate.
- Deloitte used a 13 percent discount rate used to determine the present value of the buy-in payment.
- Based on the transfer pricing study, the Luxembourg affiliate agreed to make buy-in payments with a cumulative present value of $217 million over a seven-year period beginning in 2005. The 2005 payment was $73 million and the 2006 payment was $83 million.

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Dueling Buy-In Payment Valuations (cont'd)

The IRS hired Horst Frisch to perform its valuation. Horst Frisch:

- Applied the discounted cash flow (DCF) method as an unspecified method under Treas. Reg. § 1.482-4(d).
- Used same European website operating profit projections that were identified by Deloitte in its transfer pricing study.
- Used a 3.8 percent terminal growth rate.
- Used a 18 percent discount rate
- Like Deloitte, valued the intangibles in the aggregate.

Horst Frisch determined that the value of the pre-existing intangibles as of January 1, 2005 was **$3.6 billion**. Converted that value to buy-in payments over a seven-year period.

Return to Table of Contents

Amazon's Pre-Trial Maneuvering

- Amazon sought summary judgment on
  - Whether the IRS could categorically require inclusion of 100 percent of certain cost centers in the IDC pool under Treas. Reg. § 1.482-7A(b)(2) without using any allocation methodology and without specifically identifying the included costs as IDCs; and
  - Whether Amazon was entitled as a matter of law to apply an allocation method to determine IDCs under Treas. Reg. § 1.482-7A(b)(2) because its accounting books and records do not specifically identify costs related to the intangible development area.
- Court denied motion: "Because there is a genuine dispute of material fact as to whether, and the extent to which, the cost centers at issue constitute 'mixed costs,' we will deny petitioner's motion for partial summary judgment on both questions."
- Amazon also sought to amend its petition to allow a new method to allocate its intangible development costs. Court denied as being prejudicial to Respondent since it was sought 15 months after Amazon filed its petition.

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Amazon's Pre-Trial Maneuvering (cont'd)

- Amazon moved to depose an economist from the firm who performed the IRS valuation (Horst Frisch) who now works at the IRS in an effort to obtain evidence of "early conversations and decisions relating to what approaches might be feasible for the IRS in the aftermath of *Veritas*.

- Amazon filed a motion to compel production of the IRS's internal training materials on transfer pricing.

- Amazon also filed a motion to compel for the IRS's administrative file and for documents for which the IRS claimed deliberative privilege. The Court upheld 85 of the 100 documents for which the IRS claimed privilege.

- The IRS sought production of documents relating to Amazon's allocation of intangible development costs. Court denied as overly burdensome but allowed selected discovery on the issue.

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Return to Table of Contents

Amazon's Cost Share Formula

- The wholly owned Luxembourg subsidiary had the rights to exploit the co-developed intangible property in Europe and Amazon reserved the rights to exploit the intangible property in the rest of the world.

- The parties agreed to share and allocate intangible development costs and costs which contribute both to intangible development activity and other business activities on a reasonable basis. 1.482-7(d)(1).

- Under the cost sharing agreement, Amazon used a formula to calculate the Reasonably Anticipated Benefits (RAB) shares based on revenues generated.

Return to Table of Contents

Amazon's Cost Share Formula (cont'd)

- Amazon failed to segregate its intangible development costs from other operating costs so it developed and applied a formula to allocate to its intangible development costs a portion of the costs accumulated in various costs centers. Costs centers were accounting classifications that enabled it to manage measure operating expenses. These expenses came in 6 categories:
  - Cost of sales
  - Fulfillment
  - Marketing
  - Technology and content
  - General and administrative; and
  - Other.

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Amazon's Cost Share Formula (cont'd)

- The IRS challenged the allocation as it related to the technical and content costs. T&C category expenses "consist principally of payroll and related expenses for employees involved in research and development, including application development, editorial content, merchandising selection, systems and telecommunications support, and costs associated with the systems and telecommunications infrastructure.
- The IRS determined that 100% of the T&C category were IDCs. Amazon contends that the T&C categories were mixed costs.
- The IRS also challenged the formula used by Amazon to allocate the IDCs.

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Return to Table of Contents

Key Issues at Trial

- Whether the useful life of pre-existing intangibles for purposes of developing future intangibles is perpetual or not.
- The IRS's use of the income method (IRS used DCF method). *Veritas* had cast doubt on this method.
- If the decision is broad, it could help the IRS overcome *Veritas*. If narrow, it will much less helpful.

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Medtronic Inc. v. Commissioner, T.C. Docket No. 6944-11 (2011).

Presiding Judge: Judge Kathleen Kerrigan of the U.S. Tax Court (Appointed 2012).

Set for Trial in February, 2015 in Chicago.

Facts:

- Petition filed 3/23/11
- According to the notice of deficiency issued December 23, 2010, Medtronic's Cayman Island CFC failed to make arm's length payments to Medtronic U.S. for licensing intangibles and purchasing components used in manufacturing pulse generators and leads for tax years 2005 and 2006.
- IRS proposed to increase Medtronic's income by $496.5 million in 2005 and $750.7 million in 2006. There are over $2 billion in transfer pricing adjustments at stake.
- Medtronic's Cayman Island CFC owned a Puerto Rican manufacturing subsidiary which manufactures medical devices for several foreign jurisdictions and the U.S market. The IRS maintains that that the Cayman Island CFC and its Puerto Rican manufacturing subsidiary are a sub-manufacturer rather than an autonomous, risk-bearing entity. Medtronic maintained that its Puerto Rican operations represent "an entrepreneurial, risk-bearing, and functionally autonomous licensed manufacturer."

Alternative IRS Theories

- As an alternative to section 482, the IRS asserted that a section 367(d) inclusion is required if the Commissioner's section 482 position related to the Devices and Leads Transfer Pricing Issue is not upheld by the Court. As a reminder, section 367(d) treats the taxpayer as having sold the intangible property in exchange for payments over the useful life of such property and commensurate with the income attributable to the intangible.

- Section 965 Dividends Received Deduction Issue: During 2006, Medtronic received cash dividends from its controlled foreign corporations totaling $1,310,010,463. Of this amount, dividends totaling $933,700,000 were qualifying dividends under section 965(b) (the "Section 965 Dividends"). In accordance with section 965, Medtronic claimed a dividends received deduction in 2006 for the Section 965 Dividends in the amount of $793,645,000.

- The IRS argues that Medtronic's taxable income since 2003 created "existing or potential" intercompany accounts receivable under the principles of Revenue Procedure 99-32, 1999-2 C.B. 296, which constituted "related party indebtedness" under section 965(b)(3) and disallowed Medtronic's dividends received deduction for the Section 965 Dividends and increased Medtronic's income by $793,645,000 for 2006. We will discuss this provision in more detail with respect to a Fifth Circuit case *infra*.

Medtronic's Motion for Summary Judgment

Medtronic moved for summary judgment as a matter of law that the IRS adjustments was arbitrary, capricious, or unreasonable b/c the IRS had:

- Entered into a Memorandum of Understanding (MOU) with Medtronic with respect to the Puerto Rico operations which included an agreement with respect to the arm's length royalty rates during three separate audits (2002, 2003, 2004).
- For the 2005-2006 tax years, the IRS again made a determination that the Puerto Rico MOU reflected "arm's length" royalty rates.
- During a second examination of the 2005-2006 tax years, the IRS changed its mind. Its new determinations in support of the Notice of Deficiency more than doubled the amounts that it had determined were "arm's length" in March 2009 for 2005 and more than tripled the amounts it had determined were "arm's length" in March 2009 for 2006.

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Return to Table of Contents

Medtronic's Motion for Summary Judgment (cont'd)

- Argued that any transfer of goodwill or going concern value, including workforce in place, to Medtronic Puerto Rico by Med Rel, Inc., and Medtronic Puerto Rico, Inc., was exempt from royalty imputation under section 367(d), because these assets were 100 percent foreign assets.

- In the alternative, Medtronic argued that these assets were already valued by the IRS during its examination of Medtronic's 2002 tax return. Medtronic did not contest the IRS's valuation and factual determinations made under section 367(d) with respect to Medtronic's 2002 tax year and included the resulting section 367(d) amounts in its 2005 and 2006 tax returns.

- Summary of argument w/respect to section 965: On December 7, 2010, Medtronic US, Medtronic Europe, and the IRS entered into the Buy-In Closing Agreement, resolving the Medtronic Europe Buy-In issue. Under the terms of the Buy-In Closing Agreement, the parties agreed to increase Medtronic's taxable income and earnings and profits for 1999. Subject to express contingencies, the amount of the increased taxable income and earnings and profits was treated as though an intercompany account receivable from Medtronic Europe to Medtronic US was established as of the last day of 1999 and thus did not affect its dividend received deduction in an earlier year.

The Tax Court denied the motion.

IRS's Motion for Partial Summary Judgment

- The IRS also moved for partial summary judgment on the alleged absence of economic substance in the purported risk indemnification agreement between Medtronic U.S and its wholly owned Puerto Rican entities because the intercompany agreements failed to transfer product liability risk under governing law.
- The Tax Court denied the motion on September 29th, 2014 ruling that there were material facts in dispute.

Key Issues

- Although repudiating the MOU does not look good for the IRS, contract manufacturers, which the IRS argues Medtronic Puerto Rico is, are generally not entitled to premium returns. Whether the court is willing to accept the contractual allocation of risk to the Puerto Rican operation will be crucial.

- The former head of the IRS's Transfer Pricing Practice has indicated that the IRS wants to close a perceived gap amongst taxpayers that there is a more restrictive definition of assets under section 367(d) that are subject to section 482. This case could provide some clarity on this issue.

- If the decision is adverse to Medtronic, the case could have a chilling effect on MOU's or other method of settlements w/ respect to transfer pricing issues b/c of the ability of the IRS to repudiate later.

Zimmer Holdings, Inc. v. Commissioner, T.C. Docket No. 19073-14 (2013)

- Filed a petition in the U.S. Tax Court contesting IRS transfer pricing deficiencies in the amount of $709,878 for 2005, $40,451,275 in 2006, and $38,114,578 for 2007.

- Zimmer had a CFC located in the Netherlands who owned a manufacturing branch. The IRS asserted that under section 482, Zimmer's income should be increased by $108 million and $120.5 million for 2006 and 2007, respectively.

- Alternatively, the IRS said that Zimmer's 2006 and 2007 taxable income should be increased by $111.5 million and $164.2 million, respectively, based on transfers of intangible property to its Dutch subsidiary under section 367(d).

- In a second alternative, the IRS determined that Zimmer's 2006 taxable income should be increased by $998.6 million, based on the value of licensing agreements, workforce-in-place, and goodwill allegedly transferred from one of Zimmer's U.S. subsidiaries to its Dutch subsidiary, for which Zimmer had a zero basis, under section 367(a)(1).

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Return to Table of Contents

BMC Software Inc. v. Commissioner, 141 T.C. No. 5 (2013).

- The 2004 repatriation program permitted U.S. corporations to bring home income held outside the U.S. at an effective rate of 5.25 percent instead of the top 35 percent corporate income tax rate.
- BMC, based in Houston, contended that accounts receivable (as a result of a closing agreement with the IRS) on its books should not be counted as debt that would reduce the amount of money it could bring to the U.S. from foreign affiliates at the reduced tax rate.
- Tax Court disagreed (Kroupa), ruling that the IRS's "treatment of the accounts receivable are consistent with the dictionary definition" and "may constitute indebtedness" for purposes of calculating how much in earnings could be taxed at the lower rate in effect at the time.
- BMC claimed $709 million in earnings qualified for the tax holiday. The IRS ruled that $43 million was ineligible for taxation at the lower rate because it represented a foreign unit's debt to BMC created by accounts receivable, according to court filings.

BMC Software Inc. v. Commissioner, 141 T.C. No. 5 (2013) (cont'd)

- Underlying dispute began in late 2006, when BMC elected to bring $721 million held by its foreign subsidiary BMC Software European Holding into the U.S. under a "dividends-received deduction" Congress passed in 2004 as a stimulus measure designed to encourage major companies to repatriate overseas cash.
- Of the $721 million, nearly $709 million qualified for the tax holiday.
- In 2007, BMC entered into a deal with the IRS to resolve an unrelated transfer pricing dispute that increased the company's taxable income by $102 million during tax years 2003 through 2006.
- The settlement created an account imbalance between BMC and its foreign subsidiary, which the company resolved by creating $102 million in accounts receivable owed by BMC European Holding.
- BMC sought to square the company's accounts pursuant to Revenue Procedure 99-32 to avoid having the cash treated as a taxable dividend.

BMC Software Inc. v. Commissioner, 141 T.C. No. 5 (2013) (cont'd)

- The IRS demanded that BMC retroactively reduce its deduction on the cash it repatriated in 2006. The IRS says that a provision of the tax holiday statute required that "related party debt" – such as accounts receivable – accrued between October 2004 and March 2006 had to be discounted from funds eligible for the deduction.

- BMC unsuccessfully argued that the accounts receivable were not related party debt and that even if they were, Congress only intended that related party debt created for the purpose of effectuating an intentionally abusive transaction had to be taken into account.

- As a result, BMC was required to reduce its funds subject to the dividends-received deduction by $43 million, which yielded a $13 million tax liability.

- BMC appealed the Tax Court decision to the Fifth Circuit.

- In recent oral arguments in September at the Fifth Circuit, Justice Reavley noted that Revenue Procedure 99-32 insulates a party from any adverse tax consequence flowing from squaring accounts, which he suggested likely prohibits the IRS from reducing BMC's 2006 deduction.

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Return to Table of Contents

Key Issues

- This case has larger implications because of the widespread use of the tax repatriation holiday and subsequent transfer pricing adjustments. Both Microsoft and Medtronic submitted amicus briefs in support of BMC's appeal.

- Closing agreement with the IRS specified that the transfer pricing adjustments would have no secondary effects for unrelated items.

- Key issue is when was the debt incurred? The taxpayer believes the IRS position flouts traditional tax rules w/respect to when debts are accrued.

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Caterpillar Inc. v. Commissioner, T.C. Docket No. 10790-13 (2013)

- The IRS issued a proposed adjustment that raised Caterpillar's U.S. taxable income by $55 million for royalties allegedly owed by its Belgian subsidiary, and by $27 million for royalties allegedly owed by its French subsidiary. The amounts reflected the full 5 percent royalty that would have been paid under the previous agreement in the 1992-1994 period.

- The dispute arose over Caterpillar's decision in 1990 to amend licensing agreements (originally signed in the 1960s) with its manufacturing subsidiaries in France and Belgium to suspend the subsidiaries' royalty obligations until they were profitable.

- The royalty rate of 5 percent had been determined on a value added basis (net sales less costs such as parts and components).

Caterpillar Inc. v. Commissioner, T.C. Docket No. 10790-13 (2013)(cont'd)

- The amended licensing agreements suspended royalty payments in years during which the subsidiaries incurred net operating losses, and it allowed for the carry forward of NOLs to limit the royalty in future years. During the years in question, the subsidiaries incurred losses and, under the agreement, made either no or reduced royalty payments.

- Caterpillar said in its Tax Court petition that at the time of the amendments to the agreements, it was undergoing a prolonged period of weak sales and accumulating losses. It claimed that suspending the royalty payments was an arm's-length approach intended to help the foreign subsidiaries return to profitability.

- The IRS argued that the suspensions were not an arm's-length result, noting that the company had not suspended a similar royalty arrangement with its 50-percent-owned Japanese joint venture with Mitsubishi Heavy Industries Ltd.

- Caterpillar sought to resolve the matter through the competent authority provisions of the U.S. tax treaties with Belgium and France, but the competent authorities failed to reach agreement.

- In a February 28 stipulation, Caterpillar and the IRS agreed to adjust the company's U.S. taxable income. The parties agreed to an increase of $22 million for income from Caterpillar's Belgian subsidiary and $11 million for income from its French subsidiary.

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Intersport Fashions West Inc. v. United States, Fed. Cl., No. 07-739 (filed by the court Feb. 13, 2012), Doc. No. 2012-2983, *Intersport Fashions West Inc. v. U.S.*, Fed. Cir., No. 2012-5080, appeal docketed Apr. 19, 2012.

- Intersport filed two amended returns on which it replaced the claimed deductions for payments to its foreign parent Eurobike with its purported allocable share of restructuring expenses incurred by Eurobike, which were not reported on the taxpayer's original or "first return."

- Intersport claimed a total deduction for allocated expenses of $1.3 million for 2001 and $1.7 million for 2002, which would have resulted in a $393,992 decrease in its 2001 tax liability and a $583,354 decrease in its 2002 tax liability.

- The IRS denied the refund claim on the grounds that the deductions were barred by Treas. Reg. section 1.482-1(a)(3) since they were not claimed on initial "timely filed" returns.

- It has been a general administrative practice over a long period of time to recognize amended returns filed after the due date for the purpose of correcting clear errors or plain mistakes on original returns. For example, the filing of an amended return to increase deductions (unrelated to transfer pricing) is explicitly authorized by Treas. Reg. section 1.461-1(a)(3).

Return to Table of Contents

Intersport Fashions West Inc. v. United States, Fed. Cl., No. 07-739 (filed by the court Feb. 13, 2012), Doc. No. 2012-2983. *Intersport Fashions West Inc. v. U.S.*, Fed. Cir., No. 2012-5080, appeal docketed Apr. 19, 2012. (cont'd)

- Intersport relied on the Tenth Circuit's 1963 holding in *United States v. Van Keppel*, 321 F.2d 717 (10th Cir. 1963), that it was an abuse of discretion for the IRS to refuse to accept an amended return correcting a mistake even though the regulation required the return to be timely filed.

- The Court of Claims rejected this argument, finding *Van Keppel* to be inconsistent with two Supreme Court cases, *Scaife Co. v. Commissioner*, 314 U.S. 459 (1941) and *Helvering v. Lerner Stores Corp.*, 314 U.S. 463 (1941) which allowed the IRS to deny amended returns when the regulation required a first return even though it involved a mistake in computation and despite any "hardship" that resulted.

Intersport Fashions West Inc. v. United States, Fed. Cl., No. 07-739 (filed by the court Feb. 13, 2012), Doc. No. 2012-2983. *Intersport Fashions West Inc. v. U.S.*, Fed. Cir., No. 2012-5080, appeal docketed Apr. 19, 2012. (cont'd)

- The government successfully persuaded the Court of Claims to characterize the claim as an attempt to "allocate income" under section 482 and analogized the regulatory prohibition at Treas. Reg. section 1.482-1(a) against taxpayer-initiated favorable "allocations" on amended returns.
- The Court of Claims ultimately concluded that a favorable section 482 allocation of income can be initiated only by a taxpayer on an original or first return.
- Intersport has appealed the Court of Claims' decision to the U.S. Court of Appeals for the Federal Circuit.

The interesting question raised by Intersport is whether taxpayers can be barred from amending returns to report ***actual*** *results of controlled party transactions?*

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Return to Table of Contents

Altera Corp. v. Commissioner, T.C., Docket No. 6253-12 (2012).

- Petitions filed 3/6/2012 and 4/20/2012.

- After losing *Xilinx v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010), which involved the prior costs sharing regulations, the IRS amended 1.482-7(d)(2) in 2003 to require the cost sharing of stock-based compensation.

- The regulation is contrary to the arm's length principle because there are numerous comparable transactions of unrelated parties where stock based compensation is not included in joint R&D agreements.

- The computer chip maker is challenging the validity of 2003 cost sharing regulations that explicitly require the inclusion of stock-based compensation in the cost pool.

Eaton Corp. v. Commissioner, T.C. Docket No. 5576-12

- $368.6 million transfer pricing adjustment arising from the cancellation of two advance pricing agreements. Out of 1,000 APAs executed over the past 20 years, only 11 have been canceled or revoked.
- The industrial and aerospace manufacturer argues that the IRS abused its discretion in canceling the unilateral APAs involving the sale of "breaker products" from manufacturing operations in Puerto Rico and the Dominican Republic to its affiliates in the United States.
- In December, Eaton filed a series of motions—asking the court to reconsider its order denying the company access to key IRS internal memos, seeking partial summary judgment on the abuse of discretion issue, and opposing an IRS motion to bifurcate the trial into two proceedings. The IRS seeks separate trials on the merits of canceling the APAs and the adjustment itself.

Return to Table of Contents

Eaton Corp. v. Commissioner, T.C. Docket No. 5576-12 (cont'd)

- A Dec. 15, 2011, transfer pricing study conducted for the IRS shows the profits in Eaton's Cayman Islands subsidiaries were 10 times the median return reported by comparable manufacturers.

- The IRS reallocated, to the U.S. subsidiary, 90 percent of the operating profits of Eaton's Cayman Islands operations.

- IRS questioned the functional analyses performed by Eaton and indicated in correspondence that Eaton was less than forthcoming in the documentation it provided.

- The IRS concluded that, in contrast to what was provided in the APAs, the tested party should be the Cayman Islands subsidiaries together, which would leave the profits and losses associated with the intangibles with the U.S. affiliate.

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Guidant LLC v. Commissioner, T.C. Docket No. 5898-11, 5990-11, 10985-11, 26876-11, 5501-12, 5502-12

- IRS is starting to challenge intercompany financing agreements that have the effect of shifting income to low tax jurisdictions.
- A consolidation of petitions filed by Boston Scientific and its subsidiaries Guidant LLC and Cardiac Pacemakers. Together the parties are protesting a total of $2.3 billion in IRS transfer pricing adjustments.
- IRS argues that the loans are not bona fide debt for federal income tax purposes
- Most documents are now subject to a protective order.

3M Company v. Commissioner, T.C. Docket No. 5816-13

- IRS allocated royalty income from a Brazilian subsidiary to its U.S. parent.
- 3M asserts that the royalty is prohibited under Brazilian law and argues that the IRS does not have the authority to reallocate income if foreign law prohibits payment or receipt. Under different facts, the U.S. Supreme Court held that the IRS does not have such authority, which the IRS sought to overrule with regulations.
- The validity of Treas. Reg. § 1.482-1(h)(2) is at issue.

CURRENT INTERNATIONAL TAX ISSUES

Presented Before the Texas Bar Association

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I. Inversions.

A. Temp. Treas. Reg. § 1.7874-4T (Jan. 2014) codified Notice 2009-78 with modest changes. The temporary regulation follows the notice's guidelines, designed to prevent self-inversions through the entry of a new private placement investor contributing cash for more than 20% of the stock. In determining whether the 80 percent (or 60 percent) share ownership thresholds are satisfied, stock of the foreign acquiring corporation issued in exchange for nonqualified property is ignored. "Nonqualified property" means cash, marketable securities, obligations of certain related persons, and any other property acquired in a transaction related to the acquisition with a principal purpose of avoiding the anti-inversion rules. A de minimis exception applies if former shareholders of the domestic corporation own less than 5 percent of the acquiring foreign corporation and a number of other conditions are satisfied.

B. In its Greenbook released March 2014, the Obama Administration proposed new statutory restrictions on inversion transactions. Under the proposal, the threshold for a failed inversion would be reduced from 80 percent to anything over 50 percent. The proposal would also add a special rule to treat the new foreign parent as a domestic corporation, regardless of the percentage ownership, if the parent has substantial business activities in the United States and is primarily managed and controlled in the United States.

C. In May 2014, certain Democratic Congressmen and Senators introduced companion bills in the House and Senate designed to further curtail inversions. The bills would adopt the Obama Administration's proposed new 50 percent threshold, as well as the special rule where the group has substantial business activities in the United States and is primarily managed and controlled in the United States. Consistent with a statement made by Senate Finance Committee

Chairman Wyden, both bills would apply retroactively to any transaction within their scope completed on or after May 8, 2014. Interestingly, Chairman Wyden has distanced himself from these bills and has stated repeatedly since these bills were introduced that inversions should be addressed in a bipartisan manner.

D. Notice 2014-52.

1. On September 22, 2014, the IRS issued Notice 2014-52, announcing special new rules that will apply to inversion transactions and certain transfers that occur after an inversion transaction. Thus, the Notice effectively applies to inversions in which former shareholders of the domestic entity hold at least 60 percent, but less than 80 percent, of the stock of the new foreign parent by reason of holding stock in the domestic entity.

2. The Treasury Department and IRS intend to issue regulations under § 7874(c)(6) providing that, if more than 50 percent of the gross value of all "foreign group property" constitutes "foreign group nonqualified property," a portion of the stock of the foreign acquiring corporation will be excluded from the denominator of the ownership fraction, as described below. This 50 percent test is applied after the acquisition and all transactions related to the acquisition, if any, are completed.

3. For this purpose, "foreign group property" means any property (including property that gives rise to disqualified stock under Treas. Reg. § 1.7874-4T) held by the EAG after the acquisition (and all transactions related to the acquisition, if any) are completed, other than the following property: (i) property that is directly or indirectly acquired in the acquisition and that, at the time of the acquisition, was held directly or indirectly by the domestic entity; and (ii) to avoid double counting, stock or a partnership interest in a member of the EAG and an obligation of a member of the EAG.

3. The Treasury Department and the IRS intend to issue regulations under §§ 7874 and 367 disregarding non-ordinary course distributions made by the domestic entity during the 36-month period ending on the acquisition date. "Non-ordinary course distributions" mean the excess of all distributions made during a taxable year by the domestic entity with respect to its stock or partnership interests over 110 percent of the average of such distributions during the 36-month period immediately preceding that taxable year. A distribution means any distribution, regardless of whether it is treated as a dividend or whether, for example, it qualifies under § 355. A distribution also includes a transfer of money or other property to the owners of the domestic entity that is made in connection

with the acquisition, to the extent the money or other property is directly or indirectly provided by the domestic entity.

4. Regulations to be issued also include regulations modifying the determination of the ownership fraction in certain cases. Except as provided, if stock of the foreign acquiring corporation is received by a former corporate shareholder or former corporate partner of the domestic entity and, in a transaction (or series of transactions) related to the acquisition, that stock is subsequently transferred, the transferred stock is not treated as held by a member of the EAG for purposes of applying the EAG rules. Accordingly, the transferred stock is included in the numerator and the denominator of the ownership fraction. Exceptions apply for certain subsequent transfers involving a U.S.-parented group and certain subsequent transfers involving a foreign-parented group.

5. In order to prevent the avoidance of § 956, the Treasury Department and the IRS intend to issue regulations under § 956(e) providing that, solely for purposes of § 956, any obligation or stock of a foreign related person (within the meaning of § 7874(d)(3) other than an "expatriated foreign subsidiary") (such person, a "non-CFC foreign related person") will be treated as United States property to the extent the obligation or stock is acquired by an expatriated subsidiary during the applicable period (within the meaning of § 7874(d)(1)). An "expatriated foreign subsidiary" is a CFC with respect to which an expatriated entity is a U.S. shareholder. However, an expatriated foreign subsidiary does not include a CFC that is a member of the EAG immediately after the acquisition and all transactions related to the acquisition are completed (the "completion date") if the domestic entity is not a U.S. shareholder with respect to the CFC on or before the completion date. A similar rule applies to an expatriated foreign subsidiary that is a pledgor or guarantor of an obligation of a non-CFC foreign related person. The exception provided by Notice 88-108 will not apply.

6. The Treasury Department and the IRS intend to issue regulations under § 7701(l) providing that a "specified transaction" completed during the applicable period will be recharacterized in the manner described, subject to certain exceptions. A "specified transaction" is a transaction in which stock in an expatriated foreign subsidiary ("specified stock") is transferred (including by issuance) to a "specified related person." A "specified related person" means a non-CFC foreign related person, a U.S. partnership that has one or more partners that is a non-CFC foreign related person, or a U.S. trust that has one or more beneficiaries that is a non-CFC foreign related person. In addition, the Treasury Department and the IRS intend to issue regulations providing that if a deemed dividend is included in a CFC's income under § 964(e) as a result of a specified transaction that is completed during the applicable period, the deemed dividend will not be

Return to Table of Contents

excluded from foreign personal holding company income under § 954(c)(6) (to the extent in effect, and notwithstanding Notice 2007-9).

7. A specified transaction is recharacterized for all purposes of the Code, as of the date on which the specified transaction occurs, as an arrangement directly between the specified related person and one or more § 958(a) U.S. shareholders of the expatriated foreign subsidiary. However, if the specified transaction is a fast-pay arrangement that is recharacterized under the fast-pay rules of Treas. Reg. § 1.7701(l)-3, then the fast-pay rules will apply. A § 958(a) U.S. shareholder of an expatriated foreign subsidiary is a U.S. shareholder that owns (within the meaning of § 958(a)) stock in the expatriated foreign subsidiary, but only if the U.S. shareholder is related (within the meaning of § 267(b) or 707(b)(1)) to the specified related person or is under the same common control (within the meaning of § 482) as the specified related person.

8. If an expatriated foreign subsidiary issues the specified stock to a specified related person, the specified transaction will be recharacterized as follows: (i) the property transferred by the specified related person to acquire the specified stock ("transferred property") will be treated as having been transferred by the specified related person to the § 958(a) U.S. shareholder(s) of the expatriated foreign subsidiary in exchange for instruments deemed issued by the § 958(a) U.S. shareholder(s) ("deemed instrument(s)"); and (ii) the transferred property or proportionate share thereof will be treated as having been contributed by the § 958(a) U.S. shareholder(s) (through intervening entities, if any, in exchange for equity in such entities) to the expatriated foreign subsidiary in exchange for stock in the expatriated foreign subsidiary. Similar principles will apply to recharacterize a specified transaction in which a shareholder transfers specified stock of the expatriated foreign subsidiary to a specified related person. An example illustrates an application of these principles when a shareholder of an expatriated foreign subsidiary transfers stock of an expatriated foreign subsidiary to a partnership that is a specified related person.

9. A deemed instrument will have the same terms as the specified stock (other than issuer). Accordingly, if a distribution is made with respect to specified stock of the expatriated foreign subsidiary, matching seriatim distributions with respect to stock will be treated as made by the expatriated foreign subsidiary (through intervening entities, if any) to the § 958(a) U.S. shareholder(s). The § 958(a) U.S. shareholder(s), in turn, will be treated as making payments, with respect to the deemed instrument(s), to the specified related person(s). An expatriated foreign subsidiary will be treated as the paying agent of a § 958(a) U.S. shareholder of the expatriated foreign subsidiary with respect to the

deemed instrument. Rules similar to those described in Treas. Reg. § 1.7701(l)-3(b)(3)(iii) will apply.

10. Notwithstanding the preceding paragraphs, a specified transaction will not be recharacterized in two situations. The first exception applies if the specified stock was transferred by a shareholder of the expatriated foreign subsidiary and, under applicable U.S. tax rules, the shareholder either is required to recognize and include in income all of the gain in the specified stock (including gain treated as a deemed dividend under § 1248(a) or 964(e) or characterized as a dividend under § 356(a)(2)) or has a deemed dividend included in income with respect to the specified stock under Treas. Reg. § 1.367(b)-4, including by reason of the new regulations described elsewhere in the Notice.

11. The second exception applies if (i) the expatriated foreign subsidiary is a CFC immediately after the specified transaction and all related transactions, and (ii) the amount of stock (by value) in the expatriated foreign subsidiary (and any lower-tier expatriated foreign subsidiary) that is owned, in the aggregate, directly or indirectly by the § 958(a) U.S. shareholders of the expatriated foreign subsidiary immediately before the specified transaction and any transactions related to the specified transaction does not decrease by more than 10 percent as a result of the specified transaction and any related transactions.

12. The Treasury Department and the IRS intend to amend the regulations under § 367(b) to provide that an exchanging shareholder described in Treas. Reg. § 1.367(b)-4(b)(1)(i)(A) will be required to include in income as a deemed dividend the § 1248 amount attributable to the stock of an expatriated foreign subsidiary exchanged in a specified exchange, without regard to whether the conditions in Treas. Reg. § 1.367(b)-4(b)(1)(i)(B) are satisfied. The regulations will apply to specified exchanges completed during the "applicable period" as defined in § 7874(d)(1) (generally, the 10-year period following the inversion).

13. For this purpose, a "specified exchange" is an exchange in which a shareholder of an expatriated foreign subsidiary exchanges stock in that entity for stock in another foreign corporation pursuant to a transaction described in Treas. Reg. § 1.367(b)-4(a). The regulations will provide an exception that incorporates the principles of paragraph 11 above.

14. The regulations will also provide that Treas. Reg. § 1.367(b)-4(c)(1) (regarding the exclusion of a deemed dividend from foreign personal holding company income) will not apply to a deemed dividend that results from a specified exchange, and that such a deemed dividend will not

qualify for either the § 954(c)(3) same-country exception or the § 954(c)(6) look-through exception (to the extent in effect).

15. The Treasury Department and IRS are considering whether to provide an exception to the "specified transaction" rules, such that a taxpayer's chosen form would be respected when (i) a specified transaction is undertaken in order to integrate complementary businesses, and (ii) after the inversion, the inverted group does not exploit that form in order to avoid U.S. tax on the expatriated foreign subsidiary's pre-inversion E&P. The Treasury Department and IRS request comments on whether such an exception is warranted, and on the provisions that would be necessary to administer any such exception.

16. The Treasury Department and IRS intend to issue regulations providing that, for purposes of § 304(b)(5)(B), the determination of whether more than 50 percent of the dividends that arise under § 304(b)(2) are subject to tax or includible in a CFC's E&P will be made by taking into account only the E&P of the acquiring corporation (and therefore excluding the E&P of the issuing corporation). If a partnership, option, or other arrangement is used with a principal purpose of avoiding this rule, the partnership, option, or other arrangement will be disregarded in applying the rule. These rules will apply as a general matter, without regard to whether an inversion transaction has occurred.

17. In general, the regulations to be issued will apply to acquisition occurring on or after September 22, 2014, the date the Notice was issued. No exception is provided for transactions with respect to which a binding contract exists, or which have been announced in an SEC filing.

E. A Treasury Department official recently stated that further anti-inversion notices will be forthcoming. At the fall Tax Division meeting of AICPA, Douglas Poms, senior counsel in Treasury's Office of International Tax Counsel, declined to specify what would be addressed in Notice #2. Asked about the potential effective date of the forthcoming guidance, Poms said it will apply to inversions that take place on or after Sept. 22, the effective date of Notice 2014-52. He stated that Notice #3 would address earnings stripping, but that would represent a broader change and is likely to take some time. See BNA Daily Tax Report, Nov. 6, 2014.

II. Foreign Tax Credits.

A. Bank of New York Mellon.

1. *Bank of New York Mellon Corp. v. Commissioner*, 140 T.C. 15 (2013), addressed the availability of foreign tax credits in a Structured Trust Advantaged Repackaged Securities ("STARS") transaction. The Tax Court stated that the STARS transaction was developed by Barclays Bank and KPMG, and promoted to U.S. banks. Barclays was the counterparty to Bank of New York in the transaction at issue.

2. The STARS structure involved the establishment of a U.K. resident Trust through a series of affiliates and partnerships. The Trust was treated as a partnership for U.S. tax purposes. The interests in the trust consisted of class A, class B, class C, and class D units. The class A and class B units were held directly or indirectly by BNY and members of its consolidated group.

3. Barclays subscribed for the class C and class D Trust units for approximately $1.5 billion. The subscription agreement also required Barclays to pay further subscription amounts equal to distributions made on the class C unit, which were paid to a blocked account in Barclays' name controlled by BNY. Finally, BNY and Barclays entered into a forward sale agreement under which BNY was obligated to repurchase the class C unit. The repurchase price was equal to the original subscription price paid for the class C unit, plus interest at 4%, minus a portion of the U.K. income taxes paid on the Trust's income. BNY and Barclays also entered into a forward sale agreement under which BNY was obligated to repurchase the class D unit for its original purchase price. Certain swap, security and other agreements were also put into place. As described by the Tax Court, the net effect of these arrangements was that Barclays made a secured loan to BNY and its affiliates at LIBOR plus 20 basis points.

4. Under U.K. law, the Trust was subject to a 22% income tax, regardless of whether it distributed its income. Barclays was subject to a 30% corporate income tax on deemed annual Trust distributions, grossed up for the U.K. taxes paid by the Trust. Those taxes were creditable against Barclays' corporate income tax liability.

5. For U.S. tax reporting purposes, BNY treated the Barclays subscription and forward sale as a loan, and treated the Trust distributions to Barclays as interest paid on the loan. It reported the Trust income on its U.S. consolidated return as foreign source income, and claimed foreign tax credits for the U.K. income taxes paid by the Trust.

6. The Tax Court looked to precedents in the Second Circuit Court of Appeals, where an appeal in the case would lie, for guidance in applying the economic substance doctrine. The court stated that under those precedents, the economic substance analysis evaluates both the subjective business purpose of the taxpayer for entering into the transaction and the objective economic substance of the transaction. These are not rigid steps in a two-part analysis, stated the court, but rather, are more precise factors to consider in the overall inquiry.

7. The court first identified the relevant transaction to be analyzed under the economic substance inquiry. The relevant transaction to be tested, stated the court, is the one that produces the disputed tax benefit, even if it is part of a larger set of transactions or steps. Thus, the court held that the relevant transaction was the STARS structure, and not the loan as BNY asserted. The disputed foreign tax credits, stated the court, were generated by circulating income through the STARS structure; in contrast, the loan was not necessary for the STARS structure to produce the disputed foreign tax credits.

8. The court then concluded that the STARS structure lacked economic substance. It lacked objective economic substance because it did not increase the profitability of the STARS assets, but rather, reduced their profitability by adding substantial transaction costs. In this regard, the court considered foreign taxes as a transaction cost of the structure. The court further concluded that BNY did not have a legitimate non-tax business purpose for using the STARS structure. The court rejected BNY's asserted purpose of obtaining low-cost financing, stating that the STARS structure lacked any reasonable relationship to the loan.

9. In this regard, the court viewed the agreed reduction in interest cost for a portion of the U.K. income taxes paid by the Trust as a "tax effect" of the STARS structure, and not as a pre-tax cash flow accruing to BNY. Having "backed out" this economic benefit, the court concluded that the loan's interest rate was above market.

10. The court held further that the STARS transaction still lacks economic substance even if the STARS structure and the loan are evaluated as an integrated transaction.

11. Because the STARS transaction lacked economic substance, the Tax Court denied all of BNY's claimed foreign tax credits and deductions arising from the transaction. The court also upheld that the IRS's adjustment to BNY's foreign source income. The income could not be treated as foreign source under the U.S.-U.K. Income Tax Treaty. Because the STARS transaction lacked economic substance, it was disregarded for U.S. tax

Return to Table of Contents

purposes. Thus, the income involved was treated as being derived by BNY within the United States.

12. In a supplemental opinion, *Bank of New York Mellon Corp. v. Commissioner*, T.C. Memo 2013-225, 106 T.C.M. 367 (2013), the Tax Court granted BNY's motion to more fully consider certain corollary aspects of its main decision (*BNY I*), to bring them into harmony with *BNY I*.

13. In its tax returns as filed, BNY did not deduct interest on the loan, treating the loan and the spread as though they were paid under an integrated contract. In light of the Tax Court's holding in *BNY I* that the loan and the spread are properly bifurcated, BNY argued that a deduction for the loan interest should be allowed. The court agreed. The court stated that interest accruing on a real loan that is used for economically substantive activity is deductible even if the borrower is also motivated by favorable tax consequences. The court further stated, as it had in *BNY I*, that the loan was not necessary for the STARS structure to produce the disallowed foreign tax credits. Rather, the loan proceeds were available for BNY to use in its banking business.

14. In its tax returns as filed, BNY reported as income the "spread"—the agreed reduction in its interest cost on the loan that Barclay's offered to reflect the tax benefits it received under the STARS structure. In light of the Tax Court's holding in *BNY I* that the STARS structure lacked economic substance, BNY argued that the spread should not be includible in income. The court again agreed. Because the spread arose from the STARS structure, a transaction that lacked economic substance, the court did not give effect to the spread.

15. The court also did not sustain the IRS's determination that certain interest deductions should be disallowed. The court found these interest deductions were not attributable to the STARS structure, as the IRS had asserted.

16. The taxpayer has appealed the principal holding of the case, denying its foreign tax credit on economic substance grounds, to the Second Circuit Court of Appeals. The parties have filed their opening briefs. See 2014 TNT 117-17 (Jun. 12, 2014) (taxpayer's brief); 2014 TNT 189-9 (Sept. 25, 2014) (government's brief).

B. AIG.

1. *American International Group, Inc. v. United States*, 2013-1 U.S.T.C. ¶ 50,255, 2013 TNT 63-11 (S.D.N.Y. 2013), addressed the availability of foreign tax credits in a series of tax-advantaged cross-border sale and repurchase transactions. The transaction involved AIG's wholly-owned domestic subsidiary, AIG-FP, selling preferred shares of a foreign subsidiary to a foreign bank and agreeing to repurchase the shares after a term of years. The foreign subsidiary invested its capital in investments that generated a steady income stream and paid foreign tax on the income. It distributed the majority of its after-tax earnings to the foreign bank on the preferred shares, and distributed the remainder to AIG-FP.

2. In the foreign bank's jurisdiction, the bank was treated as the owner of the preferred shares. The bank therefore received the distributions as tax-free dividends. AIG asserted that for U.S. tax purposes, AIG-FP's obligation to repurchase the preferred shares caused AIG-FP to be treated as the owner of the preferred shares and caused the transaction to be treated as a loan. AIG treated the distributions to the foreign bank as interest expense of the foreign subsidiary and claimed foreign tax credits in the U.S. for the entire amount of foreign tax paid by the subsidiary.

3. AIG moved for summary judgment that it was entitled to the foreign tax credits. It contended that the transactions were instances of highly profitable spread banking activity that were expected to generate a significant pre-tax profit. The government argued that tax benefits generated AIG's spread profit, and that the transactions therefore lacked economic substance. AIG argued that the economic substance doctrine does not apply in every context, but rather, only where its requirements can fairly be derived from the terms and purpose of the statute at issue.

4. The district court denied AIG's motion for summary judgment, based on the record before it. The court stated that the requirements of the economic substance doctrine are consistent with the purpose of the foreign tax credit. The court considered the early history of the credit, concluding that Congress intended the credit to facilitate purposive business transactions. It cited Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966) for the proposition that Congress appears not to have intended the credit to be available to transactions "that have no economic utility and that would not be engaged in but for the system of tax imposed by Congress," simply because the transactions caused the taxpayer to pay foreign tax. Thus, it held that AIG must show that its transactions, apart from the tax benefits, had economic utility.

Return to Table of Contents

5. AIG asserted that its transactions were expected to generate $168 million of pre-tax profit. If the computation of that figure proves correct, stated the court, AIG would be entitled to judgment. AIG's computation of the $168 million disregarded the effects of all taxes: the foreign tax paid by AIG-FP's foreign subsidiary, the U.S. income tax paid by the AIG group on the subsidiary's income, and the value of the foreign tax credits to the AIG group. AIG asserted that as a matter of law, the tax-exempt status of the lender's dividends is not a tax effect to be isolated and removed from the transactions in order to determine the extent of their non-tax purpose and effect. Solely for purposes of the summary judgment motion, AIG conceded that the transaction would have had no pre-tax profit absent the lender's tax-exempt dividends.

6. The court disagreed with AIG's assertion. It stated that the lender shared the benefit of its tax-exempt dividends with AIG-FP through the parties' economic arrangement. The tax exemption, stated the court, "was not a trivial or speculative factor," but rather, "shaped the transactions." AIG and the banks, stated the court, structured the transactions to obtain the tax savings generated by the banks' tax exemption, and negotiated how to divide those savings. Thus, the court denied AIG's motion for summary judgment.

7. In a subsequent opinion, upon AIG's motion and over the government's objection, the district court certified its opinion for interlocutory appeal under 28 U.S.C. § 1292(b). *American International Group, Inc. v. United States*, 2013 U.S. Dist. LEXIS 184786, 2013 TNT 234-14 (S.D.N.Y. 2013).

8. The district court acknowledged that interlocutory appeals are only appropriate in exceptional circumstances. It found those exceptional circumstances to be present with respect to its *AIG* opinion. The court stated that its ruling in *AIG* turned on two related questions of law which together are controlling and that "there are substantial grounds for difference of opinion as to each of them." The court also stated that a reversal on either ground would produce judgment for AIG on the most significant of its claims.

9. The court observed that preventing double taxation has been recognized as the purpose of the foreign tax credit by the U.S. Supreme Court, and that disallowance of the credits would subject AIG to double taxation on the same income in the U.S. and a foreign jurisdiction. Thus, stated the court, there are "substantial grounds" for ruling that the economic substance doctrine is inapplicable.

Return to Table of Contents

10. The court stated that in applying the economic substance doctrine in *AIG*, it removed the effects of the AIG lenders' foreign tax benefits because AIG and the lenders structured the transactions to achieve those tax benefits and negotiated how to divide them. Nevertheless, stated the court, two other circuit courts of appeal have adopted the view that the foreign tax benefit given to a foreign entity and shared with a U.S. taxpayer should be included in the U.S. taxpayer's profit in applying the economic substance test, citing *Compaq v. Commissioner*, 277 F.3d 778 (5th Cir. 2001), and *IES Industries Inc. v. United States*, 253 F.3d 350 (8th Cir. 2001). The court also cited two scholarly articles supporting the view that this question is particularly difficult and merits appellate review.

11. On March 17, 2014, the Second Circuit Court of Appeals granted the interlocutory appeal. 2014 TNT 53-15.

12. The parties have now filed briefs, and a decision is expected reasonably soon. See 2014 TNT 129-19 (Jun. 30, 2014) (taxpayer's brief); 2014 TNT 201-18 (Sept. 29, 2014) (government's brief); and 2014 TNT 201-19 (Oct. 14, 2014) (taxpayer's reply brief).

C. Salem Financial.

1. *Salem Financial, Inc. v. United States*, 112 Fed. Cl. 543, 2013-1 U.S.T.C. ¶ 50,517 (2013), is another case involving a U.S. bank that entered into a STARS transaction. Salem Financial is a subsidiary of BB&T Corporation. The court stated that although many entities were involved in the STARS transaction, the real parties in interest were BB&T and Barclays. The other entities were created or became involved to serve some special purpose for the transaction.

2. The court's opinion is lengthy: 67 pages in single space, though it's clear where the court is going from Page 1. The opinion, for example, includes a facts section entitled "BB&T's Participation in Other Tax Shelters." The court skewered the individual company personnel and their outside advisors, calling their involvement in the transaction "nothing short of reprehensible." The court stated they should have known better than to follow the STARS path, "rife with its conflicts of interest, questionable pro forma legal and accounting opinions, and a taxpayer with a seemingly insatiable appetite for tax avoidance." The court noted that one of the advisors involved had already been incarcerated in a federal penitentiary as a result of his involvement in other tax transactions.

3. The court's substantive analysis borrows heavily from the Tax Court's *BNY I* opinion. The court held that the loan and the STARS transaction

should be bifurcated in determining whether they had economic substance. It then held that neither the STARS structure nor the loan had economic substance. The court stated that the loan was not structured to make a profit, but instead "was devised to provide BB&T with a pretext for a purported business purpose for engaging in a sham transaction." The loan, stated the court, had no business purpose and no possibility of pre-tax profit.

4. In reaching this conclusion, the court treated the so-called "Bx payments" as a "tax effect," and not as pre-tax revenue of BB&T. The Bx payments were the payments Barclay's made to BB&T under the STARS structure equal to 51% of Barclay's U.K. tax savings resulting from the trust distributions. The court isolated the Bx payments as a tax effect, "and in particular as a U.S. tax effect." It then determined that BB&T had no potential for pre-tax profit in the remainder of the transaction. Without potential for pre-tax profit, the transaction lacked economic substance. The court stated that the Bx payments simply reimbursed BB&T for one-half of its out-of-pocket U.K. tax costs on the transaction.

5. The court further held that even if the STARS structure and the loan were viewed as an integrated transaction, that transaction lacked economic substance. In this regard, the court stated that there was no substantive economic activity occurring in the U.K. to warrant a U.K. tax. Yet, by subjecting the trust funds to a U.K. tax, the taxpayer and its U.K. counterparty were able to realize and share a tax benefit. "No aspect of the STARS transaction," stated the court, "has any economic reality."

6. The court also upheld penalties. The court noted that both the accounting firm and law firm involved had a significant interest in convincing BB&T to engage in the STARS transaction. Thus, the court stated that it could not say that BB&T acted reasonably in relying on their advice. The court stated that BB&T's engagement with its auditor also was insufficient to remove the taint of unreasonableness from the professional tax advice received.

7. The auditor had arrived at a "less than should" level of comfort that the IRS would accept the STARS transactions, but BB&T nonetheless decided to move ahead with it. In fact, the court stated that the auditor explicitly informed BB&T that it "in no way was providing an opinion" regarding the STARS transaction. During cross examination, a partner with the audit firm also was described as "evasive and had few answers for the glaring weaknesses" that the auditor should have seen in the STARS transaction.

8. The court stated that BB&T's concern over the tax risk also was significantly reflected in the negotiations and eventual fee arrangement with the accounting firm promoting the transaction. The court stated that the skepticism on the part of BB&T was well-founded, because, as a successful financial holding company with banking subsidiaries in over 12 states, it surely would have recognized that the ability to claim nearly $500 million in foreign tax credits merely by subjecting its assets to U.K. tax was too good to be true.

9. Thus, the negligence penalty of § 6662(b)(1) and the substantial understatement penalty of § 6662(b)(2) applied and the defenses of reasonable basis, substantial authority and reasonable cause and good faith were not available.

10. In a separate opinion filed January 7, 2014, the court denied the taxpayer's motion for reconsideration. The court found that the taxpayer failed to meet the legal standard for a motion to alter or amend the court's judgment. Notwithstanding that the Tax Court had granted a similar motion and issued a supplemental opinion in *BNY II* allowing the taxpayer certain interest deductions, the Court of Federal Claims stated that the Tax Court's decision "is not controlling authority in this Court."

11. Even if the taxpayer had met the standard required for reconsideration, stated the court, the *BNY II* opinion carried little weight because the Tax Court's findings of fact differed from the its findings. In particular, while in *BNY I* the Tax Court had found the STARS loan to have economic substance, in its *Salem Financial* opinion the Court of Federal Claims found that BB&T entered into the loan to disguise the refund of taxes through the Bx payments. Under the court's factual findings, the loan failed the economic substance test and BB&T was not entitled to deduct interest payments.

12. The taxpayer has appealed the case to the Federal Circuit Court of Appeals. The parties have filed their opening briefs. See 2014 TNT 160-15 (May 12, 2014) (taxpayer's brief); 2014 TNT 160-14 (Aug. 14, 2014) (government's brief).

D. <u>Santander Holdings</u>.

1. *Santander Holdings USA, Inc. v. United States*, 2013-2 U.S.T.C. ¶50,564, 112 A.F.T.R.2d 6530 (D. Mass. 2013), is yet another STARS case, but with a very different outcome than *BNY I* or *Salem Financial*. Santander Holdings was formerly known as Sovereign Bancorp and is referred to as Sovereign in the court's opinion. Sovereign moved for summary

judgment on the sole issue of whether the payment it received from Barclay's should be accounted for as revenue in assessing whether Sovereign had a reasonable prospect of profit from the transaction. This is the very issue that was decided against the taxpayers in *BNY I* and *Salem Financial*, leading to government victories in those cases.

2. The court held for the taxpayer. It stated that the government "might be forgiven for suspecting that the designers of anything this complex must be up to no good," but that reaction is not a substitute for careful analysis. Upon careful analysis, the court stated, the government's position does not hold up.

3. The court first addressed the government's position that Sovereign did not in substance pay the U.K. taxes claimed as credits, because the Bx payment was an "effective rebate" of one-half of Sovereign's taxes. The court cited § 901(i) and the regulations under that section, dealing with subsidies. Under those rules, an income tax is not treated as a creditable tax to the extent the amount of the tax is used directly or indirectly by the foreign country to provide a subsidy, including to a counterparty, and the subsidy is determined by reference to the amount of the tax, or the base used to compute the tax. The regulations specify that substance and not form shall govern in determining whether a subsidy exists. In pretrial discovery, the government had disavowed any claim that the Bx payment was a subsidy under these rules. The concession, the court stated, must be understood to mean that the Bx payment was not "in substance" a subsidy.

4. The court held that the Bx payment was also not an "effective" or "constructive" rebate of taxes paid, citing *Doyon, Ltd. v. United States*, 37 Fed. Cl. 10 (1996), *rev'd on other grounds*, 214 F.3d 1309 (Fed. Cir. 2000), for the proposition that "amounts paid between private parties pursuant to private contracts are not and cannot be" taxes. The court also mentioned private letter rulings in which the IRS determined whether items were tax items or private transactions based on whether the taxing authority was actually a party to the transfer of a payment or credit, and not to the economic substance of the transfer.

5. Even if the Bx payment was intended to be and was the assumption of part of Sovereign's U.K. tax burden (which Sovereign conceded for purposes of the summary judgment motion), the court found that Sovereign is nonetheless treated as having paid the full U.K. tax for purposes of the foreign tax credit. In this regard, the court cited Treas. Reg. § 1.901-2(f)(2), which states that tax is considered paid by the taxpayer even if another party to the transaction agrees to assume the taxpayer's liability.

Return to Table of Contents

6. The court acknowledged that both the *BNY I* and *Salem Financial* courts had reached different conclusions regarding the Bx payment (or the "spread" as it was described in *BNY I*), finding it to be a "tax effect." The court observed, however, that those other courts had made that finding as a matter of fact, based on the strength of the government's expert witnesses' testimony. The court stated that the question whether the Bx payment can be so characterized is a question of law for the court, and neither *BNY I* nor *Salem Financial* addressed the legal question whether a private party payment can properly be classified as such.

7. Accordingly, the court granted the taxpayer's motion for partial summary judgment.

E. <u>WFC Holdings</u>.

1. The U.S. Supreme Court again refused to address the economic substance doctrine, this time in a case involving a Wells Fargo subsidiary. See 2014 TNT 111-4 (Jun. 10, 2014).

2. The Eighth Circuit Court of Appeals had held that the taxpayer's lease restructuring transaction lacked economic substance. As a result, the taxpayer was denied related deductions even though the plain language of the Code allowed those deductions. *WFC Holdings Corp. v. United States*, 728 F.3d 736 (8th Cir. 2013).

3. Some commentators had urged the Court to hear the case, as it presented the economic substance issue in an ideal posture for the Court's consideration. See, e.g., 2014 TNT 52-10 (Mar. 14, 2014).

F. <u>PPL – Supreme Court Decision</u>.

1. The U.S. Supreme Court issued its opinion in *PPL Corp. v. Commissioner*, 133 S. Ct. 1897, 2013-1 U.S.T.C. ¶50,335 (2013), holding unanimously in favor of the taxpayer. The Supreme Court thus agreed with the Tax Court in *PPL v. Commissioner*, 135 T.C. 304 (2010), and the Fifth Circuit in *Entergy Corp. v. Commissioner*, 683 F.3d 233 (5th Cir. 2012). The Third Circuit, which held in favor of the Commissioner, was reversed.

2. The Court stated that "Consistent with precedent and the Tax Court's analysis below, we apply the predominant character test [of the Treasury regulations] using a commonsense approach that considers the substantive effect of the tax. Under this approach, we hold that the U.K. tax is

Return to Table of Contents

creditable under § 901 . . . ." Under Treas. Reg. § 1.901-2(a)(3)(i), a foreign tax's predominant character is that of a U.S. income tax "if…the foreign tax is likely to reach net gain in the normal circumstances in which it applies."

3. The Third Circuit, following the Commissioner's view, believed that it could look no further than the tax formula that the U.K. parliament enacted and the way in which the Labour government characterized the tax. Under that view, the tax captures a portion of the difference between the price at which each company was sold in the privatization transaction and the price at which the Labor government believed each company should have been sold given the actual profits earned.

4. In contrast, PPL argued that the substance of the windfall tax is that of an income tax in the U.S. sense. While recognizing the tax ostensibly is based on the difference between two values, PPL argued that every "variable" in the windfall tax formula except for profits and flotation value is fixed (at least with regard to 27 of the 32 companies that were subject to the tax).

5. The Court stated that an examination of the tax formula used by the U.K. demonstrates that the windfall tax is economically equivalent to the difference between the profits each company actual earned and the amount the Labor government believed that it should have earned given its flotation value.

6. The Commissioner argued that any algebraic rearrangement of the U.K. formula is improper, asserting that U.S. courts must take the foreign tax rate as written and accept whatever tax base the foreign tax purports to adopt. As a result, the Commissioner claimed that an analysis begins and ends with the Labor government's choice to characterize its tax base as the difference between "profit-making value" and flotation value. The Court stated that such a rigid construction is unwarranted. It cannot be squared with the black letter principle that "tax law deals in economic realities, not legal abstractions." The court felt that the windfall tax is nothing more than a tax on actual profits above a threshold.

7. As discussed in footnote 6, one amicus brief argued that because two of the 32 privatized companies had initial periods substantially shorter than four years, the U.K. tax formula did not equate to an excess profits tax for those two companies, and thus the predominant character of the U.K. windfall tax was not a tax on income in the U.S. sense. The Court stated in footnote 6 of its opinion that this argument amounts to a claim that two outliers changed the predominant character of the U.K. tax law. The Court, however, stated that it expressed no view on the merits of this

argument, as the Commissioner admitted at oral argument that it did not preserve this argument.

8. Justice Sotomayor, in her concurring opinion, stated that if the predominant character inquiry were expanded to include the five companies that had different initial periods, especially those with much shorter initial periods, it would become impossible to rewrite the windfall tax as an excess profits tax "for all persons" subject to it. Instead it would become clear that the windfall tax is functionally a tax on value. However, Justice Sotomayor's concurring opinion states that because the government took the position at oral argument that the predominant character inquiry should disregard such "outlier companies," and this argument is therefore only pressed in an amicus brief, Justice Sotomayor reserved consideration of this argument for another day in another context.

9. It seems that the government's concession is right, and that these five (or two) outliers should not change the predominant character of the tax. Otherwise, the Service could disqualify other taxes as creditable simply by searching for one outlier despite the fact that perhaps thousands of taxpayers are subject to the tax as an income tax.

G. AM2013-006 – Redemption of Foreign Shareholder's Stock Requires Reduction in CFC's Foreign Tax Pool.

1. Chief Counsel Advice AM2013-006 addresses the redemption by a CFC of its stock held by a foreign minority shareholder. The redemption is a sale or exchange to the shareholder under § 302(a). The issue is whether the CFC's post-1986 foreign tax pool must be reduced. The CCA holds that it does.

2. In the CCA, a U.S. parent company ("P") owned 60% of the stock of the CFC. The other 40% was owned by an unrelated foreign party ("FP"). The CFC did not earn any Subpart F income. In Year 1, the CFC redeemed all of the stock owned by FP by way of a distribution of cash. Pursuant to § 302(b)(3), the redemption was treated as a § 302(a) distribution in full payment in exchange for the stock. Thus, the distribution was not treated as a dividend.

3. After the distribution, P owned 100% of the stock of the CFC. In Year 2, the CFC paid its entire remaining post-1986 undistributed earnings to P as a dividend and P claimed a § 902 deemed paid foreign tax credit equal to the CFC's post-1986 foreign income taxes.

Return to Table of Contents

4. Section 902 provides the rules for determining a U.S. shareholder's deemed paid foreign tax credit. Section 902(c)(2) defines the term "post-1986 foreign income taxes," i.e., the foreign tax pool, as the foreign income taxes with respect to the taxable year in which a dividend is distributed, and the foreign income taxes with respect to prior post-1986 taxable years to the extent such foreign taxes were not attributable to dividends distributed by the foreign corporation in prior taxable years. Section 902(c)(8) provides the authority for regulations as may be necessary or appropriate to carry out the provisions of § 902.

5. Treas. Reg. § 1.902-1(a)(8)(i) provides

> "... the term post-1986 foreign income taxes of a foreign corporation means the sum of the foreign income taxes paid, accrued or deemed paid in the taxable year of the foreign corporation in which it distributes a dividend plus the foreign income taxes paid-accrued or deemed paid in the foreign corporation's prior taxable years beginning after December 31, 1986, to the extent the foreign tax is not attributable to dividends distributed to, or earnings otherwise accrued (for example under §§ 304, 367(b), 551, 951(a), 1248, or 1293) in the income of, a foreign or domestic shareholder in prior taxable years. [Subject to an exception not relevant here] foreign taxes paid or deemed paid by a foreign corporation on or with respect to earnings that were distributed *or otherwise removed* from the post-1986 undistributed earnings in prior post-1986 taxable years shall be removed from the post-1986 foreign income taxes regardless of whether the shareholder is eligible to compute an amount of foreign taxes deemed paid under § 902, and regardless of whether the shareholder in fact chose to credit foreign income taxes under § 901 for the year of the distribution or inclusion. Thus, if an amount is distributed or deemed distributed by a foreign corporation to a U.S. person that is not a domestic shareholder within the meaning of paragraph (a)(1) of this section...or a foreign person that does not meet the definition of an upper-tier foreign corporation under paragraph (a)(6) of this section, then although no foreign income taxes shall be deemed paid under § 902, foreign income tax attributable to the distribution or deemed distribution that would have been deemed paid had the shareholder met the ownership requirements...shall be removed from post-1986 foreign income taxes."

6. Although the distribution of cash by the CFC in redemption of the stock held by the foreign person was treated as a sale or exchange under § 302(a), and not a dividend, §§ 312(a) and (n)(7) provide that the CFC's earnings and profits ("E&P") are decreased by the amount of the distribution to the extent of the ratable share of the E&P attributable to the stock so redeemed. Accordingly, the CFC's post-1986 undistributed earnings are reduced to take into account the redemption.

7. In considering whether there is also a corresponding reduction in the CFC's post-1986 foreign income taxes pool, the CCA states that Treas. Reg. § 1.902-1(a)(8) and its "otherwise removed" language is sufficiently broad to cover reductions of E&P under § 312(a). Some taxpayers have argued that this is not a proper interpretation of the language "otherwise removed" in the regulation, taking into consideration the context of the paragraph. The CCA disagrees with this interpretation. In the view of the Service, such an interpretation would be contrary to the intent and text of the final regulations and to the preamble to those regulations, and more generally to the principles and purpose of the § 902 rules.

H. CCA 201349015 – Transactions Between Disregarded Entities & Their Owners.

1. Chief Counsel Advice 201349015 deals with the proper reporting of U.S. taxable income and the proper standard for determining the compulsory amount of creditable foreign taxes imposed with respect to transaction between (1) a U.S. corporation and its foreign disregarded entity or an unincorporated branch operation and (2) between a U.S. corporation and an affiliated U.S. corporation's foreign branch or disregarded entity.

2. Transactions between a foreign branch or disregarded entity and its U.S. tax owner are generally disregarded for tax purposes. These transactions do not give rise to income or expense for U.S. tax purposes. Thus an application of the arm's length standard under § 482 to these disregarded transactions would not affect the amount of taxable income the U.S. owner recognizes for U.S. tax purposes. However, U.S. transfer pricing principles may be relevant in determining whether non-arm's length transfer prices and transactions between a foreign branch or disregarded entity and its U.S. owner result in noncompulsory payments of foreign tax under Treas. Reg. § 1.901-2(e)(5).

3. Transactions between a foreign branch or disregarded entity of a member of the consolidated group and another member also can give rise to these issues. Transactions between members of a consolidated group are intercompany transactions subject to Treas. Reg. § 1.1502-13. Under that regulation, the amount and location of intercompany items are determined on a separate entity basis, but the timing, character, source and other attributes of the intercompany items and corresponding items are adjusted to produce the effect of transactions between divisions of a single corporation. *See, for example,* Treas. Reg. § 1.1502-13(c)(7)(f)(ii) Examples 14 and 15. Example 14 involves the source of income from intercompany sales and Example 15 involves the timing, source and character of gain on sale of a CFC. In addition, § 864(e) and the regulations thereunder often operate to eliminate the effect of

intercompany transactions in determining the control group's relative amounts of U.S. and foreign source income and the allocation of the corresponding intercompany expense in determining the group's foreign tax credit limitation under § 904.

4. As a result, adjustments to the transfer price of a transaction between a U.S. corporation and another consolidated group member's foreign branch or disregarded entity generally would result in offsetting amounts of gross income and expense. Transfer pricing adjustments would not change the total amount of worldwide taxable income recognized by the U.S. corporate group. However, in determining the compulsory amount of foreign taxes paid, Treas. Reg. § 1.901-2(e)(5) is relevant.

5. The primary concern under Treas. Reg. § 1.901-2(e)(5) in these scenarios is that through the use of non-arm's length transfer prices a disregarded entity may report too much income to the foreign country or countries in which it operates resulting in an overpayment of foreign income tax. Similarly, a controlled foreign corporation in one country that operates through a branch or a disregarded entity in a foreign third country may report too much income and overpay its foreign taxes in either its home country or the third country.

6. The Chief Counsel Advice states that the legal basis for disallowing a foreign tax credit for overpayments of foreign tax attributable to non-arm's length transfer prices in these situations is not § 482 but the noncompulsory payment rule of Treas. Reg. § 1.901-2(e)(5). Under that regulation, the amount of taxable income reported on the foreign tax return must be computed in accordance with a reasonable interpretation of foreign law, as modified by applicable treaties.

7. Under the noncompulsory payment rules, as well as § 905(b) and the regulations under that section, a taxpayer must substantiate that its or its disregarded entity's foreign tax return is in accordance with a reasonable interpretation and application of the substantive and procedural provisions of foreign tax law, including with reference to applicable tax treaties, in such a way as to reduce, over time, its reasonably expected liability under foreign tax law.

8. In addition, the taxpayer must show that it exhausted all effective and practical remedies, including competent authority procedures if available, to minimize its foreign tax liability. Taxpayers must act to preserve their administrative remedies under foreign law or treaties to claim refunds of the overpaid foreign tax. The noncompulsory rules do not require the taxpayer to waste time and money in a futile effort, but if there is a

reasonable prospect of relief, the credit may be disallowed if the taxpayer chooses not to pursue its possibilities for obtaining a refund.

9. U.S. transfer pricing principles may be relevant in determining whether the non-arm's length transfer prices result in noncompulsory payments of foreign tax, to the extent foreign law, as modified by treaties to which the foreign country is a party, includes similar arm's length principles, as most do. These issues also can arise in the context of a CFC with a foreign branch or disregarded entity, as noted above.

10. The Chief Counsel Advice also states that transactions involving the U.S. branch or disregarded entity of a foreign corporation raises different issues. Foreign corporations engaged in a trade or business within the U.S. are subject to tax on gross income that is effectively connected with their conduct of a trade or business within the U.S. and are allowed deductions that are properly allocated and apportioned to the foreign corporation's U.S. effectively connected income. Because transactions between a branch or disregarded entity and its owner are typically disregarded for federal income tax purposes, they do not give rise to ECI or to deductions that are properly allocated and apportioned to ECI.

11. However, in limited circumstances, disregarded transactions between the foreign home office of a foreign corporation and its U.S. disregarded entity or branch, which do not give rise to effectively connected income or deductible expenses, may nonetheless be given effect for limited U.S. income tax purposes. For example, a transaction between a U.S. branch and its foreign home office may affect the determination of the source of certain income derived from sources within and without the United States. *See* Treas. Reg. § 1.863-3(b)(3) involving the sourcing of certain inventory sales by reference to an entity's books.

12. Certain U.S. tax treaties adopt the OECD's approach to attributing profits to a permanent establishment, and therefore generally compute business profits of a foreign corporation that are taxable in the U.S. by reference to the assets used, risks assumed, and functions performed by the U.S. permanent establishment. Under these treaties, profits of a U.S. permanent establishment may be determined based on all of the permanent establishment's dealings, including transactions between a U.S. permanent establishment and the foreign corporation of which it is a part. This is true even though the inter-branch dealings would not give rise to income, gain, profits, or loss of that foreign corporation under the Internal Revenue Code.

Return to Table of Contents

I. CCA 201330031 – Period of Limitations for Refund Claims.

1. Chief Counsel Advice 201330031 addresses the special 10-year limitations period under § 6511(d)(3) for refunds arising from foreign tax credit claims. On Date 1, Year 17, Taxpayer filed an amended return for Year 8, reflecting its election to change previously-claimed FTCs under § 901 to deductions for foreign income taxes under § 164(a)(3). On the same date, Taxpayer also filed an amended return for Year 3 to reflect its claimed carryback of the increased NOL created by its election to deduct foreign taxes in Year 8. Finally, on the same date, Taxpayer filed a refund claim for Year 1, based on the carryback of FTCs from Year 3 to Year 1. The FTCs from Year 3 were released due to the NOL from Year 8 carried back to Year 3.

2. The Service ruled that Taxpayer's refund claim for Year 1 was not timely under § 6511(d)(3)(A). Because Taxpayer elected to deduct foreign taxes in Year 8, rather than credit, the special 10-year statute of limitations did not apply. This interpretation, states the CCA, is supported by Treas. Reg. § 301.6511(d)-3(a), which specifically states that the 10-year SOL only applies to an overpayment of income tax that results from a credit allowed under § 901. No provision is made under the regulations for an extended statute where the claim for refund results from a deduction of foreign income taxes.

3. The Service adopted a similar position in ILM 201204008, ruling that the special 10-year statute of limitations did not apply where the taxpayer was electing to deduct, rather than credit, foreign taxes. Practitioners questioned the result, noting that Treas. Reg. § 1.901-1 specifically states that the taxpayer may elect to credit or deduct at any time within the 10-year period prescribed by § 6511(d)(3)(A). The position adopted in ILM 201204008 would mean that the election can be changed from credit to deduction, but no refund is available for the reduced taxes resulting from that election, an odd result to say the least! However, the Service appears committed to its position.

4. Additionally, the Service ruled that Taxpayer's claim was untimely because the claim was not "attributable to" foreign taxes paid or accrued in Year 8. Instead, the claim was "attributable to" foreign taxes paid or accrued in Year 3, which were carried back and claimed as credits in Year 1. In order for the claim to be timely under § 6511(d)(3), states the CCA, all of the cascading carrybacks to Year 3 and Year 1 would have to be deemed "attributable to" the Year 8 foreign taxes.

Return to Table of Contents

J. <u>CCA 201441015 – Pre-1987 Taxes Paid in Post-1986 Years</u>.

1. Chief Counsel Advice 201441015 addresses a CFC ("X CFC2") acquired by the U.S. Parent group in 2002. No § 338 election was made. In 2007, X CFC2 settled a Country X audit for tax years 1994-1999, and paid additional Country X taxes. In 2010, X CFC2 liquidated, and its post-1986 foreign tax pool was deemed paid under § 902 by the U.S. parent. X CFC2 was entirely foreign owned during the 1994-1999 years. The question at issue is whether the additional taxes paid by X CFC2 in 2007 are post-1986 taxes, for which a deemed paid credit is available, or pre-1987 taxes, in which case a credit would not be available.

2. Under § 902(c)(3), a foreign corporation's post-1986 pooling of E&P and foreign taxes does not begin until the first year in which the foreign corporation has a 10-percent domestic corporate shareholder that is eligible to compute foreign tax credits under § 902 with respect to the foreign corporation. On the facts of the CCA, post-1986 pooling did not begin with respect to X CFC2 until after the audit years.

3. The CCA states that E&P accumulated by the X CFC2 qualified group prior to meeting the 10 percent ownership threshold are pre-1987 accumulated profits, and that foreign income taxes paid, accrued, or deemed paid with respect to those pre-1987 accumulated profits are pre-1987 foreign income taxes. Accordingly, states the CCA, additional amounts of creditable foreign taxes paid by X CFC2 in 2007 with respect to those pre-1987 accumulated profits are also pre-1987 foreign income taxes.

4. The CCA also discusses § 905(c), which provides rules for foreign tax redeterminations—when the amount of foreign taxes when paid differs from the amount accrued. This includes a case where additional taxes are incurred after the original accrual for the taxable year.

5. Section 905(c)(2)(A) states that in general, in making the required redetermination of U.S. taxes, no foreign tax credit is allowed for taxes that were not paid within 2 years of the last day of the relevant taxable year to which the taxes relate. However, § 905(c)(2)(B) states that any such taxes if subsequently paid shall be taken into account (i) in the case of taxes deemed paid under § 902 or 960, for the taxable year in which paid, and (ii) in any other case, for the taxable year to which the taxes relate. Since X CFC2's taxes were deemed paid under § 902, clause (i) of § 905(c)(2)(B) would appear to treat the additional taxes paid by X CFC2 as "taken into account" for 2007, the taxable year in which they were paid. This would make them post-1986 taxes.

6. The CCA, however, takes a different view. It states that under § 902(c)(6) and accompanying regulations, the amount of a distribution out of pre-1987 accumulated profits, and the amount of foreign income taxes deemed paid under § 902 with respect to such a distribution, is determined by applying the law in effect prior to the 1986 Tax Act. That prior law, states the CCA, did not include the current provisions of § 905(c)(2)(B)(i) (which were added in 1997). The CCA appears to imply that § 902(c)(6) should be read to impose its effective date rule on § 905(c)(2)(B). The CCA states that treating the additional Country X taxes paid in 2007 as post-1986 taxes "finds no support in the Code, the regulations, or sound tax policy."

7. In a footnote, the CCA also observes that § 905(c)(2)(B)(i) is effective for taxes that related to taxable years beginning after December 31, 1997. While this statement appears to contradict the IRS's main argument, the CCA states that U.S. Parent cannot rely on § 905(c)(2)(B)(i) as support for including X CFC2's taxes for 1994-1997 in its post-1986 tax pool.

K. <u>Notices 2014-44 and 2014-45: Section 901(m) Anti-Avoidance</u>.

1. Section 901(m) deals with covered asset acquisitions ("CAAs"), and can permanently prevent a portion of foreign tax paid from qualifying as a creditable foreign income tax. Section 901(m) was enacted in 2010. Treasury and the IRS have yet to issue regulations under the provision, which is not completely surprising given that the statutory rules present so many practical problems.

2. IRS Notice 2014-44 is the Service's first pronouncement under § 901(m). It addresses a relatively narrow § 901(m) issue, and closes what the IRS believes is an inappropriate attempt on the part of some taxpayers to avoid § 901(m) by utilizing the check-the-box rules.

3. Under the § 901(m) general rule, a certain portion of foreign tax can be disallowed each year as a creditable foreign tax during the relevant foreign asset's ("RFA") amortization or depreciation period. If the RFA is disposed of, then any remaining basis difference is taken into account in that one year.

4. The Joint Committee on Taxation's Technical Explanation of § 901(m) states: "If there is a disposition of any relevant foreign asset before its cost has been entirely recovered or of any relevant foreign asset that is not eligible for cost recovery (*e.g.*, land), the basis difference allocated to the taxable year of the disposition is the excess of the basis difference with respect to such asset over the aggregate basis difference with respect to

Return to Table of Contents

such asset that has been allocated under this provision to all prior taxable years. Thus, any remaining basis difference is captured in the year of the sale, and there is no remaining basis difference to be allocated to any subsequent tax years. However, it is intended that this provision generally apply in circumstances in which there is a disposition of a relevant foreign asset and the associated income or gain is taken into account for purposes of determining foreign income tax in the relevant jurisdiction."

5. Accordingly, § 901(m)(3)(B)(ii) provides that, except as otherwise provided by the IRS, if, after there has been a § 901(m) acquisition, there is a disposition of an RFA, the basis difference allocated to the taxable year of the disposition will be the excess of the basis difference of the asset over the aggregate basis difference of the asset that was allocated to all prior taxable years (the "Unallocated Basis Difference"). No part of the basis difference with respect to the asset will be allocated to any taxable year thereafter.

6. IRS Notice 2014-44 states that applying the statutory disposition rule under § 901(m)(3)(B)(ii) to the disposition of an RFA is appropriate in fact patterns in which the gain or loss from the disposition is fully recognized for purposes of both U.S. income tax and a foreign income tax. However, in certain cases, states the Notice, including cases in which the gain or loss from the disposition is recognized for purposes of U.S. income tax but not for purposes of a foreign income tax, or, as described below, cases in which no gain or loss is recognized for purposes of U.S. income tax or foreign income tax, it may not be the appropriate time for all, or any, of the Unallocated Basis Difference to be taken into account. Further, § 901(m) should continue to apply to the remaining Unallocated Basis Difference.

7. The Notice states that the IRS and the Treasury are aware that certain taxpayers are engaging in transactions shortly after a CAA occurs that are intended to invoke application of the statutory disposition rule under § 901(m)(3)(B)(ii) to avoid the purposes of § 901(m). For example, assume USP, a domestic corporation, wholly owns FSub, a foreign corporation. FSub acquires 100 percent of the stock of FT, a foreign corporation, in a qualified stock purchase for which an election under § 338 is made. The acquisition of FT is a § 338 CAA, and the assets of FT are RFAs with respect to that § 338 CAA.

8. Shortly after the acquisition of FT, FT becomes disregarded as an entity separate from its owner pursuant to an entity classification election under the check-the-box rules. As a result of the entity classification election, FT is deemed, solely for U.S. tax purposes, to distribute all of its assets and liabilities to FSub in a deemed liquidation. On these facts, no gain or

loss is recognized on the deemed liquidation by either FT or FSub pursuant to §§ 332 and 337.

9. These taxpayers take the position that the deemed liquidation constitutes a disposition of the RFAs for purposes of § 901(m)(3)(B)(ii). As a result, states the Notice, these taxpayers claim that all of the basis difference with respect to the RFAs is allocated to the final taxable year of FT that occurs by reason of the deemed liquidation, and that no basis difference with respect to the RFAs is allocated to any later taxable year. This claim is made notwithstanding that (i) the disparity in the basis in the assets of FT for purposes of U.S. income tax and the foreign income tax that arose as a result of the § 338 CAA continues to exist after the deemed liquidation, and (ii) since no gain is recognized for foreign income tax purposes as a result of the deemed liquidation, there is also no foreign income tax that is subject to disqualification under § 901(m) as a result of the liquidation. Although the deemed liquidation of FT is also a CAA, the basis difference that arises with respect to this subsequent CAA generally would be minimal.

10. According to the Notice, taxpayers have engaged in other variations of this transaction, each of which raises significant policy concerns. Therefore, Treasury and the IRS intend to issue regulations addressing the issue.

11. For purposes of the to-be-issued § 901(m) regulations, a disposition means an event (for example, a sale, abandonment, or mark-to-market event) that results in gain or loss being recognized with respect to an RFA for purposes of U.S. income tax or foreign income tax, or both. In transactions such as those described in the notice, the tax-free deemed liquidation arising upon FT's entity classification election does not result in a disposition of an asset for purposes of § 901(m).

12. The portion of a basis difference with respect to an RFA that is taken into account for a taxable year as a result of a disposition will be determined pursuant to either of two rules. First, if a disposition is fully taxable (that is, results in all gain or loss, if any, being recognized with respect to the RFA) for purposes of both U.S. income tax and a foreign income tax, the disposition amount is equal to the Unallocated Basis Difference. This is because there generally will no longer be a disparity in the basis of the RFA for purposes of U.S. income tax and the foreign income tax.

13. Second, if a disposition is not fully taxable for purposes of both U.S. income tax and foreign income tax, generally there will continue to be a disparity in the U.S. basis and the foreign basis following the disposition. In such a case, it is appropriate for the RFA to continue to be subject to § 901(m). To the extent that the disparity in the U.S. basis and the foreign

basis is reduced as a result of the disposition, however, a portion of the Unallocated Basis Difference (or in certain cases, all of the Unallocated Basis Difference) should be taken into account.

14. In the case of a positive basis difference, a reduction in basis disparity generally will occur upon a disposition of an RFA if (i) gain is recognized for purposes of a foreign income tax, which generally results in an increase in the foreign basis of the RFA, or (ii) loss is recognized for U.S. income tax purposes, which generally results in a decrease in the U.S. basis of the RFA. If the RFA has a positive basis difference, the disposition amount equals the lesser of (I) any foreign disposition gain plus any U.S. disposition loss (solely for this purpose, expressed as a positive amount), or (II) the Unallocated Basis Difference.

15. In the case of a negative basis difference, a reduction in basis disparity generally will occur upon a disposition of an RFA if (i) loss is recognized for purposes of a foreign income tax, which generally results in a decrease in the foreign basis of the RFA, or (ii) gain is recognized for U.S. income tax purposes, which generally results in an increase in the U.S. basis of the RFA. If the RFA has a negative basis difference, the disposition amount equals the greater of the following amounts: (I) any foreign disposition loss plus any U.S. disposition gain (solely for this purpose, expressed as a negative amount), or (II) the Unallocated Basis Difference.

16. To the extent the entire Unallocated Basis Difference is not taken into account as a disposition amount, § 901(m) will continue to apply to the remaining Unallocated Basis Difference. Section 901(m) will continue to apply to an RFA until the entire basis difference in the RFA has been taken into account under § 901(m)(3)(B)(i) using the applicable cost recovery method for U.S. income tax purposes or as a disposition amount (or both). Thus, even if there is a change in the ownership of an RFA, for example, by reason of a transaction that is a disposition only for U.S. income tax purposes, § 901(m) will continue to apply to the RFA until any remaining Unallocated Basis Difference in the RFA has been taken into account. The IRS and Treasury are continuing to consider whether and to what extent § 901(m) should apply to an asset received in exchange for an RFA in a transaction in which the basis of the asset is determined by reference to the basis of the RFA transferred.

17. Notice 2014-44 provides that the regulations will generally apply to dispositions that occur on or after, and any unallocated basis difference for a relevant foreign asset as of, July 21, 2014. Notice 2014-45, a follow-up Notice, provides that the regulations will also apply to determine the tax consequences under § 901(m) of an entity classification election that is filed after July 28, 2014, and that is effective before July 22, 2014,

including whether a disposition results from the election for purposes of § 901(m) and the treatment of any Unallocated Basis Difference that results from the election.

18. No inference is intended as to the treatment of transactions under previous law, and the IRS may challenge them under applicable Code provisions or judicial doctrines.

III. E&P Following an Asset Reorganization.

A. Treasury and the IRS proposed regulations under § 381 that are a follow on to proposed regulations previously issued under § 312. The proposed regulations under § 312 provide that in an asset reorganization the earnings and profits of the transferee move to the acquiring corporation. However, if the transferee corporation transfers all of the transferor corporation's assets to a controlled subsidiary, then that controlled subsidiary will succeed to the transferor corporation's earnings and profits.

B. A number of comments were submitted with respect to the § 312 proposed regulations concerning the electivity provided to taxpayers with respect to which corporation would succeed to the earnings and profits. Some of these commentators noted the international tax-planning opportunities.

C. Consequently, Treasury and the IRS proposed § 381 regulations providing that only the direct acquiring corporation will succeed to the earnings and profits. This will be the result even if the transferee corporation ultimately retains none of the assets because they are contributed to a subsidiary corporation.

D. Treasury and the IRS stated in the preamble that the proposed § 381 regulations produce more appropriate results because they would eliminate the electivity raised by commentators on the proposed § 312 regulations.

IV. Economic Substance.

A. Notice 2014-58, 2014-44 I.R.B. 1, "amplifies" Notice 2010-62, 2010-2 C.B. 411, by providing additional guidance regarding the codification of the economic substance doctrine and the related penalty amendments. See 2014 TNT 197-11 (Oct. 9, 2014).

B. The Notice provides guidance on how the IRS will interpret the term "transaction" in applying the codified economic substance doctrine. It states that for purposes of determining whether the codified economic substance doctrine applies, "transaction" generally includes all the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement; and any or all of the steps that are carried out as part of a plan. Facts and circumstances determine whether a plan's steps are aggregated or disaggregated when defining a transaction.

C. Generally, when a plan that generated a tax benefit involves a series of interconnected steps with a common objective, the "transaction" includes all of the steps taken together. This means that every step in the series will be considered when analyzing whether the "transaction" as a whole lacks economic substance. However, in keeping with *Coltec Industries, Inc. v. United States*, 454 F.3d 1340 (Fed. Cir. 2006), the Notice states that when a series of steps includes a tax-motivated step that is not necessary to achieve a non-tax objective, an aggregation approach may not be appropriate. In that case, the "transaction" may include only the tax-motivated steps.

D. The Notice also provides guidance on whether other judicial doctrines and statutory provisions constitute a "similar rule of law" in applying the 40% economic substance penalty. For purposes of § 6662(b)(6), "similar rule of law" means a rule or doctrine that disallows the tax benefits under subtitle A of the Code related to a transaction because (1) the transaction does not change a taxpayer's economic position in a meaningful way (apart from Federal income tax effects); or (2) the taxpayer did not have a substantial purpose (apart from Federal income tax effects) for entering into the transaction.

E. In other words, "similar rule of law" means a rule or doctrine that applies the same factors and analysis that is required under § 7701(o) for an economic substance analysis, even if a different term or terms (for example, "sham transaction doctrine") are used to describe the rule or doctrine.

F. The Notice states that the IRS will not apply a penalty under § 6662(b)(6) (or otherwise argue that a transaction is described in § 6662(b)(6)) unless it also raises § 7701(o) to support the underlying adjustments. If the IRS does not raise § 7701(o) to disallow the claimed tax benefits and instead relies upon other judicial doctrines (e.g., the substance over form or step transaction doctrines) to support the underlying adjustments, the IRS will not apply the penalty (or otherwise argue that a transaction is described in § 6662(b)(6)) because the IRS will not treat the transaction as failing to meet the requirements of a similar rule of law.

G. The Notice states that Code sections and Treasury regulations, other than § 7701(o) and the regulations under that section, that disallow tax benefits are not similar rules of law for purposes of § 6662(b)(6).

V. Forthcoming Regulations.

A. A Treasury official reportedly stated that the § 367(a) gain recognition final regulations will be issued "any day now." BNA Daily Tax Report, Nov. 6, 2014. The regulations, once final, will ease the penalties that apply for an inadvertent failure to file a GRA. The regulations as proposed would eliminate the need for taxpayers to prove "reasonable cause" in seeking relief from penalties and gain recognition after failure to fully or properly file a GRA. Instead, taxpayers would only need to show that the failure was not "willful."

B. Other regulations projects stated to be "far along" include: (i) § 956 regulations on loans by controlled foreign corporations to foreign partnerships, (ii) final regulations on foreign tax credit determinations under § 905(c), to replace temporary regulations that expired in 2010, and (iii) guidance on § 871(m) equity swap payments, to replace temporary regulations that will expire in January.

C. The government is also "working to finalize" foreign currency rules under § 987 and rules on the transfers of intangibles offshore under § 367(d). Projects described as "longer term" include guidance on the PFIC asset and income tests under § 1297, PTI under § 959, and substantial business activities under § 7874. Notably absent from the list are the much-needed regulations under § 901(m).

D. See BNA Daily Tax Report, Nov. 6, 2014.

VI. Camp International Tax Reform Proposal.

A. In February 2014, House Ways and Means Committee Chairman Dave Camp (R-MI) introduced his comprehensive tax reform plan. H.R. ___, 2014 TNT 39-40. The Camp proposal includes a territorial system (of sorts) of international corporate tax, but with a minimum 15% tax on certain "intangible income" earned through CFCs. The Camp proposal has received a chilly reception from other Republican members of the Ways and Means Committee.

B. The Camp proposal would authorize a 95% DRD on the foreign source portion of dividends received by a domestic corporation from a specified 10%-owned foreign corporation (a CFC or 10/50 company) if the domestic corporation holds the foreign corporation's stock throughout the 1-year period extending 6 months before and after the ex-dividend date.

C. Losses on the sale of a specified 10%-owned foreign corporation's stock would be reduced by the amount of any 95% DRD previously claimed. Foreign branches of domestic corporations would continue to be subject to full U.S. tax (at the generally applicable 25% tax rate under Camp's domestic tax reform proposal). Branch loss recapture would be strengthened.

D. Section 902 would be repealed. No foreign tax credit would be allowed with respect to (withholding) taxes imposed on dividends eligible for the 95% DRD. Foreign tax credits would continue to be allowed under § 960 with respect to Subpart F inclusions. Section 904 would be modified so as to allocate only directly allocable deductions to foreign source income.

E. Subpart F would continue to apply, and would include a new category, foreign base company intangible income. "Foreign base company intangible income" would equal the excess of (i) so much of the CFC's adjusted gross income as exceeds 10% of the CFC's aggregate basis in tangible property used in a trade or business, over (ii) the applicable percentage of the CFC's other Subpart F income. The "applicable percentage" is the ratio of the excess in clause (i) to the CFC's AGI. When fully phased in (2019), foreign base company intangible income would only include income subject to an effective foreign tax rate that is less than 60% of the U.S. rate (i.e., a minimum 15% under Camp's domestic proposal to reduce the U.S. rate to 25%).

F. Subpart F income would include foreign base company sales income only if the income is subject to an effective foreign tax rate which is less than half the U.S. rate (i.e., 12.5%). The active finance exception would be extended through the end of 2018 but would be treated similarly to foreign base company sales income, that is, it would apply in full only to income subject to an effective foreign tax rate of at least half the U.S. rate. The CFC look-through rule of § 954(c)(6) would be made permanent.

G. Existing foreign corporation earnings of both CFCs and 10/50 companies as of the close of the foreign corporation's last taxable year beginning before 2015 would be subject to a forced repatriation tax, though at reduced rates. The rate would be 6.25% for foreign corporation E&P represented by cash and cash equivalents, and 2.5% for other E&P. To prevent manipulation, the foreign corporation's cash position would be based on its average cash position as of the close of its last two taxable years ending before February 26, 2014.

Return to Table of Contents

VII. BEPS and EU State Aid Investigations.

A. As the BEPS freight train continues to roll forward, U.S. officials have continued to express concerns. Robert Stack, Deputy Assistant Treasury Secretary for International Tax Affairs, recently provided an update of the OECD's progress and the U.S.'s concerns. He stated that:

- The U.S. will probably succeed in getting section B of the revised discussion draft on intangibles removed for recirculation. This would be good. Section B of the intangible draft is highly controversial. It addresses which member of a multinational group should be entitled to intangibles-related returns.

- Working party no. 6 has yet to debate how multinational companies will share their country-by-country reporting templates with tax authorities.

- The U.S. probably will be able to have the related-party threshold increased under the hybrid discussion draft.

- The U.S. will make a reservation to the OECD model treaty if a "main purpose" (GAAR) clause is added to the model.

- There is little support among members of the digital economy tax force for adopting a virtual permanent establishment.

B. Stack said that U.S. tax advisors should be aware by now that a cash box in Bermuda with a zero return is an endangered species. He stated this is either because the world is going to refine "arm's length" or because that type of structure will be the target of a "special measure." The term "special measure" refers to an approach contemplated under the BEPS plan for attributing income to hard-to-value intangibles that goes beyond the arm's length standard. Stack said the Bermuda example is easy when it involves just two employees and some cash in Bermuda, but wonders what happens if you move that cash into Ireland with a few more people and a 12.5% tax rate.

C. The U.S., he stated, wants a thorough discussion paper on the arm's-length principle that deals with how to price hard-to-value intangibles. He said that others want to use the intangibles project as a "kind of modified arm's-length standard to combat BEPS," and the U.S. believes that is a bad idea.

D. Regarding treaties, Stack stated that the U.S.-style limitation on benefits rule is unpopular. There are concerns about weaknesses in our LOB provisions, such as our approach to discretionary relief and our approach to benefits.

Return to Table of Contents

E. According to Stack, while the U.S. does not like the "main purpose" (GAAR) approach for purposes of a treaty, other countries assert that the U.S. can deny treaty benefits to taxpayers under its statutory and case law (for example, *Aiken Industries v. Commissioner*). (Note, incidentally, that the IRS is arguing in *Altera v. Commissioner* that it also can write regulations that deviate from the § 482 arm's-length standard. An IRS victory might prove to be a major negative in the U.S.'s efforts to preserve the arm's-length standard in BEPS discussions.)

F. Stack also said that under the current U.S. treaty position the U.S. could not join a multilateral tax treaty that has a main purpose test. In 1999, the Senate rejected "main purpose" language during its consideration of treaties with Italy and Slovenia. Under its current position, the U.S. Senate would not approve such a treaty (assuming Sen. Rand Paul allows any treaties or protocols to move forward in the Senate at all).

G. Mike Danilack, then IRS LB&I Deputy Commissioner, recently expressed his views on the potential negative impact that BEPS could have on the U.S. He said there could be an increase in cross-border disputes and litigation costs; an increase in aggressive tax audits, which will put additional pressure on competent authorities who already are strapped for resources; foreign governments will try to collect more taxes from U.S. companies which would result in the U.S. government having to permit more and much larger foreign tax credits; and there could be a general decline in U.S. tax revenues.

H. Sam Maruca, then IRS Director of Transfer Pricing under Danilack, stated a concern that some of our treaty partners view BEPS as an invitation to "snatch away" the U.S.'s tax base. "My fear is that some of our treaty partners view this as a land grab – of reaching out and helping yourself to the tax base." He said that attitude means controversies will be on the uptick and competent authorities worldwide will be under more pressure to resolve them. According to Maruca, the U.S. delegation to the OECD and the U.S. Department of Treasury are very much wedded to the arm's-length principle.

I. Robert Stack, stated that despite the U.S.'s grave policy concerns, BEPS likely would result in "special measures" given the inexorable political pressure being exercised by the rest of the world. He said the contours of the "special measures" to value transfers of hard-to-value intangibles are unknown, but the subject will be vigorously debated in 2015. From a U.S. perspective, such measures could be "within § 482, or they may need special legislation."

J. Stack said it is important for a U.S. audience to understand that the world "wants to do something" about the "blob of money" in Bermuda. He said it will be very difficult, if not impossible, for the U.S. to defend zero-tax buckets of money offshore in intangibles structures. He added that he was not saying the U.S.

agrees with any particular options but rather that consideration will take place next year.

K. Stack added that perhaps the "special measure" is the U.S.'s "commensurate with income" provision. He said if the intangibles were transferred offshore at a cheap price and they later contributed to the earning of substantial profits, the IRS might be able to use hindsight to modify the price for which the intangibles were transferred. This could operate in a manner that lets the U.S. bring back the income to the United States in the case of a U.S. parent company. Stack said this idea is not on the working party's list of possible approaches yet, but it is something one could do.

L. In the past several months, the European Union has announced a number of "state aid" investigations, focusing on whether Ireland, Luxembourg, and the Netherlands have provided illegal "state aid" to foreign companies, most of which are U.S. multinationals. These include investigations into Ireland's tax treatment of Apple, the Netherlands' treatment of Starbucks, and Luxembourg's treatment of Fiat and Amazon.

M. Under EU principles, member states are generally permitted to provide favorable tax rates and tax incentives but must do so equally to all affected taxpayers. The investigations at issue focus on whether Ireland, the Netherlands and Luxembourg offered special arrangements to certain companies that were not generally available. Such arrangements could constitute illegal state aid under EU rules.

N. The prospect of a negative finding in these cases could be daunting for the companies involved. If an EU member state is determined to have provided illegal state aid, the EU can force that member state to collect the back taxes from the company that would have been due had the illegal arrangement not been in place. This could represent hundreds of millions, or billions, of dollars of tax over the course of many years.