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STATE BAR OF TEXAS

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CHAIR'S MESSAGE

The Tax Section has a lot going on as we pass the half-way mark for this fiscal year some of which I will review below. First, however, you should note the following Tax Section events on your calendar:

- March 25, 2013 – Property Tax Conference, Austin, Texas
- June 20-21, 2013 – Annual Meeting of the State Bar of Texas (including the Tax Section Annual Meeting on June 21 which is discussed in detail below), Dallas, Texas; and
- August 13-15, 2013 – Advanced Tax Law Course, Houston, Texas

Further details of these upcoming events will be forwarded to you via Section e-blasts and posted on the Tax Section's website at www.texastaxsection.org.

Second, what has been going on in your Section? Continue reading . . .

2013 Outstanding Texas Tax Lawyer

I am pleased to announce that the Tax Section Council has selected Professor Ira Shepard as the 2013 recipient of the Outstanding Texas Tax Lawyer award. This is the highest award that the Tax Section bestows as a recognition honoring recipients for their outstanding reputation, expertise and professionalism in the practice of tax law in Texas. Professor Shepard has been at the University of Houston Law Center since 1975 and has taught thousands of law students tax law during this time. He was a primary force in establishing the LL.M. Taxation program at the University of Houston. Before his tenure at the Law Center, he taught at the University of Georgia School of Law and was a visiting professor at the University of North Carolina Law School. He received his baccalaureate degree from Harvard College in 1958 and his law degree from Harvard University in 1964, where he was an editor of the Harvard Law Review. Following graduation, he practiced in New York City with the firm of Paul, Weiss, Rifkind, Wharton & Garrison. He is a fellow of the American College of Tax Counsel and a frequent speaker at various tax programs including our Advanced Tax Law Course. He is the single most sought after speaker to provide a yearly tax law update for this course. He is knowledgeable and entertaining – a rare combination. He has been the Special Advisor to the Southern Federal Tax Institute since 1974. He has chaired the Continuing Legal Education and Research Committee of the American Bar Association Tax Section and the planning committee for the University of Texas Tax Conference. Congratulations to Professor Shepard.

Inaugural Class of the Tax Section Leadership Academy

Congratulations to the recent graduates from the Inaugural Leadership Academy. During the past year, these individuals participated in a program consisting of various leadership development events throughout the State of Texas. The graduates are: Christopher A. Cunningham, Sharon L. Ellington, Renesha N. Fountain, David C. Gair, Brent C. Gardner, Megan R. Horn, Matthew C. Hunsaker, Christian S. Kelso, C. Stoddard Lowther, Sam L. Merrill, Robert C. Morris, Ryan L. Morris, Michelle U. Rosenblatt, Ronald J. Rucker, Jeffrey M. Slade, Molly C. Sorg, Michelle L. Terbay, Jaime Vasquez, and Benjamin W.

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Vesely. For information on these graduates, see a brief bio for each included in this publication of the *Texas Tax Lawyer*.

A huge "THANK YOU" to David Colmenero who served as the program director of the Leadership Academy. He and his committee did an outstanding job in planning the various programs, obtaining presenters, and dealing with the logistics of putting on such a course. Their job was made easier because of the hard work of Susan House who was an indispensable asset to this program.

We will hold our next Leadership Academy program beginning in 2014. Be on the lookout for applications and further information.

COGS Projects

We continually seek to improve the substance and administration of state and federal tax laws through our Committee on Government Submissions ("COGS") process. The COGS process also enhances the profile of our members within the tax community and furthers the national reputation of the Texas Tax Bar. Currently, the COGS chair is Stephanie Schroepfer who continues to do an incredible job in shepherding through our COGS projects. In addition to the three COGS projects previously reported to you, we have also submitted the following:

- Comments on the proposed regulations relating to Circular 230;
- Comments on the proposed regulations relating to incentives for non-discriminatory wellness programs and group health plans; and
- Comments on the proposed regulations regarding net investment income tax under Section 1411 relating to trusts and estates.

Many thanks to David Gair, David Colmenero, Chair of the Controversy Committee, Shawn R. O'Brien, and Mary McNulty for their work on the Circular 230 comments; Henry Talavera, Vice Chair of the Compensation and Employee Benefits Committee, and Stephanie Schroepfer, Susan A. Wetzel, David D'Alessandro, and Josephine Stewart Harvey for their work on the wellness comments; and Melissa Willms, Vice Chair of Estates and Gift Tax Committee, and Amanda Gyeszly, Lora Davis, and Celeste Lawton for their work on the net investment income tax under Section 1411. There are additional COGS projects in the works which will be reported to you at a later date. If you wish to get involved with an ongoing project or have ideas for leading one yourself, please contact Stephanie Schroepfer at (713) 651-5591 or sschroepfer@fulbright.com.

Annual Meeting and Sponsorship Opportunity

We have an unbelievable program lined up for our Annual Meeting. YOU WILL NOT WANT TO MISS IT! The meeting will take place on June 21, 2013, at the Hilton Anatole in Dallas. This year's world-class program will be headlined by Douglas Shulman, Ex-Commissioner of Internal Revenue. Other renowned speakers will include Kathryn Keneally, Mark Matthews, Terence Cuff, Stanley Blend, and Professor Christopher Hanna and our luncheon with a legend – Professor Stanley Johanson.

We are offering a $5,000 sponsorship which provides the following:

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- Five seats at a Speaker's Dinner, which Ex-Commissioner Shulman will attend and to which all listed speakers are invited
- Five tickets to the Annual Meeting's Tax Legends Luncheon, which will feature an extensive interview with Professor Stanley Johanson
- Recognition at the Tax Section Annual Meeting
- Recognition in Tax Section Chair introductory remarks
- Recognition on Tax Section Annual Meeting handouts
- Recognition on Annual Meeting e-blasts from Tax Section leadership to members of the Tax Section
- Recognition at each separate Leadership Academy event, including course materials, posters, and in introductory remarks
- Recognition on Leadership Academy e-blasts and brochures

For more information on this sponsorship, see the announcement and Sponsorship Form included in this issue of the *Texas Tax Lawyer*.

We have had a number of things going on this year with hard work by a number of people. These are just some of the activities of your Tax Section. However, the greatest benefit you can receive as a member is to become involved with one or more of the Section's many activities. It provides you with a great way to meet fellow tax professionals and make a lasting impact on the practice of tax law – both in Texas and nationally. If you are not sure how to get involved, please contact me at (903)223-9544 or at tgreen@capshawgreen.com. I look forward to finishing out an active and strong year with your help.

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2013 TEXAS STATE BAR TAX SECTION ANNUAL MEETING

We are excited to announce the 2013 Texas State Bar Tax Section Annual Meeting will take place on June 21 at the Hilton Anatole in Dallas.

This year's world-class program will be headlined by Douglas Shulman, Ex-Commissioner of Internal Revenue. Other renowned speakers will include Kathryn Keneally, Mark Matthews, Terence Cuff, Stanley Blend, and Professors Christopher Hanna and Stanley Johanson.

We encourage you to take a greater part in this exceptional event by becoming a sponsor.

A $5,000 sponsorship provides:

- Five seats at a Speaker's Dinner, which Ex-Commissioner Shulman will attend and to which all listed speakers are invited
- Five tickets to the Annual Meeting's Tax Legends Luncheon, which will feature an extensive interview with Professor Stanley Johanson
- Recognition at the Tax Section Annual Meeting
- Recognition in Tax Section Chair introductory remarks
- Recognition on Tax Section Annual Meeting handouts
- Recognition on Annual Meeting e-blasts from Tax Section leadership to members of Tax Section

In addition to these valuable benefits, a sponsorship includes publicity throughout an exciting new year-long program for outstanding young tax lawyers, the Tax Section Leadership Academy. Over a series of 1-2 day events throughout the year, participants from private practice and industry will hear from leading Texas tax lawyers. The program is intended to foster lasting relationships and provide a forum for developing the skills necessary to lead and inspire current and future generations of Texas tax attorneys. The experience received rave reviews from the inaugural Leadership Academy class. The sponsorship also provides:

- Recognition at each separate Leadership Academy event, including course materials, posters, and in introductory remarks
- Recognition on Leadership Academy eblasts and brochures

To discuss this opportunity further or to reserve a sponsorship form, please contact:

Tina R. Green, Tax Section Chair
903.223.9544
tgreen@capshawgreen.com

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2013 TEXAS STATE BAR TAX SECTION ANNUAL MEETING

2013 Texas State Bar Tax Section Annual Meeting
June 21, 2013
Hilton Anatole - Dallas, Texas

SPONSORSHIP FORM

☑ $5000 package

SPONSORSHIP NAME (AS YOU WOULD LIKE IT TO APPEAR)	CONTACT NAME
STREET ADDRESS	CITY, STATE, ZIP
PHONE	EMAIL

PAYMENT INFORMATION

Please submit this form and payment in form of a check by June 10.

Alyson Outenreath
Assistant Professor of Law
Texas Tech University School of Law
1802 Hartford Avenue
Lubbock, Texas 79409-0004

*Checks should be made out to State Bar of Texas Tax Section.

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The Tax Section of the State Bar of Texas wishes to congratulate the following recent graduates from the inaugural Leadership Development Academy. These individuals participated in a year-long program that consisted of various leadership development events throughout the State of Texas. We congratulate these emerging leaders of the tax profession and look forward to their continuing involvement in the Tax Section.

Christopher (Chris) A. Cunningham cac@cacfirm.com

Mr. Cunningham has his own solo business tax law practice, providing tax planning and transactional representation to a diverse group of local, national, and international clients. Primarily, his practice centers on U.S. federal and international tax, but he also addresses state and local as well as selected estate tax issues. He works directly with clients as well as with other attorneys to provide clients the tax law support to which they would not otherwise have access. Mr. Cunningham received his LL.M. in Taxation from New York University School of Law and his J.D. from The University of Texas School of Law.

Sharon (Shari) L. Ellington sharon.l.ellington@wellsfargo.com

Ms. Ellington is a Senior Wealth Planning Strategist with Wells Fargo Private Bank. She works closely with a team of specialists to offer family wealth transfer, charitable gifting, investment and income tax planning solutions to affluent families, private business owners and corporate executives. Prior to joining Wells Fargo, she practiced as an attorney in the areas of estate planning and probate, and federal income tax and business planning. In addition, she is a Certified Public Accountant and a Certified Financial Planner™. Ms. Ellington received her J.D. from The University of Florida Levin College of Law.

Renesha N. Fountain renesha.fountain@chamberlainlaw.com

Ms. Fountain joined Chamberlain, Hrdlicka, White, Williams & Aughtry in 2005, and she is currently an associate practicing in the firm's tax controversy group. She represents individuals and businesses in disputes with the IRS and state and local taxing authorities. She has extensive experience representing clients in civil tax matters, including handling audits and negotiating installment agreements, offers in compromise and other collection alternatives. She has also drafted protests, motions and petitions, filed claims for refund and requests for abatement of penalties as well as assisted with trial preparation in both civil and criminal tax cases. Ms. Fountain has successfully resolved numerous tax matters before the IRS Appeals Office and in the United States Tax Court. Ms. Fountain received her LL.M. in Taxation from Georgetown University Law Center and her J.D./B.C.L. from Paul M. Hebert Law Center, Louisiana State University.

David C. Gair dgair@lrmlaw.com

Mr. Gair is an associate attorney at Looper Reed & McGraw, P.C. His practice focuses on civil and criminal tax controversy matters, but also involves tax planning for entrepreneurs and businesses. He is Board Certified in Tax Law by the Texas Board of Legal Specialization. Mr. Gair received his J.D. from Sturm College of Law, The University of Denver.

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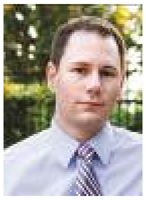
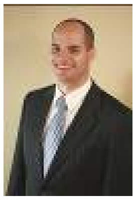


Brent C. Gardner bgardner@gardere.com

Mr. Gardner is an associate at Gardere Wynne Sewell, where he represents clients with respect to tax controversies before the Internal Revenue Service ("IRS") and in tax deficiency and refund litigation. He has recently represented clients in tax cases involving issues such as: deductions for premiums paid to a Bermuda captive insurance company (case recently tried and briefed before the U.S. Tax Court), contested claims for refund related to secondary adjustments under Rev. Proc. 99-32, deductions for worthless stock losses, abatement of tax penalties, Section 6672 trust fund penalties, and voluntary disclosures as part of the IRS's Offshore Voluntary Disclosure Initiative. Mr. Gardner received his LL.M. in Taxation from New York University School of Law and his J.D. from The University of Iowa School of Law.

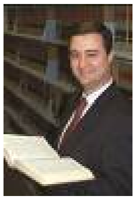
Megan R. Horn meagan.horn@energyfutureholdings.com

Ms. Horn currently serves as Tax Counsel for Energy Future Holdings. As Tax Counsel, she advises on various federal and state/local tax matters relevant to EFH and its subsidiaries. Prior to joining EFH, Meagan was an associate at Vinson & Elkins. Ms. Horn received her J.D. from Harvard Law School.



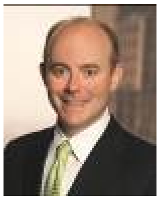
Matthew (Matt) C. Hunsaker matt.hunsaker@bakerbotts.com

Mr. Hunsaker is a senior associate at Baker Botts, LLP. He practices in the area of state and local taxation. His practice involves both tax planning and tax controversy. Mr. Hunsaker received his LL.M. in Taxation from Georgetown University Law Center and his J.D. from Brigham Young University, J. Reuben Clark Law School.



Christian S. Kelso ckelso@mljs.net

Mr. Kelso is an attorney with Malouf, Lynch, Jackson & Swinson, P.C. in Dallas, TX. His practice focuses primarily on estate and tax planning for a broad range of individual clients. He also practices in the areas of probate and guardianship. Finally, his practice includes a fair amount of corporate transactional work, including tax, for closely held businesses. Being Of Counsel, he splits his time working on firm matters and those he has developed independently. Mr. Kelso received his LL.M. in Taxation and his J.D. from Southern Methodist University Dedman School of Law.



C. Stoddard (Todd) Lowther todd.lowther@tklaw.com

Mr. Lowther is an associate in the Houston office of Thompson & Knight, LLP. He provides tax advice to clients on mergers and acquisitions, private equity transactions, and corporate and general business matters, including business formation, reorganization, and partnership and limited liability company structuring. His experience includes a focus on the taxation of natural resources, partnerships, international joint ventures, and other transactions common in the petroleum industry. Mr. Lowther also advises and represents clients in adversarial matters with federal, international, state, and local taxing authorities, as well as in alternative dispute resolution procedures. Additionally, his experience includes tax cases in U.S. Tax Court and U.S. District Court involving taxpayers with previously unaddressed income characterization issues. Mr. Lowther received his J.D. from Tulane University Law School.

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Sam L. Merrill sam.merrill@tklaw.com

Mr. Merrill has been an associate in the tax group at Thompson & Knight, LLP since 2006. His practice focuses on the federal income tax aspects of domestic and international transactions. The majority of his work involves advising clients on the formation of business ventures; mergers, acquisitions and dispositions; and private equity fund formation and fund transactions. He also has significant experience representing energy clients in a broad range of transactions and tax planning matters, including farmout arrangements and issuances of volumetric production payments. Mr. Merrill received his J.D. from The University of Texas School of Law.

Robert (Rob) C. Morris rmorris@fulbright.com

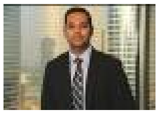
Rob Morris is with Fulbright & Jaworski, L.L.P. and practices out of the firm's Houston office. He focuses on tax controversy matters, and represents taxpayers in all phases of tax controversies: from preparing for and handling IRS audits, to preparing protests and negotiating with the IRS Appeals Office, to litigation. He also assists clients in utilizing alternative dispute resolution programs such as the IRS Fast Track Settlement process. Mr. Morris received his LL.M. in Taxation from Georgetown University Law Center and his J.D. from Brigham Young University, J. Reuben Clark Law School.

Ryan L. Morris ryan.morris@bakerbotts.com

Mr. Morris works in Houston as an associate attorney in the State and Local Tax Section of Baker Botts, LLP. He advises and represents clients in planning and controversy matters related to property tax, sales tax and other transfer taxes, income tax, franchise tax, severance tax, various other state and local taxes, and unclaimed property. He has experience with tax planning (especially regarding available incentives), audits, administrative hearings, voluntary disclosure agreements, taxability inquiries, and litigation. He has also helped to advance and defend favorable tax legislation and regulations. Mr. Morris received his J.D. from The University of Texas School of Law.

Michelle U. Rosenblatt mrosenblatt@morganadler.com

Ms. Rosenblatt is an attorney in the Austin office of Morgan Adler. Ms. Rosenblatt's primary focus is on the design, implementation, and administration of foreign and domestic trust and entity structures to meet the estate planning and asset protection goals of multi-jurisdictional clients. She prepares both traditional and sophisticated estate plans, including the drafting of wills, disability documents, trust, and business and entity agreements. Prior to joining Morgan Adler, Ms. Rosenblatt practiced for a boutique estate and tax planning firm in Los Angeles, California, and worked as a charitable planning consultant. Ms. Rosenblatt received her J.D. from Pepperdine University School of Law.



Ronald (Ron) J. Rucker ronald.j.rucker@us.pwc.com

Mr. Rucker is a Manager in the State and Local Tax (SALT) practice for PricewaterhouseCoopers LLP in Houston, Texas. His practice focuses on state income and franchise tax controversy, planning, compliance, and legislation. His primary clients include several public utilities and major entities in the energy sector, including electricity generation and distribution companies, and natural gas and renewable energy companies. He has additionally served as a member of the Houston Mergers and Acquisitions (M&A) practice and was one of only thirteen high-performing Senior Associates and Managers nationally to be selected and attend PwC's intensive Mergers & Acquisitions University Program. As a member of the M&A practice, he was involved in several major restructuring projects for clients in the energy industry including merger related and post-deal tax planning oriented projects. Mr. Rucker received his LL.M. in Taxation from the University of Houston, and his J.D. from Drake University Law School.

Jeffrey (Jeff) M. Slade JS593D@att.com

Mr. Slade is a Senior Attorney in AT&T's legal department, handling state and federal tax matters, including both controversy and planning matters. Prior to joining AT&T, he worked as a federal and state tax litigator in the Dallas office of Baker & McKenzie, LLP. Mr. Slade received his LL.M. in Taxation from New York University School of Law and his J.D. from South Texas College of Law.

Molly C. Sorg molly.sorg@energyfutureholdings.com

Ms. Sorg is the Director of Investor Relations and Project Assistant to the CEO and CFO at Energy Future Holdings in Dallas, Texas. In her current role, she serves as the interface between EFH and the investor community and works closely with the CEO and CFO on special projects and board meeting preparation. Prior to her role in Investor Relations, Ms. Sorg was Tax Counsel at EFH. She began her legal career at Skadden, Arps, Slate, Meagher & Flom in Chicago before relocating to Dallas and working for Vinson & Elkins. Ms. Sorg received her J.D. from Northwestern University School of Law.

Michelle L. Terbay mterbay@mondriklaw.com

Ms. Terbay is an associate attorney at Mondrik & Associates in Austin, Texas, focusing her practice on state and federal tax controversies and litigation. She represents state tax clients in administrative and legal proceedings before the Comptroller's office, the State Office of Administrative Hearings and the Texas state courts. She also represents federal tax clients at the administrative appeals level and in proceedings before the United States Tax Court and the United States District Courts. Ms. Terbay received her J.D. from Baylor University School of Law.

Jaime Vasquez jaime.vasquez@chamberlainlaw.com

Mr. Vasquez is an associate attorney with Chamberlain, Hrdlicka, White, Williams & Aughtry in San Antonio, Texas. He represents for-profit and non-profit entities and individuals in income and employment disputes with the IRS and state and local taxing authorities. Specifically, he has experience resolving IRS examinations, collection cases, installment agreements, offers in compromise, requests for collection due process hearings, private letter rulings and requests for innocent spouse relief. He also has experience with civil tax litigation, including drafting motions, Tax Court petitions and letters requesting penalty and interest abatement. Mr. Vasquez provides defense in criminal tax matters and has successfully resolved several cases before the IRS Criminal Investigation Division. He organizes and provides business and tax planning advice to corporations, partnerships and limited liability companies. Mr. Vasquez received his LL.M. in Taxation from New York University School of Law and his J.D. from The University of Texas School of Law.

Benjamin (Ben) W. Vesely bvesely@bdo.com

Mr. Vesely works as a manager in the International Tax group of BDO USA, LLP. His work primarily focuses on international tax planning, including various acquisitions, dispositions and restructuring projects, for many large, multi-national clients. He has presented several firm-wide trainings on international tax and is also actively involved in recruiting for BDO's International Tax group. Mr. Vesely received his LL.M. in Taxation from Northwestern University School of Law and his J.D. from Southern Methodist University Dedman School of Law.

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Catching the Leprechaun: Potential pitfalls and perplexing problems with finding the now-permanent portability pot-of-gold

By Christian S. Kelso, Esq.

1. Introduction. Leprechauns of Irish folklore are well-known masters of deception and cunning pranksters. According to legend, they hoard their gold at the end of the rainbow and if you catch one, he must grant you three wishes in exchange for his release. But the leprechaun is wily and if you are not careful, your wish will likely come with unintended and unwanted consequences. For example, you may wish for great wealth and then find that you have inherited following the death of a loved one. On the other hand, if your wishes are thoughtful and well-planned, you stand to gain tremendously.

The now permanent availability of portability within our federal transfer tax system is similar. On its face, it seems simple, but close inspection reveals many more complicated details and decisions than one might expect. So much so, in fact, that taxpayers are well-advised to seek professional assistance before relying on portability alone for fending off the estate tax banshee.

Portability is a system created to allow married taxpayers to make full use of their collective estate tax exclusion amounts without the necessity of employing sophisticated estate planning techniques. This paper will discuss its background and fundamental concepts, as well as the current rules associated with it. The paper will also discuss new strategic considerations and potential problems which planners should consider now that Congress has made portability a permanent part of the Code.[1]

2. What is Portability? For those who might be less familiar with the transfer tax system, portability is generally a set of rules which aim to prevent a phenomenon known as 'estate stacking.' Estate stacking occurs when a married person dies, leaving his or her entire estate to a surviving spouse. As a result of the gift, the surviving spouse's estate is increased, usually by a factor of two in community property states, and may needlessly cause or augment estate taxation. Because gifts between spouses are generally deductible,[2] the gift from the predeceasing spouse to the surviving spouse does not use up any of the predeceasing spouse's estate tax exclusion.[3] To better understand the problem, consider the following two examples:

> **Example 1:** Husband and Wife, who are both US citizens, have a $6mm estate composed entirely of community property. Neither has made taxable gifts during life and the estate tax exclusion amount is $5mm. There is no portability and the estate tax rate is 40%. Husband predeceases Wife, bequeathing all his assets outright to her. Wife dies some years later without remarrying and while the

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[1] All references to the Code are to the Internal Revenue Code of 1986, as amended.

[2] Code §2056.

[3] For purposes of this paper, a taxpayer's estate tax "exclusion" amount is intended to mean the unused portion of his or her applicable exclusion amount as described under Code §2010(c). As indexed for inflation, this amount is $5,250,000.00 in 2013.

> exclusion amount is still $5mm. Although Husband's half of the marital estate ($3mm) is less than the $5mm threshold for estate taxation, his bequest to Wife is not subject to estate taxation as a result of the marital deduction. Thus, even though no tax is due, none of Husband's exclusion amount is used at his death. The trouble, however, occurs upon Wife's subsequent death. Once she inherits from Husband, her estate is large enough ($6mm) for the estate tax to apply so her estate will have to pay $400k in tax (40% of the $1mm excess over the $5mm threshold). At this point, you might ask what happened to Husband's $5mm exclusion and the answer would be that it was simply wasted. Oops.
>
> **Example 2:** The facts of this example are the same as in Example 1, except that the value of the marital estate is $15mm. In that case, Wife's half of the estate ($7.5mm) will already be taxable, but amount of the liability is much higher than needed. Instead of owing only $2mm in estate tax (40% tax on the $5mm by which the marital estate exceeds the total of the spouses' exclusion amounts), $4mm will be due (40% on the 10mm by which Wife's estate exceeds her exclusion amount) at Wife's death. Bigger oops.

Traditionally, the way to avoid wasting the exclusion of the first spouse to die has been to use a 'credit shelter' or 'bypass' trust. Such a trust would shelter the predeceasing spouse's exclusion amount by keeping the assets in the trust out of the surviving spouse's estate. To accomplish this goal, spouses had to set out the desired structure in their estate planning documents and for many years, this is exactly what estate planners have done. In situations where one spouse did not have sufficient assets to fully utilize his or her exclusion, assets also had to be retitled in the poorer spouse's name in case the poorer spouse died first. Typically, at the first death, the bypass trust is funded using a formula designed to capture the predeceasing spouse's exclusion remaining at death with any overage bequeathed to the surviving spouse outright or into a marital trust (known as qualified terminable interest property or "QTIP" trust). Under this structure, the bypass trust should escape estate tax at the surviving spouse's death, regardless of the value of the bypass trust at that time. All other assets the surviving spouse received from the predeceasing spouse whether outright or in the QTIP trust are subject to estate tax upon the surviving spouse's death, assuming that these assets when combined with other assets owned by the surviving spouse exceed the exclusion available at the surviving spouse's death.

> **Example 3:** Consider what would have happened in Example 1, if Husband had implemented a traditional estate plan as described above. In such a scenario, Husband's assets would have been sheltered by a bypass trust and kept out of Wife's estate such that, upon Wife's subsequent death, no tax would be due because her estate would only include her half ($3mm) of the marital estate. Even if the value of the bypass trust grew in the time between Husband's and Wife's deaths, there would still be no estate tax due. Thus, the value of the bypass trust could even double to $6mm without causing estate taxation.

But some people, apparently including President Obama, found this planning to be overly "burdensome"[4] for average taxpayers. As early as 2004, some members of Congress began thinking of ways to statutorily prevent the wasting of a predeceasing spouse's exclusion. What they came up with was portability.

Portability, originally a temporary provision, was introduced as law as part of the Tax Relief, Unemployment Reauthorization, and Job Creation Act of 2010[5] under which Congress authorized Treasury to write new regulations "as may be necessary or appropriate to carry out" its provisions.[6] Treasury then issued Notice 2011-82 requesting comments on certain aspects of portability and, on June 15, 2012, Treasury issued temporary regulations titled, *Portability of a Deceased Spousal Unused Exclusion Amount.*[7] Concurrently, Treasury issued a notice of proposed rulemaking, and issued the proposed regulations, using the temporary regulation's text to serve as the text for the proposed regulations.[8] For purposes of this paper, the term "Portability Regulations" refers to the temporary and proposed regulations recently issued. The American Taxpayer Relief Act of 2012 (H.R. 8) (hereinafter, "ATRA 2012"), which became law on January 2, 2012, has made portability permanent[9] and it also amended Code §2010(c)(4)(B) to conform[10] the Code to the Portability Regulations.[11]

In its simplest form, portability is the ability of a surviving spouse to use the predeceasing spouse's unused exclusion amount. In theory, portability is supposed to work like this:

> **Example 4:** Same facts as Example 1, except that portability is in effect. Under this scenario, Wife can 'port' Husband's unused estate tax exclusion amount and use it at her death or during her life. Because Husband's entire bequest to Wife qualifies for the marital deduction, none of his exclusion is used up at his death, so Wife can port $5mm of exclusion for a total of $10mm available to her. Since Wife only has a $6mm estate, no estate tax will be due on her death. This saves the $400k which would otherwise be lost under the Example 1 facts.

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[4] **The term 'burdensome' was used in the General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals, Department of the Treasury, p. 123 (February 2011) when describing planning with by-pass and marital trusts. The website link is: http://www.treasury.gov/resource-center/tax-policy/Documents/Final%20Greenbook%20Feb%202012.pdf**

[5] **P.L. 111-312 (Dec. 17, 2010).**

[6] **Code §2010(c)(6).**

[7] **Treasury Decision (TD) 9593, June 15, 2012. A copy of the Temporary Regulations can be found at the Federal Register's website at: http://www.gpo.gov/fdsys/pkg/FR-2012-06-18/pdf/2012-14781.pdf.**

[8] **(NPRM REG-141832-11). A copy of the Proposed Regulations can be found at the following website: https://www.federalregister.gov/articles/2012/06/18/2012-14775/portability-of-a-deceased-spousal-unused-exclusion-amount.**

[9] **Section 101 and 102 of ATRA 2012 provides for the permanent application of portability to estate and gift taxes.**

[10] **As it happens, the Code and the Portability Regulations are not totally in sync. It would be preferable if further statutory changes would be made to align the Code and Portability Regulations.**

[11] **Section 101(c)(2) of the ATRA 2012 provided that a technical correction to Code Section 2010(c)(4)(B) by striking "basic exclusion amount" and inserting "applicable exclusion amount".**

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Thus, in theory, the solution to estate stacking seems quite simple. But as we shall soon see, things are never as simple as they first appear.

3. Practical Questions and Problems. From the get-go, portability caused problems. Although sound in principle, portability creates a myriad of practical problems. The following discussion addresses some but not all of these practical problems.

3.1. Establishing and Calculating Portability. One of the first problems encountered was how to establish and calculate the predeceasing spouse's exclusion amount that can be ported to the surviving spouse. This amount, which is generally the leftover exclusion amount of the predeceasing spouse, is called the deceased spousal unused exclusion ("DSUE") amount.[12] .

Because DSUE necessarily involves two different estates, a vexing problem arises from the very beginning. DSUE is most valuable to the estate of a surviving spouse, but it is established based on the estate of the predeceasing spouse. Where both spouses die in a short period of time, it might not be very difficult for the survivor's personal representative to work out the DSUE amount available to his or her estate. But where many years pass in the interim, the problem becomes more challenging because records are lost or harder to find.

Although Congress could have left the task of establishing the DSUE amount up to the surviving spouse's estate, they decided instead to put the onus on the predeceasing spouse's executor. Under Code §2010(c)(4), the executor of the estate of the predeceasing spouse is required to make a timely and proper election on such spouse's estate tax return ("Form 706"). In other words portability is available to a surviving spouse only where an estate tax return is filed in a timely manner after the predeceasing spouse's death. This holds true even in the situation where the predeceasing spouse's estate is not otherwise required to file an estate tax return.[13] To use Treasury's word, the requirement to file an estate tax return when none is otherwise required is certainly burdensome.

The election requirement flies directly in the face of portability's intent. If the point of portability is to avoid complicated and costly estate planning, how is that intent served by requiring an estate to elect portability on an estate tax return, particularly when there is a time limit on when the return may be filed? Generally, a Form 706 is due nine months after the date of a decedent's death, with an extension available (upon proper request) for an additional six months. Failure to make the nine-month deadline will leave a bereft surviving spouse without recourse, as there is no provision for late filings.

Preparing a Form 706 is also quite costly and should generally be handled only by an experienced professional. By and large, this fact alone will thwart most of the stated purpose behind portability. But, as we shall see below, this does not diminish the value of portability as an estate planning tool for those who have the resources to make use of it.

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[12] Code § 2010(c).

[13] Under Code § 6018, an estate tax return is required to be filed when the gross estate exceeds the basic exclusion amount ($5,250,000 in 2013).

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Because the current exclusion amount is $5.25mm,[14] the election requirement effectively creates three distinct classes of married taxpayers. The first is the class of taxpayers whose marital estate is less than $5mm. For these people, transfer taxes generally pose no concern because even a stacked estate will not be large enough to trigger tax. On the other end of the spectrum are the those couples who have over $10mm in assets. These people generally will be subject to estate tax no matter what and they will already be required to file a Form 706, so the increased burden imposed by the election requirement is, in and of itself, marginal.

For those taxpayers whose marital estates are over $5mm and less than $10mm, however, the election requirement is particularly burdensome. Estate tax returns are generally not required for a predeceasing spouse in this category, because his or her estate is below the filing threshold. Unlike their more wealthy counterparts, taxpayers in this group may be less accustomed to dealing with lawyers and accountants, so they may miss their opportunity to claim portability until it is too late. Unlike the first category, however, missing the portability boat can be costly.

To the Treasury's credit, in cases of estates not otherwise required to file an estate tax return, certain requirements of Form 706 have been relaxed. [15] But this still does not obviate the need to make the filing in the first place and to make it within the prescribed period of time.

3.2. Quid Pro Quo. The Portability Regulations provide that the IRS may examine the Form 706 of any deceased spouse of a surviving spouse whose DSUE amount is claimed to be included in the applicable exclusion amount of the surviving spouse (whether on a gift or estate tax return).[16] The examination period of the deceased spouse’s return, which is otherwise generally only three years, is extended through the surviving spouse’s normal statute of limitations. This is the 'quid pro quo' for making the portability election. In other words, one of the “costs” of making the election is that the Service will generally have the opportunity to review the predeceasing spouse’s Form 706 at any time until three years have passed after the *surviving* spouse's Form 706 is filed. In contrast, if portability is not elected, the Service generally cannot review the predeceasing spouse's Form 706 more than three years after it is filed.

It appears that the Service’s scrutiny of a predeceasing spouse's Form 706 after it's standard statute of limitation has run is limited to the review and adjustment of the DSUE amount (as reported on such surviving spouse’s gift and/or estate tax return), but it is unclear just what this means or might entail. Presumably, the Service cannot reassess the amount of tax due by the surviving spouse's estate, but it can revalue assets for the purpose of calculating DSUE amount.

This raises a couple of issues that are not otherwise made clear by the Portability Regulations. First, can the surviving spouse’s estate claim additional deductions (including fees associated with the examination) on that surviving spouse’s Form 706 even though the

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[14] $5mm is used elsewhere in this paper and in the examples for simplicity.

[15] See. Temp. Reg. 20.2010-2T(a)(7)(ii).

[16] Temp. Reg. § 20.2010-2T(d); Temp. Reg. § 20.2010-3T(d); and Temp. Reg. §25.25052T(e).

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examination was with respect to the deceased spouse’s Form 706? Second, what would be the tax basis of assets if they were later revalued for DSUE purposes and what would happen if they had already been given away, sold or contributed to a partnership? Finally, it is not uncommon for large estates to use the final determination of asset values for dispositive estate planning purposes. In such a case, what would happen if the Service reassessed the value?

The significance of the election requirement and its ancillary effects cannot be understated. If the Service alleges that the DSUE amount was improperly calculated, then the burden falls to the surviving spouse (or their estate) to prove otherwise. This means that the surviving spouse would likely have to maintain records for far longer than might otherwise be required. Just as with the election requirement itself, the related burden of proof is certainly burdensome on taxpayers.

3.3. Black Widows. Another significant area of concern surrounding portability generally is multiple marriages. Showing their capacity for optimism, the members of Congress who crafted the portability statutes were worried that wealthy taxpayers might abuse the portability rules by repeatedly marrying and outliving less wealthy taxpayers. According to Congress, such 'black widows' might be able to avoid estate taxes entirely by eliminating a succession of spouses until enough exclusion had been ported.

To combat this black widow effect, Congress set out a rule by which taxpayers may only port the available exclusion of the last spouse to die while married to the taxpayer.[17] This rule does eliminate some of the incentive for taxpayers to rub out a succession of spouses, but it is not perfect. Consider the following example:

> **Example 5:** Assume the same facts as Example 2, except that portability is in effect. Following the death of Husband (who we will now call Husband 1), Wife remarries, this time to Husband 2. Even after remarrying, Wife can still use Husband 1's DSUE amount, but only so long as Husband 2 has not died while married to Wife. Thus, if Wife predeceases Husband 2, her applicable exclusion may be augmented by Husband 1's DSUE amount.

3.4. Gifts and Timing? The example immediately above raises yet more questions. What about gifts and when may the DSUE amount used? In a very taxpayer-friendly move, the Service has confirmed that the DSUE amount not only applies to gifts, but also that it is used before the surviving spouse's lifetime exclusion amount.[18] The Portability Regulations make it clear that the date which the DSUE amount may be used by the surviving spouse is the last deceased spouse’s date of death, provided that portability has been or will be properly elected.[19] Treasury has explained that the last deceased spouse rule will apply at the time of the transfer;

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[17] **Temp. Reg. § 25.2505-2T(a).**

[18] **The statutes had not made this clear.**

[19] **Temp. Reg. § 25.2505-2T(a).**

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thus, for inter vivos gifts, the rule applies at the time of the gift[20] and for testamentary transfers it is the time of the survivor's death.[21]

This 'last in, first out' rule lessens the effectiveness of the 'last deceased spouse' rule in preventing a taxpayer from utilizing the DSUE amount of multiple predeceasing spouses. Consider the following example:

> **Example 6:** In a situation like that of Example 5, Wife could make lifetime gifts equal to Husband 1's DSUE amount, at any time before Husband 2's death. In theory, Wife could continue remarrying and making gifts of each last deceased spouse's DSUE amount until she had reduced her estate to a point that was below the estate tax threshold.

3.5. What about GST? A major potential pitfall for planners is that portability does not apply to generation-skipping transfer tax.[22] Thus, if a couple desires to give more than the basic exclusion amount to grandchildren at the second death, portability is generally not an option.

3.6. Non-Citizen Spouses. As estate planning for situations where one or both of the spouses is not a citizen of the United States is a very specialized area of law, consultation with an experienced professional is highly recommended any time the topics of portability and non-citizen spouses intersect.[23] The general rule, however, is that a nonresident surviving spouse who is not a citizen of the United States may not take into account the DSUE amount of a deceased spouse, except to the extent allowed by treaty with his or her country of citizenship.[24]

Special rules apply in the case of a qualified domestic trust ("QDOT"), which generally allows the estate of a decedent to bequeath property to a surviving spouse who is not a citizen of the United States and still receive a marital deduction.[25] When property passes to a QDOT, estate tax is imposed under section 2056A as principal distributions are made from the trust. When a QDOT is established and there is a DSUE amount, the executor of the decedent's estate will determine a preliminary DSUE amount for the purpose of electing portability. This amount will decrease as section 2056A distributions are made. In estates with a QDOT, the DSUE amount generally may not be applied against tax arising from lifetime gifts because it will not be available to the surviving spouse until it is finally determined, usually upon the death of the surviving spouse or when the QDOT is terminated.

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[20] Temp. Reg. § 25.2505-2T(a) and (c).

[21] Temp. Reg. § 20.2010-1T(d)(5); Temp. Reg. § 20.2010-3T(a); and Temp. Reg. § 20.2010-3T(c).

[22] Code §2631(c); See also The Joint Committee on Taxation's comments in Note 1581 of JCS-02-11, where they state, "The [portability] provision does not allow a surviving spouse to use the unused generation-skipping transfer tax exclusion of a predeceased spouse."

[23] Note that all examples in this paper presume that both spouses are US citizens.

[24] See instructions of Form 706.

[25] Note that under Code §2056(d)(1), the marital deduction is generally not allowed for non-citizen spouses.

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4. Strategic Issues. In addition to the practical problems described above, certain strategic issues are raised by portability's availability.

4.1. Basis and Appreciation. Under the general rule of Code §1014, the basis of a decedent's assets are adjusted (usually up) to fair market value at the time of death. This 'step-up' in basis can be very valuable where assets have appreciated or their basis has been reduced for some reason, for example, as a result of depreciation deductions. Thus, the step-up is the basis (pun intended) of the estate planner's mantra that the best thing a client can do is die.

With traditional planning, only one step-up is available for that portion of the marital estate which is placed in a bypass trust at the first death and therefore does not belong to the surviving spouse on his or her subsequent death. Portability, however, changes this.

In situations where portability is elected, the surviving spouse will continue to own all of the marital assets such that the step-up will be available for the entire marital estate at the second spouse's death. However, the DSUE amount is not indexed, so it will not increase over time like the estate tax exclusion. Thus, only a limited amount of assets can be sheltered using portability, and if the assets appreciate too much, tax will be assessed. In contrast, bypass trust assets can appreciate without limitation and still escape estate taxation at the second spouse's death.

By allowing for a second basis step-up as to the predeceasing spouse's share of the marital estate, portability presents the surviving spouse with a dilemma. On the one hand, the capital gains tax that will eventually be paid (probably by the children) on appreciated assets can be averted. On the other hand, appreciation of the same assets might create or augment estate tax liability with regard to the surviving spouse if left in his or her estate (i.e. not in a bypass trust). Consider the following examples:

> **Example 7:** At the death of Husband, he and Wife have a marital estate of $6mm composed entirely of community property and the estate tax exclusion amount is $5mm. At all times, the capital gains tax is 20% and estate tax is 40%. At Wife's subsequent death some years later, all assets have doubled in value, after accounting for any spending by Wife, and the exclusion has increased to $6mm due to indexing. Upon wife's death, all assets are liquidated by Child, as sole beneficiary under Wife's Will, before any further appreciation occurs. If Husband's share of the marital estate ($3mm) goes into a bypass trust, then its appreciation will trigger $600k (20% of the $3mm in appreciation) in capital gains tax when Child sells the assets.[26] Also, at Wife's death, her estate (now $6mm) will trigger no estate tax because it is right at the taxation threshold, as indexed. Thus, $600k in total tax will be due using traditional bypass trust planning. On the other hand, if portability is elected, no capital gains (or net investment income) tax will be due. Instead, Wife's estate will be $12mm, of which $1mm will be subject to estate tax because her $6mm exclusion and the $5mm DSUE amount ported from Husband will shelter a total of $11mm. Thus,

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[26] All or a portion of the gain may also be subject to the net investment income tax of 3.8% under Code §1411.

> $400k (40% of $1mm) in tax will be due using portability planning. Under this scenario, portability is the better option.
>
> **Example 8:** Assume the same facts as Example 7, except that the marital estate is $9mm at the time of Husband's death. Now, Husband's $4.5mm share of the estate will go into the bypass trust and double in value by Wife's death. Thus, $900k (20% of $4.5mm in appreciation) in capital gains tax will be due on Child's disposition of the assets and Wife's estate (now $9mm) will trigger $1.2mm in estate tax because it is $3mm over the $6mm threshold at her death. Thus, $2.1mm in total tax is due using traditional planning. On the other hand, if portability is elected, no capital gains tax will be due. Instead, Wife's estate will be $18mm, of which $7mm will be subject to estate tax because her $6mm exclusion and the $5mm DSUE amount ported from Husband will shelter a total of $11mm. Thus, $2.8mm (40% x $7mm) in tax will be due using portability planning. Under this scenario, traditional planning is the better option.

These examples greatly oversimplify the analysis and make somewhat unrealistic assumptions. Tax rates change over time. It is unrealistic to assume that different assets will grow at the same rate. It is not uncommon for bypass trust assets to be invested for growth while personal (or QTIP) assets are invested to produce income in an effort to minimize the surviving spouse's estate. In addition, most expenses would be borne by the surviving spouse or QTIP trust (as opposed to the bypass trust), further reducing her estate tax exposure. Wife also might be able to minimize her estate tax exposure by implementing numerous gifting techniques. Nonetheless, the overriding lesson of the examples is sound: Differing circumstances will yield varying results. Of course, there is no way to predict with any certainty which option will produce the better result.

Deciding whether to opt for portability or traditional planning in a given scenario requires sophisticated analysis. Rather than viewing portability as a backup plan for those who fail to adequately prepare, estate planners should think of it as a tool to improve upon the limited results that were achievable when traditional planning was the only option.

4.2. Wealth Preservation. Estate planning is about much more than taxes. Even in the most basic scenario, some other factor has driven the client to the lawyer's office to ask about drafting a Will or trust. The goal of the estate planner, therefore, is to get the client as close to their personal objectives as possible by minimizing taxes and other administrative costs in a manner that is both legal and effective.

The most basic concern for the majority of clients is simply to preserve wealth and provide for their families. Often, this will mean using trusts to take advantage of their qualities as asset protection vehicles.

4.3. Grantor Trusts. For the most sophisticated clients, portability presents an opportunity for actually creating more trusts. This is because, in certain situations, it will be appropriate for the surviving spouse to elect portability and take marital assets outright, then transfer those same assets to trusts which are considered 'grantor trusts' as to the surviving spouse

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per the rules of Code §§671-679 for the benefit of children. By creating one or more grantor trusts with the predeceasing spouse's DSUE amount, a surviving spouse could leverage wealth transfer by paying income tax on trust income. Additionally, grantor trusts do not require separate income tax returns, making this planning technique relatively simple and cost-effective.

This strategy allows a high degree of flexibility because it allows the surviving spouse to make decisions regarding the family's continuing estate plan after the death of the first spouse. For example, when the plan is originally set out, the financial need or acumen of the spouse's children may not be clear. The same applies to potential creditor problems or the need to encourage certain behavior modification.

Of course, this strategy should not be employed unless the surviving spouse is trustworthy and sophisticated. Additionally, this strategy presents the danger of being thwarted by the incapacity or declining ability of the surviving spouse. For example, clients may craft an estate plan of this nature while they are both healthy and sophisticated. But by the time the first of them dies, the survivor may lack the capacity to make gifts.

4.4. Simplicity. In contrast, some clients simply do not like trusts. To many people, including some lawyers, trusts represent a complexity that is expensive, administratively burdensome and thus unwarranted. For these clients, portability is a welcome relief and their sentiment should not be discounted.

Simplicity is of particular concern where it is undesirable to retitle assets. Traditional estate planning will typically require multiple changes to the title of assets, which may lead to consternation.

4.5. Blended Families. Clients with blended families often have competing objectives. In a typical situation, one spouse will be concerned about providing for both the other spouse as well as children from a previous relationship. But animosity between Children and their step-parents is all too common, putting the parent/spouse in the middle of a complicated relationship.

In traditional estate planning, this problem is mitigated by splitting the parent/spouse's estate into separate parts or creating different beneficial interests. A bypass trust can have different beneficiaries than the QTIP trust, or it might provide different distribution standards as to each of several beneficiaries.

Portability, however, causes a problem in the blended family scenario because no bypass trust is created. If the second spouse receives the assets outright, he or she will be free to transfer them to his or her children to the exclusion of the original parent/spouse's children and further descendants.

Although a QTIP trust (as opposed to an outright gift) can be used to create some protection for the parent/spouse's children where portability is preferred, using a QTIP trust is less desirable for this purpose than a bypass trust. First, to qualify for the marital deduction, a

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QTIP trust may benefit only the surviving spouse for so long as he or she is alive.[27] This is in contrast to a bypass trust which can benefit both the surviving spouse and/or children, depending on the circumstances. Second, a QTIP trust must distribute all income at least annually to the surviving spouse.[28] This limits the trust's ability to appreciate over time, again limiting the children's benefit.

On the other hand, if structured improperly, traditional estate planning can allow a surviving spouse to divert funds away from the children of the decedent's previous marriage. This could happen if the second spouse had authority to fund the bypass trust with the amount needed to take advantage of the parent/spouse's basic exclusion amount. In such a scenario, the surviving spouse could make a QTIP election with regard to the parent/spouse's entire exclusion amount,[29] causing the QTIP to be funded with more than the parent/spouse intended. A surviving spouse could divert even more assets away from the parent/spouse's children by contriving a scenario which would cause the QTIP trust to pay more in estate taxes on the surviving spouse's estate than was originally intended by the parent/spouse.

A conflict of interest like the ones described above might be avoided by carful drafting, so practitioners should watch out for and avoid such problems where possible. For example, it may be appropriate to include special language in a Will or trust whereby an independent third party is given the power to elect portability if that power would otherwise create a conflict of interest. This could even be appropriate where there is no animosity between various family members.

5. Planning Considerations. A number of considerations have been set forth above to provide guidance when deciding whether to take advantage of portability. While the strategic considerations above ask what should a surviving spouse do when faced with the option to elect portability or not, the planning considerations discussed below attempt to prospectively position a couple such they will be able to take advantage of the available rules when the time finally comes for a decision.

The primary problem with options and elections is that it is impossible for clients to know at the time they prepare their estate plan what the facts will be when the first of them dies, or even after. From a tax perspective, the goal is to leave as many options open for as long as possible so that the decision can be made as late as possible. However, this tax goal must be balanced with the overarching goal of ensuring that the ultimate wealth transfer is as close to the clients' desires as possible.

5.1. Disclaimer Planning. One effective way to provide a surviving spouse with options is to create a 'disclaimer bypass trust.' This is a typical bypass trust except that it is funded only to the extent the surviving spouse disclaims property that would otherwise pass to him or her

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[27] Code §2056(b)(7)(B)(ii)(II).

[28] 2056(b)(7)(B)(ii)(I).

[29] Although the issue has been raised on several fronts, it is by no means certain, that Rev. Proc. 2001-38, 2001-1 C.B. 1335 would invalidate such a QTIP election, as it was promulgated before portability was an issue and is designed to address other concerns.

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under the predeceasing spouse's Will. In other words, the predeceasing spouse makes outright bequests to the surviving spouse with the proviso that any property disclaimed by the surviving spouse be diverted to a bypass trust.

Although this method does require some work up front in that a timely qualified disclaimer must be filed by the surviving spouse, in the context of the portability election, such a requirement is not overly burdensome. Additionally, this method allows the surviving spouse a high degree of flexibility because assets can be selectively chosen for bypass treatment or left for outright ownership.

A variation on this method would allow for a surviving spouse (or perhaps some disinterested party) to disclaim property in a bypass trust such that it fell to a separate QTIP. Although it is unclear whether this strategy would be fully respected for tax purposes, its purpose would be to protect those families who fail to act in time to make the portability statute of limitation. In other words, the 'do nothing default' would at least trigger traditional estate planning on the theory that that would be better than inadvertently losing both portability and traditional planning.

Yet another variation on this basic idea would involve building a "Clayton" provision or "Delaware Tax Trap" into an otherwise QTIPable trust. Under the former option, a surviving spouse would only make a QTIP election as to part of the QTIP trust, and thereby cause the remainder to have more flexible provisions. Under the latter option, the spouse could cause certain assets in a bypass trust to be includable in his or her estate in hopes of getting a second step-up in basis. Again, these strategies are as yet untested, but they offer some promise.

5.2. Special Needs Planning. Unfortunately, where special needs planning is required, portability will not be available. Special needs trusts are typically created where a beneficiary is (or might) receive federal or other support which is based on need. If such a beneficiary suddenly inherits a large amount of money, he or she will suddenly become disqualified for those benefits, unless the assets pass to a trust with specific language that allows the trust not to be counted under relevant (non-tax) law. Typically, however, such trusts cannot provide for mandatory income distributions, meaning that they will not qualify as QTIP trusts. Thus, no marital deduction will be allowed in relation to them and the decedent's basic exclusion amount will be reduced.

5.3. Qualified Retirement Plans. Qualified retirement plans are not well-suited for trusts generally. Qualified retirement plans already offer a significant degree of creditor protection, so they make one of the primary benefits of trust planning moot. Thus, as a general rule, to the extent qualified retirement plans play a factor in a given marital estate, they will weigh against trust planning and favor portability planning. This dovetails well with the fact that (as is shown in Examples 7 and 8 above), the primary beneficiaries of portability, strictly from a tax perspective, will be those whose marital estate is just over the estate tax threshold.

6. Conclusion. Just as the leprechaun appears to be a jovial, lovable character, so does portability seem a simple solution to a complicated problem. Like the leprechaun, however,

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there is much more to portability than meets the eye, and if you fail to give it proper respect, it will not perform as you might expect.

Deciding whether to use portability involves a balancing act. This applies when clients set out their estate plan and after the first spouse dies. Some factors which favor the election of portability are:

1) a preference for basis step-up
2) a competent and sophisticated spouse
3) the desire to allow the surviving spouse to create grantor trusts with the DSUE amount
4) the client's desire to avoid using trusts
5) a first marriage, or at least no children from a previous relationship
6) qualified retirement plans are a large part of the estate

On the other hand, some factors that will favor traditional estate planning are:

1) the desire to eliminate future appreciation from a surviving spouse's estate
2) the desire to fully utilize trust benefits such as creditor protection
3) the desire to benefit children sooner
4) blended families
5) spouses with special needs
6) non-citizen spouses
7) higher likelihood that the surviving spouse will remarry
8) GST planning

The best strategy of all will be to plan proactively to provide considerable flexibility to a surviving spouse. This might be accomplished by allowing a surviving spouse to trigger treatment one way or the other based on careful analysis after the first spouse's death. Although not optimal, this methodology does provide more flexibility than the traditional planning available before portability was made law.

In any event, portability is far from the safety valve first conceived by Congress. It does not effectively protect those who fail to act or seek the advice of their professional advisors. It does, however, provide a useful tool to those taxpayers who have the wherewithal to seek the help they need. Thus, clients who are willing to take the time and pay the fees associated with proper and thoughtful planning stand to reap great rewards, as compared to those who don't.

This paper has used the analogy of a leprechaun to illustrate how portability involves much more than one might otherwise suspect and for the most part, that analogy holds true. But there is one very important difference between the fairy tales and the real world. In the stories, the leprechaun represents a windfall. If you can find him and outsmart him, you get his treasure. In the real world of estate tax, taxpayers fight to avoid losing money that is already theirs. Thus, the end of the rainbow is the taxpayer's pocket and it is Uncle Sam who is trying to get the pot-of gold!

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DEFINED-VALUE TRANSFERS

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I. INTRODUCTION[1]

Estate planning with hard-to-value assets has always presented clients with opportunity, but also with unwanted tax risk. Valuation experts are a must, but the IRS often takes contrary positions even when provided with an expensive appraisal report from a taxpayer's highly qualified expert. On top of that, many clients, maybe even most clients, are just not well suited for the challenges of an IRS audit, and the prospect of a trial can be even worse.

Against that back-drop, estate planners for many years have tried to achieve some tax certainty, or predictability, by using formulaic transfers of one form or another. With a formula transfer, a taxpayer has some arguments at his disposal beyond merely putting on a battle of valuation experts. Unfortunately, however, the IRS has challenged many formula transfers as being ineffectual for tax purposes. Thus, clients need to be aware that the IRS may fight both the valuation and the transfer technique itself, but lots of clients would benefit by having two issues on the table rather than one.

The law in this arena has really developed a great deal over the past several years. Five recent judicial opinions, all favorable to taxpayers, have paved the way for many estate planners and their clients. On August 22, 2006, the Fifth Circuit decided *McCord v. Comm'r*, 461 F.3d 614 (5th Cir. 2006), reversing the Tax Court's decision (*see* 120 T.C. 358). On November 13, 2009, the Eighth Circuit decided *Christiansen v. Comm'r*, 586 F.3d 1061 (8th Cir. Nov. 13,

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[1] This article is an update of a previous article by the same two authors, "Estate Planning By the Numbers – Defined-Value and Other Formula Transfers," *Estate Planning*, May 2010. Stephen Dyer is a partner, and Richard Ramirez is an associate, in the private clients practice of the tax department at Baker Botts L.L.P. Mr. Dyer was privileged to work on the planning, implementation, and defense of the transactions at issue in *McCord* (*infra*) and *Hendrix* (*infra*) and testified in the *Hendrix* trial. Other attorneys in the private clients practice at Baker Botts L.L.P. worked on the planning, implementation, and defense of the transaction at issue in *Christiansen* (*infra*) and the trial and appeal of *Petter* (*infra*). The authors are thankful to those partners and associates for their assistance with this article.

2009, corrected Nov. 18, 2009), affirming the Tax Court's decision from 2008 (*see* 130 T.C. 1). On August 4, 2011, the Ninth Circuit decided *Petter v. Comm'r*, 653 F.3d 1012 (9th Cir. 2011), affirming the Tax Court's decision from 2009. On June 15, 2011, the Tax Court decided *Hendrix v. Comm'r*, 101 T.C.M. (CCH) 1642 (2011). Finally, on March 26, 2012, the Tax Court decided *Wandry v. Comm'r*, 103 T.C.M. (CCH) 1472 (2012) (non-acq.). All five opinions strongly support formula-based transfer plans.

Formulaic transfer clauses traditionally have attempted to limit tax exposure by (1) adjusting the property transferred or the consideration to be received (sometimes called an adjustment clause or a savings clause) or (2) specifying the dollar value of a property interest transferred (most often called a defined-value clause).

II. NON-JUDICIAL AUTHORITIES

Most estate planners use formulaic transfers in their day-to-day practices that are sanctioned by Treasury Regulations or other IRS pronouncements. Following are examples noted in an excerpt from the taxpayer's reply brief to the Fifth Circuit in *McCord*:

> The standard unified credit bequest combined with a marital deduction bequest for the benefit of a surviving spouse is a common use of a value definition clause. The IRS specifically sanctioned these types of clauses in Revenue Procedure 64-19, 1964-1 CB 682. Likewise, a bequest of a transfer of unused federal generation-skipping transfer ("GST") tax exemption is another common valuation definition clause. GST tax regulations specifically sanction using formula allocations of the GST tax exemption to ensure that a generation-skipping transfer is exempt from GST tax or that a generation-skipping trust has an inclusion ratio of zero. Treas. Reg. §§ 26.2632-1(b)(2)(ii) (lifetime transfers), 26.2632-1(d)(1) (testamentary transfers). The Treasury Regulations also specifically sanction disclaimers (unqualified refusals to accept property) using formula language – Example 20 of Treas. Reg. § 25.2518-3(d) delineates a fractional disclaimer amount with a numerator equal to the smallest amount that will

> allow the Estate to pass free of federal estate tax and a denominator equal to value of the decedent's residuary estate. *See also* T.A.M. 8611004 (November 15, 1985).

In P*etter*, the Tax Court recognized that the IRS and Congress have allowed formula clauses in yet other situations:

> Section 1.664-2(a)(1)(iii), Income Tax Regs., provides: "The stated dollar amount [of a payment to the recipient of a charitable remainder annuity trust] may be expressed as a fraction or a percentage of the initial net fair market value of the property irrevocably passing in trust as finally determined for Federal tax purposes." See also Rev. Rul. 72-395, sec. 5.01, 1972-2 C.B. 340, 344 (including acceptable sample formula clause).
>
> . . . .
>
> Finally, the gift-tax regulations' definition of qualified annuity interests says that the "fixed amount" to be given to the beneficiary can include "a fixed fraction or percentage of the initial fair market value of the property transferred to the trust, as finally determined for federal tax purposes." Sec. 25.2702-3(b)(1)(ii)(B), Gift Tax Regs.

III. ADJUSTMENT CLAUSES

There are generally two types of adjustment clauses. With the first, if it is finally determined for transfer tax purposes that the value of transferred property exceeds a specified dollar amount, then the size of the transferred interest is reduced, so the value of the property transferred equals the dollar amount. The second requires the transferee to pay the difference between the value finally determined and the specified dollar amount -- a consideration adjustment clause.

An adjustment clause of the first variety was addressed almost seventy years ago in the seminal case of *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944). In *Procter*, if any part of the transfer would be subject to gift tax, the property subject to gift tax would be excluded from the transfer. The Fourth Circuit considered that structure to create a condition subsequent that violated public policy, reasoning that it would be "trifling with the judicial process" and inhibit tax collection because attempting to enforce the tax would defeat the gift. The court added that allowing such a structure to work would obstruct justice because the tax issue becomes moot when a decision is rendered.

In *Ward v. Comm'r*, 87 T.C. 78 (1986), the taxpayer made a gift of stock and reserved the right to revoke it to the extent the value of each share was finally determined to exceed $2,000. The Tax Court determined that the power of revocation was beyond the donor's control, resulting in a completed gift of the entire property. The Tax Court found the structure to violate public policy under *Procter*.[2]

On the other hand, a key taxpayer victory involved a consideration adjustment. In *King v. United States*, 545 F.2d 700 (10th Cir. 1976), the taxpayer sold stock to trusts for $1.25 per share. If the fair market value were determined to exceed a threshold amount, the purchase price would be adjusted. The Tenth Circuit found no taxable gift, distinguishing *Procter*:

> IRS reliance on *Procter*, supra, is misplaced. Here, there was at no time or in any way an attempt to alter or negate the plain terms of the valuation clause and no attempt by the trustees was made to reconvey the stock to King or to cancel the notes in anticipation of an unfavorable valuation ruling. Authorities relied upon by the Government dealing with contingencies which, upon fruition, alter, change or destroy the nature of the transaction do not apply here. The proviso for adjustment of the purchase price of the stock to equal its fair market value did not affect the nature of the transaction.

Id. at 705.

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[2] The Tax Court also ignored adjustment clauses in *Harwood v. Comm'r*, 82 T.C. 239 (1984), *aff'd*, 786 F.2d 1174 (9th Cir. 1986), and *Estate of McLendon v. Comm'r*, 66 T.C.M. (CCH) 946 (1993), *rev'd on other grounds*, 77 F.3d 477 (5th Cir. 1995).

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It should come as no surprise that the IRS does not like the *King* case, and it must be noted (and clients should be made aware) that the IRS took a position contrary to *King* in Revenue Ruling 86-41, 1986-1 C.B. 300, based on Revenue Ruling 65-144, 1965-1 C.B. 422, and *Procter*. Revenue Ruling 65-144 holds that if the terms of a trust impose a condition subsequent that substantially modifies the trust merely to qualify for the gift tax charitable deduction, the gift will be void and ineffective as against public policy under *Procter*. In Revenue Ruling 86-41, the IRS concludes that a *King*-style adjustment clause also has the purpose of recharacterizing the nature of a transaction in the event of an adjustment to the gift tax return. The IRS sees no difference between a *King*-style price-adjustment clause and a *Procter*-style savings or adjustment clause. The IRS thus concluded in Rev. Rul. 86-41 that *King* transactions "tend to discourage the examinations of returns and the collections of tax and therefore are ineffective" under *Procter*.

IV. DEFINED-VALUE TRANSFERS

Rather than adjusting the transfer itself (or the consideration to be paid to the transferor), a defined-value transaction specifies the value of the transferred property at the time of the transfer. For example, if a parent wants to give an interest in a business worth $1 million to a child, the transfer document might assign only that number of shares having a fair market value of $1 million on the date of the gift. Without saying more, at least until *Wandry* was released last year, many estate planners considered such a gift structure to be at risk under *Procter*. And that is what led planners to the architecture of *McCord*, *Petter*, *Hendrix*, and *Christiansen*.

A. *McCord* – Value in Excess of a Defined Amount Goes to Charity

In *McCord*, the taxpayers gave their 82% limited partnership interest to their sons, some trusts, and two charities. A defined-value clause gave the sons and the trusts, collectively, a

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portion of the 82% interest worth $6.9 million, with the remainder to the charities. Mr. and Mrs. McCord required the donees to split the 82% interest based on the pecuniary formula. Mr. and Mrs. McCord would take no part in that splitting of the interest. Some months after the gift was made, the donees executed an arm's length "Confirmation Agreement" splitting the 82% interest.

By design, the value of the McCords' transfer to the sons and the trusts would not be affected by the IRS. The defined-value clause very purposefully did not refer to values "as finally determined for tax purposes." To suggest otherwise misses the point. Had it been that way, the IRS could change who would own what percentage interest in the partnership, like in *Petter*. As it was in *McCord,* the sons, the trustees, and the charities decided that issue.

The Tax Court in *McCord* rejected the substance over form argument, public policy arguments, and the integrated transaction argument raised by the IRS. Unfortunately, a majority found that the charities received a partnership interest of 5.12% (rounded) and then ascribed their own value to that interest. This percentage interest was the one accepted by the charities under the "Confirmation Agreement," even though Mr. and Mrs. McCord were not parties to the Confirmation Agreement.

The Fifth Circuit reversed the Tax Court, emphasizing that the fair market value of the interests transferred must be determined on the date of the gift:

> The Majority's key legal error was its confecting *sua sponte* its own methodology for determining the taxable or deductible values of each donee's gift... The core flaw in the Majority's inventive methodology was its violation of the long-prohibited practice of relying on post-gift events. Specifically, the Majority used the after-the-fact Confirmation Agreement to mutate the Assignment Agreement's dollar-value gifts into percentage interests in MIL. It is clear beyond cavil that the Majority should have stopped with the Assignment Agreement's plain wording. By not doing so, however, and instead continuing on to the post-gift Confirmation

> Agreement's intra-donee concurrence on the equivalency of dollars to percentage of interests in MIL, the Majority violated the firmly-established maxim that a gift is valued as of the date that it is complete; the flip side of that maxim is that subsequent occurrences are off limits.

McCord at 626.

Perhaps the strongest language in the Fifth Circuit's *McCord* opinion that supports defined-value transfers is when the court said that, "[i]n the end, whether the controlling values are . . . [those in the taxpayers' appraisal] . . . or those reached by the Majority . . . (or even those . . . in the deficiency notices or those reached by the Commissioner's expert witness for that matter), have *no practical effect* on the amount of gift taxes owed here." *Id.* at 628 (emphasis added). In other words, the transfer to the "taxable" donees was defined (fixed), and no appraisal would change the value of the state law property rights given to those taxable donees.

B. *Petter* - Defined-Value Clause Based on Values as Finally Determined with Lifetime Transfer to Charity

In *Petter*, the taxpayer (Anne Petter) made a lifetime defined-value transfer of units of the Petter Family L.L.C. worth a specific value to trusts for her two children, with the excess portion over that specified value passing to charities, and, unlike *McCord*, with the division of the units to be based on values as finally determined for tax purposes. The gift documents required the trusts to transfer any excess units to the charities if the value of the units initially received was finally determined for tax purposes to exceed the defined-value amount. Similarly, the charities agreed to return any excess if the reverse were true.

The IRS argued that the value was much higher than reported. Ultimately, the parties settled on a somewhat higher valuation. Thus, the only issue before the Tax Court was whether the defined-value clauses would work as intended by the taxpayer.

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The Tax Court rejected the public policy arguments raised by the IRS under *Procter*. The Tax Court rejected the mootness argument, determining that any increase in value would result in an increased charitable deduction. The Tax Court pointed out that an adjustment to the value of the units "will actually trigger a reallocation of the number of units between the trust and the foundation under the formula clause. So we are not issuing a merely declaratory judgment." *Petter* at 543. The Tax Court also stated that "[we] simply don't share the Commissioner's fear, in gifts structured like this one, that taxpayers are using charities just to avoid tax. We certainly don't find that these kinds of formulas would cause severe and immediate frustration of the public policy in favor of promoting tax audits." *Id*.

In response to the government's assertion that regulatory formula transfers cited by the taxpayer did not support the defined-value transaction at issue in *Petter*, the Tax Court stated as follows:

> The Commissioner argues that the validity of these other types of formula clauses tells us nothing about the validity of the formula clauses at issue here. He says: "The absence of an authorization of the formula clause under the instant situation is intentional, as the use of formula clauses in this situation is contrary to public policy, and frustrates enforcement of the internal revenue laws." He seems to be saying that Congress and the Treasury know how to allow such gifts, and their failure to explicitly allow formula clauses under the Code and regulations governing gift tax means that they have implicitly banned them. But the Commissioner does not point us to any Code section or regulation generally prohibiting formula clauses in gift transfers, or denying charitable deductions for donors who use these formula clauses in transfers to charities. The Commissioner also fails to address the argument that Anne is actually making; the mere existence of these allowed formula clauses, which would tend to discourage audit and affect litigation outcomes the same way as Anne's formula clause, belies the Commissioner's assertion that there is some well-established public policy against the formula transfer Anne used.

Id. at 543-544.

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The Tax Court in *Petter* thus upheld the defined-value structure. In its opinion, the Tax Court drew something of a bright line between *Procter*-style savings clauses, on the one hand, and formula clauses like *Petter*, *Christiansen*, and *McCord*, on the other hand. The Tax Court noted that the "distinction is between a donor who gives away a fixed set of rights with uncertain value—that's *Christiansen*—and a donor who tries to take property back—that's *Procter* . . . A shorthand for this distinction is that savings clauses are void, but formula clauses are fine." *Id*. at 542. On that topic, note carefully how the Tax Court manages to decide *Wandry* without running afoul of *Procter* (discussed below).

The Ninth Circuit affirmed the Tax Court's decision. *Petter v. Comm'r*, 653 F.3d 1012 (9th Cir. 2011). The Ninth Circuit rejected the IRS's argument that the adjustment feature of the formula clause makes the "additional charitable gifts subject to the occurrence of a condition precedent." *Id*. at 1018. The court noted, citing Treas. Reg. § 25.2522(c)-3(b)(1), that "a condition precedent is one that must occur before a transfer to charity 'become[s] effective.'" *Id*. The court held that the formula clause in Mrs. Petter's transfer documents did not contain a condition precedent because the "transfers became effective immediately upon the execution of the transfer documents and delivery of the units. The only possible open question was the value of the units transferred, not the transfers themselves." *Id*. The court further held that "[a]lthough the reallocation clauses require the trusts to transfer excess units to the foundations if it is later determined that the units were undervalued, these clauses merely enforce the foundations' rights to receive a pre-defined number of units." *Id*. at 1019. The court stated that the pre-defined number of units was the same when the units were first appraised and after the IRS conducted its audit "because the fair market value of [the] units at a particular time never changes." *Id*. Even

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though, absent the audit, the foundations may never have received all the units that they were entitled to, that does not mean that part of the transfer was dependent on the audit; "rather, it merely ensures that the foundations receive those units they were already entitled to receive." *Id*.

C. *Hendrix* – A *McCord* Clone in the Tax Court (Again!!!)

The issue in *Hendrix v. Comm'r*, 101 T.C.M. (CCH) 1642 (2011), involved defined-value formula clauses -- exactly like *McCord* -- in assignment documents transferring stock in John H. Hendrix Corp. ("JHC") to some trusts and a community foundation. The Tax Court noted that any appeal would lie in the Fifth Circuit, such that it was obligated to follow *McCord* except to the extent that the IRS argued that (1) the formula clauses are not the result of an arm's length transaction or (2) the formula clauses are void as contrary to public policy. *Id*. at 1646. The Tax Court determined that the formula clauses were reached at arm's length and that they were not void as contrary to public policy.

The Tax Court rejected the IRS's argument that the formula clause was not at "arm's length because [the taxpayers] and their daughters (or their trusts) were close and lacked adverse interests, the daughters benefitted from the [their] estate plan, and the clauses were not thoroughly negotiated." *Id*. at 1647. The Tax Court held that "the mere fact that [Mr. and Mrs. Hendrix] and their daughters were 'close' and that [their] estate plan was beneficial to them does not necessarily mean the formula clauses failed to be reached at arm's length." *Id*. The Tax Court also noted that "a finding of negotiation or adverse interests is not an essential element of an arm's length transaction." *Id*. The Tax Court opined that "the economic and business risk assumed by the daughters' trusts as buyers of the stock placed them at odds with [Mr. and Mrs. Hendrix] and the Foundation." *Id*.

The Tax Court also declined to accept IRS's request to find collusion between Mr. and Mrs. Hendrix and the community foundation. The Tax Court found that the "creation of the donor advised fund at the Foundation did not diverge from their usual course of donation and that the Foundation had accepted various potential risks incident to its receipt of the gifts, including a loss of the Foundation's tax-exempt status if it failed to exercise due diligence as to the gifts." *Id*. The Tax Court also noted that the community foundation "exercised its bargaining power when its counsel insisted on certain provisions being added to the assignment agreements." *Id*. The Tax Court stressed that the community foundation was represented by independent counsel and also hired an independent appraiser to review the taxpayers' appraisal. Finally, the Tax Court noted that the Foundation had "a fiduciary obligation under Federal and State law to ensure that it received the number of shares it was entitled to receive under the formula clauses." *Id*. 1647 (citing I.R.C. §501(c)(c) and Tex. Rev. Civ. Stat. Ann. art. 1396-2.28).

The Tax Court rejected the IRS's public policy argument by distinguishing the case from *Procter*. The court held that "the formula clauses impose no condition subsequent that would defeat the transaction" and that "the formula clauses further the fundamental public policy of encouraging gifts to charity." *Id*. at 1647.

D. *Wandry* – A Defined-Value Clause Based on Values as Finally Determined, but No Third Party

In *Wandry v. Comm'r*, T.C. 103 T.C.M. (CCH) 1472 (2012) (non-acq.), the Tax Court upheld a dollar value formula transfer clause, based on values as finally determined for tax purposes, transferring units of Norseman Capital, LLC. What sets *Wandry* apart is that the adjustment clause reallocated the units among the donors and the donees (similar to *Procter*), rather than reallocating them among the donees and a charitable organization (like *Petter*).

Following the advice of counsel, the taxpayers gave LLC units to each of their four children and five grandchildren. The gift documents utilized a formula clause that specified the dollar value of the membership units given to each donee. The transfer documents provided as follows:

> I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units as a Member of Norseman Capital, LLC, a Colorado limited liability company, so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000
	1,099,000

> Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of

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> that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

Id. at 1473-74.

After an IRS audit, the parties agreed to a higher value for the units transferred. The IRS claimed additional gift tax was due. The IRS presented "three arguments to support this conclusion: (1) the gift descriptions, as part of the gift tax returns, are admissions that petitioners transferred fixed [company] percentage interests to the donees; (2) [the company's] capital accounts control the nature of the gifts, and [the company's] capital accounts were adjusted to reflect the gift descriptions; and (3) the gift documents themselves transferred fixed [company] percentage interests to the donees." *Id*. at 1474. The IRS further argued that the adjustment clause creates a condition subsequent to completed gifts and is void for federal tax purposes as contrary to public policy. *Id*.

The IRS argued that the gift descriptions in the petitioners' gift tax returns, which reflected gifts of percentage interests, are binding admissions that petitioners transferred fixed percentage interests to the donees. The IRS relied on *Knight v. Commissioner*, 115 T.C. 506 (2000), in making that argument. However, the Tax Court pointed out that in *Knight* the taxpayers disregarded the formula by arguing that the gifts were actually worth less than the

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dollar value included in the transfer documents. By contrast, in *Wandry* "[a]t all times petitioners understood and believed that the gifts were of a dollar value, not a specified number of membership units." *Id*. The Tax Court further noted that petitioner's CPA "merely derived the gift descriptions form petitioner's net dollar value transfers and the valuation report. Therefore, petitioners' consistent intent and actions prove that dollar amounts of gifts were intended." *Id*.

Regarding the IRS's argument that the capital accounts controlled the nature of the gifts and the capital accounts reflected gifts of fixed percentage interests, the Tax Court found that the "facts and circumstances determine [company] capital accounts, not the other way around." *Id*. at 1476. Therefore, the capital accounts do not control the nature of the gifts. *Id*.

The IRS next argued that the gift documents themselves transferred a fixed company percentage interest to the donees. In other words, the IRS was once again arguing that the formula contained an improper savings clause. The Tax Court relied heavily on *Petter* and concluded that the gift documents "[did] not allow for petitioners to 'take property back.' Rather, the gift documents correct the allocation of company membership units among petitioners and the donees because the valuation report understated [the company's] value." *Id*. at 1478. In coming to this conclusion, the Tax Court drew a distinction between a "savings clause" (*Procter*) and a "formula clause" (*Petter*), noting that:

> A savings clause is void because it creates a donor that tries 'to take property back.' On the other hand, a 'formula clause' is valid because it merely transfer a 'fixed set of rights with uncertain value.' The difference depends on an understanding of just what the donor is trying to give away. [citing *Petter*].

Id. at 1477. The difference does not seem obvious, but the court saw it.

In the court's opinion, it was "inconsequential that the adjustment clause reallocate[d] membership units among the petitioners and the donees rather than to a charitable organization because the reallocation did not alter the transfers." *Id*. Each donee was merely entitled to a predefined company percentage interest as expressed in the gift documents. *Id*. Accordingly, the Tax Court held that the clauses at issue are valid formula clauses. *Id*.

To the IRS's argument that the public policy concerns expressed in *Procter* should apply to *Wandry*, the court restated its holding in *Petter* that "there is no well-established public policy against formula clauses." *Id*. The court added that the "Commissioner's role is to enforce tax laws, not merely to maximize tax receipts." *Id*. Finally, the court noted that a judgment in the gift tax case regarding value would reallocate units among the donors and donees. Therefore, the court was not ruling a moot case or issuing merely a declaratory judgment. *Id*.

Wandry is an eye popping case because it is so hard to distinguish from *Procter* and because, if *Wandry* stands as good law, it could be used in planning for so many clients that do not have charitable intent. The IRS initially was appealing the decision in *Wandry*, but it later shelved the appeal and instead issued its non-acquiescence. I.R.B. 2012-46. Many estate planners were hoping for an appeal and loss by the IRS. As it stands now, though, planners can expect IRS challenges to *Wandry*-style transactions, particularly in those circuits where the IRS might perceive there to be less favorable precedent for taxpayer (such as *Procter*'s Fourth Circuit).

V. DEFINED-VALUE TRANSFERS AT DEATH

A defined-value disclaimer was at issue in *Christiansen*. Ms. Christiansen left everything to her daughter, Christine Hamilton. The will provided that disclaimed assets would pass 75% to

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a charitable lead annuity trust (the "CLAT") and 25% to a private foundation (the "Foundation"). The estate tax return reported assets worth $6.51 million, including 99% limited partner interests in two partnerships. Christine Hamilton disclaimed the portion of the estate exceeding $6.35 million based on values as finally determined for tax purposes.

The IRS and the taxpayer agreed that the discounts to net asset value should be 37% and 34% for the two partnerships. That agreement increased the gross estate to approximately $9.6 million. Like *Petter*, but unlike *McCord*, the ultimate valuation findings would change which donees would own what property interests, because the defined-value clause referred to values as finally determined. Thus, the valuation settlement caused $3.1 million (in the form of partnership interests) to pass to the CLAT and the Foundation. The question was the charitable deduction.

A majority of the Tax Court held that the disclaimer was not a qualified disclaimer as to the 75% that passed to the CLAT. The majority decided that I.R.C. § 2518 was not satisfied because Christine Hamilton had a contingent remainder interest in the CLAT. Regarding the 25% passing to the Foundation, however, there was no question that § 2518 was satisfied. The Tax Court's decision on the formula clause was unanimous in validating the disclaimer in favor of the Foundation and allowing a charitable deduction for the increased amounts passing to the Foundation. The Tax Court stated as follows:

> The regulation speaks of the contingency of "a transfer" of property passing to charity. The transfer of property to the Foundation in this case is not contingent on any event that occurred after Christiansen's death (other than the execution of the disclaimer)-it remains 25 percent of the total estate in excess of $6,350,000. That the estate and the IRS bickered about the value of the property being transferred doesn't mean the transfer itself was contingent in the sense of being dependent for its occurrence

> on a future event. Resolution of a dispute about the fair market value of assets on the date Christiansen died depends only on a settlement or final adjudication of a dispute about the past, not the happening of some event in the future. Our Court is routinely called upon to decide the fair market value of property donated to charity-for income, or estate tax purposes.

Christiansen at 24-25. The Tax Court found itself "hard-pressed to find any fundamental public policy against making gifts to charity -- if anything the opposite is true. Public policy encourages gifts to charity, and Congress allows charitable deductions to encourage charitable giving." *Id*. at 26-27. Rejecting *Procter*, the Tax Court noted:

> This case is not *Procter*. The contested phrase would not undo a transfer, but only reallocate the value of the property transferred among Hamilton, the [CLAT] and the Foundation. If the fair market value of the estate's assets is increased for tax purposes, then property must actually be reallocated among the three beneficiaries. That would not make us opine on a moot issue, and wouldn't in any way upset the finality of our decision in this case.

Id. at 27.

On November 18, 2009, the Eighth Circuit affirmed the Tax Court's decision in *Christiansen*. In reference to the appropriateness of the charitable deduction under Treas. Reg. § 20.2055-2(b)(1), the Eighth Circuit noted that "the regulation . . . does not speak in terms of the existence or finality of an accounting valuation . . . . Rather, it speaks in terms of the existence of *a transfer* at the date of death." *Christiansen*, 586 F.3d at 1062. The Eighth Circuit did not believe that its ruling would detract from the incentive to audit estate tax returns. The court stated that a formula transfer is not against public policy even when "a post-challenge correction to an estate's value could result in a charitable deduction equal to the increase in the estate . . . ."

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VI. PLANNING ISSUES

A. Adjustment Clauses

Procter has been a problem for estate planners for decades, even though perhaps it has lost some of its luster for the IRS and might even be overturned or limited by a future Fourth Circuit opinion. Whether any of that conjecture is true or not, it is fairly apparent that *McCord*, *Hendrix*, *Christiansen*, and *Petter* have successfully limited *Procter* to savings clauses, as opposed to defined-value transfers. *Wandry* is the case that opens the Pandora's box. Until *Wandry*, it was not advisable to recommend adjustment clauses if any part of the property transferred would be returned to the donor (or deemed never transferred), as in the case of a savings clause like *Procter*.[3] Yet *Wandry* allowed a taxpayer victory and distinguished *Procter* in a manner that is difficult for many lawyers to understand.

There also is the separate approach of a consideration adjustment transaction. *King* suggests that consideration adjustments work, in spite of Rev. Rul. 86-41, 1986-1 C.B. 300. *King* is, after all, a Tenth Circuit opinion, and the Tax Court in *Petter* appeared to have a favorable view of *King*. Therefore, a consideration adjustment may be worthwhile in the right circumstances, particularly in the Tenth Circuit.

B. Charitable Defined-Value Transfers

The structures in *McCord* and *Hendrix*, on the one hand, and *Petter* and *Christiansen*, on the other hand, are very different in terms of who decides which recipients will own what property interests. *McCord* and *Hendrix* rely entirely on state law property rights, such that the

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[3] Note that the issue arises only in *inter vivos* transactions.

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IRS cannot change who owns what. *Petter* and *Christiansen* turn on finally determined values, such that the IRS does affect how much property passes to charity.

In a *McCord/Hendrix* structure, if the IRS disagrees with a taxpayer's valuation, the donor should not be at fault for how the donees split the assets. Indeed, the donor is not even involved. There should be no gift tax on the donor, even if the IRS perceives that family members got the better end of the deal as compared to the charity. To the contrary, the charity may have conferred a benefit on the children, and the IRS could challenge the charity under the private inurement or private benefit doctrines. As noted in *Petter*, if there were collusion, "the Commissioner himself could revoke the foundations' 501(c)(3) exemptions." Further, as noted in *Christiansen*, charities owe fiduciary duties to their wards and are supervised by the applicable Attorney General.

Even outside the Fifth Circuit, there should be no gift in a *McCord/Hendrix* transaction above the defined-value amount, absent collusion with the charity. The majority of the Tax Court in *McCord* queried whether a charity would look a gift horse in the mouth (*see* footnote 9 of the opinion). That is, of course, a far cry from collusion.

Some commentators have expressed concern about *McCord* in the face of public policy and other common law arguments. Even though the Tax Court rejected those arguments, the concern exists because the government did not brief those arguments properly to the Fifth Circuit. The Fifth Circuit considered those arguments to be waived:

> Although the Commissioner relied on several theories before the Tax Court, including doctrines of form-over-substance, violation-of-public policy, and, possibly, reasonable-probability-of-receipt, he has not advanced any of those theories on appeal. Accordingly, the Commissioner has waived them, and has instead - *not*

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> *surprisingly* - devoted his efforts on appeal solely to supporting the methodology and holdings of the Majority.

McCord at 623 (emphasis added). It is difficult to find any reluctance by the Fifth Circuit to support the *McCord* transaction as structured. Perhaps other circuit courts would favor the policy arguments more than the Fifth Circuit, but it would be difficult for the government to prevail against good taxpayer facts. The Tax Court itself did not find those arguments to be sufficient in *McCord*, *Hendrix*, or *Petter*.

In a charitable defined-value transfer structure, the timing of the appraiser's work is important to the client. In order to set the defined-value amount for the non-charity recipients, a client will need to know the total value of the asset to have an idea regarding how much would pass to family and how much would pass to charity. The charity and the IRS may have a different view of valuation, but almost no client would want to structure the formula without an up-front opinion on value. The problem is one of simultaneous information. It is almost impossible to have a solid appraisal, set the formula, and close a transaction without some wiggle room. Communications with the charity should encourage a complete review of the asset and the transaction ahead of time, but without indications of appraised value, how the asset might be split post-closing, or the value intended for the charity. As usual, there is a premium on quality appraisal work.

C. Testamentary Transfers v. *Inter Vivos* Transfers

With testamentary transfers, a client will not know the ultimate value of his estate when he writes his will. The value of the gross estate is a moving target. Unless the client has a strong view about how much (or little) to leave the children, it will be difficult to set a cut-off amount between the children's share and the charity's share in a will or revocable trust. This is why the disclaimer technique of *Christiansen* makes so much sense. Assume that a testator leaves his residuary estate to children, as in *Christiansen*. The testator also provides that any amount disclaimed by a child passes to charity. Thus, the child is not directing to whom the disclaimed assets will pass. The children can consider values post-death (with appraisals in hand) and decide the defined-value amount to keep, disclaiming the rest. The client merely has given the children the opportunity to engage in what can be very useful post-mortem planning.

One problem with a *Christiansen* approach is that it requires all children to act together in order to work properly. If not, the defined-value structure will have a "leak," and the estate will have to pay tax on any value that is not disclaimed by the children. If there is a leak, there would be more incentive for the IRS to audit the return and assert a higher value, since any increase in the value of the estate would lead to more tax being paid due to the undisclaimed portion.

The disclaimer technique also puts stress on the allocation of debts, expenses, and taxes; specifically, whether the charity's share should bear tax (which reduces the charitable deduction). If an increase in valuation would result in a tax increase because of the resulting circular calculations, the IRS may challenge value.

Regarding private foundations in charitable defined-value transactions, there is a difference between *inter vivos* transactions and testamentary transactions. In the *inter vivos* situation like *McCord* or *Hendrix*, when values are not based on those as finally determined, a key component is the independence of the charity, so a private foundation is not advisable, and a public charity is preferable (*McCord* and *Hendrix* utilized community foundations). In a death situation, however, a private foundation can work because the charity's independence is less important (assets are split based on values as finally determined, not a negotiated deal with an

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independent charity). If the will gives a fixed amount to children (as finally determined) and the residuary passes to a private foundation, it likely will be necessary later to have the foundation sell the hard-to-value asset to family members in a state court proceeding that follows the requirements for indirect self-dealing under the Treasury Regulations to I.R.C. § 4941. On the other hand, if the disclaimer approach of *Christiansen* is used, there is concern under I.R.C. § 2518 about the disclaimant having authority over the assets disclaimed, as it could render the disclaimer invalid without a “Chinese Wall” (which may render the transaction undesirable).

Another issue is that an estate is a convenient mechanism to hold all the property until the final determination of value is obtained. In an *inter vivos* transaction, there is no such convenient mechanism if the transaction follows the “as finally determined” approach of *Petter* and *Wandry* rather than the approach of *McCord* and *Hendrix*. In the case of flow-through entities like partnerships, an estate can hold the asset for some time before funding the bequests under the will, and the estate would have the profit and loss allocations as well as the cash distributions. In an *inter vivos* transaction, multiple transferees will not know their final ownership shares until “finally determined.”

In *Petter,* the taxpayer used intentionally defective grantor trusts to solve some of the income tax issues, but doing so did not solve the problem of which party enjoys what economic benefits during the time between the initial allocation and a subsequent reallocation of interests. The Tax Court in *Petter* held that the charitable deduction applies in the year of the original gift, and any subsequent reallocation is irrelevant. *Petter* at 544-545.

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A *Wandry*-style transaction would create the same problem of uncertainty as to which party enjoys what economic benefits after the initial allocation and a subsequent reallocation of interests. The only difference is that the donor would share in that uncertainty.

D. Non-Charitable Defined-Value Transfers

McCord, *Hendrix*, *Petter*, and *Christiansen* all involved transfers to charity of the excess amount above the defined-value threshold. However, some clients are not charitably inclined, yet they still desire some level of certainty with respect to their transfer. One option is using a *Wandry*-style formula clause. Some planners also have utilized grantor retained annuity trusts (GRATS) and qualified terminable interest property (QTIP) trusts as recipients of the non-taxable portion of the transfer.

(i) *Wandry*

As discussed above, a *Wandry*-style formula clause would involve the transfer of a specified dollar amount of assets, with any “overage” simply not being transferred. Such a transaction might be considered for any client aiming at an exemption number (like the $5 million federal gift tax exemption, as indexed for inflation), particularly if there is no charitable intent. However, those clients need to be aware of the downside. Because the IRS issued a non-acquiescence in reaction to *Wandry*, clients might expect audit activity from the IRS, particularly in the Fourth Circuit jurisdictions. *Wandry* is the only taxpayer victory in which the “excess value” was retained by the transferor and not shifted to a third party like a charity or paid for with extra consideration (like *King*).

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(ii) *Grantor Retained Annuity Trusts*

Another defined-value transfer technique often discussed by planners is a so-called "GRAT lid." If *Petter* is a "charitable lid," a GRAT lid is a similar *inter vivos* transaction in which a grantor retained annuity trust (a "GRAT") takes the place of the charity, and the values to be used are those as finally determined for tax purposes. The GRAT could be structured with a very high annuity payable to the grantor, such that any property passing to the GRAT results in almost no gift tax.

For clients without charitable intent, or for those worried about the appraisal risk that operates in favor of charity under a *Petter* or *McCord/Hendrix* transaction, planners might consider a GRAT lid and perhaps a consideration adjustment like *King*. In fact, a GRAT lid, based on values as finally determined, is very similar to *King*, given that a valuation increase results in more annuity payable to the transferor. The difference is that, in a *King* transaction, the property transferred to one recipient does not shift to another recipient; rather, the first recipient simply has to pay more. In addition to the Tax Court's opinion in *Petter*, the Regulations under I.R.C. § 2702 offer some comfort in the GRAT arena if faced with a *Procter* argument, because those Regulations provide for an annuity adjustment in the event of a valuation change. Also, in the case of a GRAT lid, unless the GRAT is completely zeroed-out for gift tax purposes, there would be some gift tax consequence to an increased valuation. That exposure helps in the face of a *Procter* argument.

(iii) *Lifetime QTIP Trusts*

Many planners have used a qualified terminable interest trust (a "QTIP trust") instead of a charity in their defined value planning because the transfer of assets to a QTIP trust avoids gift tax via the marital deduction. The idea is that the defined-value transfer technique should work

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to help against valuation risk, and the "excess value" stays in the family (indeed, it stays in the same room!). Testamentary formula transfers to QTIP trusts have been used for decades (so-called pecuniary or reverse pecuniary marital deduction formula bequests). There is little reason to think that the same thing would not work in an *inter vivos* setting. The theory underlying the decisions in *McCord*, *Hendrix*, *Petter*, and *Christiansen* should apply to an *inter vivos* transfer to a QTIP trust just the same as it does with transfers to charity.

One concern with a so-called "QTIP lid" is that, in most planning scenarios, the remainder beneficiaries of the QTIP trust will be the same people that are the beneficiaries of the trust receiving the defined-value portion. In fact, those same beneficiaries might act as trustees of both the QTIP trust and the trust receiving the defined-value portion. In those circumstances, the IRS might question whether those parties have the incentive to enforce the terms of the formula transfer. Clearly the trustees of the QTIP trust would have a fiduciary obligation to all beneficiaries of the trust, including the non-donor spouse, to ensure the proper valuation of the interest being transferred. *See, e.g.*, *Estate of Duncan v. Comm'r*, T.C. Memo 2011-255 (Oct. 31, 2011). Differentiating the QTIP trustees and remainder beneficiaries from the recipients of the defined-value portion of the transfer might be easier said than done.

VII. CONCLUSION

It has been quite a run for defined-value transfer planners with successful outcomes in *McCord*, *Hendrix*, *Christiansen*, *Petter*, and, most recently and most notoriously, *Wandry*, all in the last several years. These judicial opinions are exceptionally significant, but the IRS has announced that it will not back down.

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We know that there was a tremendous volume of gift-making activity in 2012 as clients were anticipating the loss of their $5 million gift tax exemptions heading into the fiscal cliff. We also know that many of those transactions involved defined-value transfers. We therefore would expect to see some audit and litigation activity, even though the IRS seems to have quite an uphill battle on its hands.

Estate Planning Issues With Intra-Family Loans and Notes

February 15, 2013

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Estate Planning Issues With Intra-Family Loans and Notes

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I. SIGNIFICANCE

A. Examples of Uses of Intra-Family Loans and Notes. Wealthy families often run a "family bank" with advances to various family members as they have liquidity needs. Many of the uses of intra-family loans take advantage of the fact that the applicable federal rate ("AFR") is generally lower than the prevailing market interest rate in commercial transactions. (The AFR is based "on outstanding marketable obligations of the United States." The short-term, mid-term, and long-term rates under §1274[1] are determined based on the preceding two months' average market yield on marketable Treasury bonds with corresponding maturity.[2]) Examples of possible uses of intra-family loans and notes include:

1. Loans to children with significant net worth;
2. Loans to children without significant net worth;
3. Non-recourse loans to children or to trusts
4. Loans to grantor trusts;
5. Sales to children or grantor trust for a note;
6. Loans between related trusts (e.g., from a bypass trust to a marital trust, from a marital trust to a GST exempt trust, such as transactions to freeze the growth of the marital trust and transfer appreciation to the tax-advantaged trust);
7. Loans to an estate;
8. Loans to trusts involving life insurance (including split dollar and financed premium plans);[3]
9. Home mortgages for family members;

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[*] Copyright 2013 by Bessemer Trust Company, N.A. All rights reserved. Portions of this article, in particular Sections IV-VII and IX-X (the intricacies of §7872), Section XVIII (income tax effects of installment sales under the §§ 483, 1274, and 7872 rules), and Section XX (SCINs) are based on (and in large part taken verbatim from) outstanding articles by Philip J. Hayes. Philip J. Hayes, *Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners*, 13 CALIF. TR. & EST. QUARTERLY 5 (Summer 2007)(permission granted for the use of portions of this article); Philip J. Hayes, *Adventures in Forgiveness and Forgetfulness, Part 2: Intra-family Sales for Beginners*, 13 CALIF. TR. & EST. QUARTERLY 15 (Fall 2007)(permission granted for the use of portions of this article); Philip J. Hayes, *Intra-Family Loans: Adventures in Forgiveness and Forgetfulness,* ABA REAL PROP., PROB. & TR. L. SECTION SPRING MEETING (2007).

[1] References to a "§" in the text will be to sections of the Internal Revenue Code of 1986, as amended.

[2] *See* Whitty, *Effects of Low Interest Rates on Investment-Driven Estate Planning Techniques,* 30 EST. PL. 587 (Dec. 2003).

[3] The split dollar regulations provide that a premium financing arrangement will be governed by §7872, unless it provides for the payment or accrual of interest at the AFR. Treas. Reg. § 1.7872-15(a)(1). Even if the loan provides for adequate interest, if the split dollar loan is "non-recourse" (e.g., a loan to a trust with no other assets than the life insurance policy), the loan will be treated as a below-market loan under § 7872 unless the parties attach statements to their annual income tax returns representing that a reasonable person would expect all payments under the loan to be made. Treas. Reg. § 1.7872-15(d)(2)("Each party should … attach a copy of this representation to its Federal income tax return for any taxable year in which the lender makes a loan to which the representation applies"). Split dollar life insurance plans are outside the scope of this outline and will not be addressed further.

10. Loans for consumption rather than for acquiring investment assets (these may be inefficient from an income tax perspective because the interest payments will be personal interest that does not qualify for an interest deduction);

11. Loans as vehicles for gifts over time by forgiveness of payments in some years, including forgiveness of payments in 2012 as a method of utilizing $5.0 million gift exemption available in 2012;

12. Loan from young family member to client for note at a higher interest rate (to afford higher investment returns to those family members than they might otherwise receive) (In a different context, the Tax Court has acknowledged the reasonableness of paying an interest rate higher than the AFR[4]); and

13. Client borrowing from a trust to which client had made a gift in case the client later needs liquidity (and the resulting interest may be deductible at the client's death if the note is still outstanding at that time[5]).

B. Inadvertent Loans. Loan situations can arise inadvertently. For example, assume that a client pays a significant "endowment" for the client's parent to live in a retirement facility. The facility will refund a portion of the endowment when the occupant dies. The maximum refund is 90%. Payment of the "endowment" appears to represent a 10% gift and a 90% percent interest-free loan.

C. Advantages of Loans and Notes.

1. Arbitrage. If the asset that the family member acquires with the loan proceeds has combined income and appreciation above the interest rate that is paid on the note, there will be a wealth transfer without gift tax implications. With the incredibly current low interest rates, there is significant opportunity for wealth transfer.

Example: Assume a very simple example of a client loaning $1 million to a child in December 2012 with a 9-year balloon note bearing interest at 0.95% compounded annually (the AFR for mid-term notes). Assume the child receives a 5% combined growth and income, annually (net of income taxes-- the taxes would be borne by the client if the loan were made to a grantor trust).

Amount child owns at end of nine years (@5.0%, compounded annually):	$1,551,328
Amount owed child at end of nine years (@0.95%, compounded annually):	1,088,822
Net transfer to child (with no gift tax)	$ 462,506

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[4] Estate of Duncan v. Commissioner, T.C. Memo. 2011-255. The court's reasoning is compelling:

> " Interest rates are generally determined according to the debtor's rather than the creditor's characteristics... The long-term applicable Federal rate is thus inappropriate because it is based on the yield on Government obligations… It therefore reflects the Government's cost of borrowing, which is low because Government obligations are low-risk investments…Using the long-term applicable Federal rate consequently would have been unfair to the Walter Trust. [citations omitted; emphasis in original]."

Estate of Duncan is discussed in Section XXI.B.3 of this outline, *infra.*

[5] See Section II.D.4 of this outline, *infra.*

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2. "All in the Family." Interest payments remain in the family rather than being paid to outside banks.

3. Poor Credit History. Intra-family loans may be the only source of needed liquidity for family member members with poor credit histories.

4. Closing Costs. Borrowing from outside lenders may entail substantial closing costs and other expenses that can be avoided, or at least minimized, with intra-family loans.

D. Advantages of Gifts Over Loans. If a client inquires about making a loan to children, do not just knee-jerk into documenting the loan without considering whether gifts would be more appropriate.[6]

1. Circumstances Indicating a Gift is Preferable to a Loan. Several circumstances suggesting that a gift may be preferable include: (i) the lender does not need the funds to be returned; (ii) the lender does not need cash flow from the interest on the loan; (iii) is not apparent how the law will never be repaid; and/or (iv) the lender does not plan on collecting the loan.

2. Note Receivable in Client's Estate. The note receivable will be in the client's estate for estate tax purposes. In particular, make use of annual exclusion gifts, which allows asset transfers that are removed from the donor's estate and that do not use up any gift or estate exemption.

3. Lower Effective Gift Tax Rate If Live Three Years. The gift tax rate is applied to the net amount passing to the donee, whereas the estate tax rate is applied to the entire state, including the amount that will ultimately be paid in estate taxes. If the donor lives for three years, gift taxes paid are removed from the gross estate.

4. Fractionalization Discounts. If the client transfers a fractional interest or a minority interest in an asset owned by the client, the transfer may be valued with a fractionalization discount. On the other hand, if cash is loaned to the child, no fractionalization discounts are appropriate.

5. State Death Tax Avoidance. Gifts remove assets from the donor's gross estate for state estate tax purposes without payment of any federal or state transfer taxes (assuming the state does not have a state gift tax or "contemplation of death" recapture of gifts back into the state gross estate).

6. Avoiding Interest Income. If the transfer structured as a loan, the parent will recognize interest income (typically ordinary income) at least equal to the AFR, either as actual interest or as imputed interest, thus increasing the parent's income tax liability. Using loans to fund consumption needs of children is inefficient in that the interest is taxable income to the lender without any offsetting deduction to the borrower, thus generating net taxable income for the family.

7. Avoiding Accounting Burden. Someone must keep track of the interest as it accrues to make sure that it is paid regularly or is reported as income. This can be particularly tedious for a demand loan or variable-

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[6] The materials in this section are derived primarily from an excellent outline by Benjamin Pruett (Bessemer Trust, Washington, D.C): Pruett, *Loans Within the Family—Cautions and Considerations.*

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rate term loan where the interest rate is changing periodically. There are additional complications for calculating the imputed interest for below-market loans (which means that loans should always bear interest at least equal to the AFR).

8. Avoiding OID Computations If Interest Not Paid Annually. If interest is not paid annually, the original issue discount (OID) rules will probably require that a proportionate amount of the overall interest due on the note will have to be recognized each year by the seller, even if the seller is a cash basis taxpayer. Determining the precise amount of income that must be recognized each year can be complicated, particularly if some but not all interest payments are made. The amount of OID included in income each year is generally determined under a "constant yield method" as described in Regulation §1.1272-1(b)(1).[7] (The OID complications can be avoided if the loan is made to a grantor trust.)

9. Avoiding Non-Performance Complications. If the borrower does not make payments as they are due, additional complications arise.

    a. Possible Recharacterization as Gift. The IRS takes the position that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect on the note, the note will not be considered valuable consideration and the donor will have made a gift at the time of the loan to the full extent of the loan.[8] While some cases have rejected this approach,[9] and while the lender can attempt to establish that there was no intention from the outset of forgiving the loan, if the lender ends up forgiving some or all of the note payments, questions can arise, possibly giving rise to past due gift tax liability which could include interest and penalties.

    b. Imputed Gift and Interest Income. Even if the loan is not treated as a gift from the outset, forgiven interest may be treated the same as forgone interest in a below-market loan, resulting in an imputed gift to the borrower and imputed interest income to the lender. (However, if the forgiveness includes principal "in substantial part" as well as income, it may be possible for the lender to avoid having to recognize accrued interest as taxable income.[10])

    c. Modifications Resulting in Additional Loans. If the parties agree to a loan modification, such as adding unpaid interest to the principal of the loan, the modification itself is treated as a new loan, subject to the AFRs in effect when the loan is made, thus further compounding the complexity of record keeping and reporting.

10. Loan to Grantor Trust Can Have Some Advantages of Gift. One of the advantages of making gifts to a grantor trust is that the grantor pays income taxes on the grantor trust income without being treated as making

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[7] I.R.C. § 1272(a).

[8] Rev. Rul. 77-299, 1977-2 C.B. 343.

[9] See Section II.E.2-3 of this outline *infra.*

[10] Prop. Reg. §1.7872-11(a). See Section XVI.C of this outline *infra.*

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an additional gift. This allows the trust assets to grow faster (without having to pay taxes) and further reduces the grantor's estate for estate tax purposes. This same advantage is available if the loan is made to a grantor trust. In addition, making the loan to a grantor trust avoids having interest income taxed to the lender-grantor, and avoids having to deal with the complexity of the OID rules.

II. LOAN VS. EQUITY TRANSFER

A. Significance. The IRS may treat the transfer as a gift, despite the fact that a note was given in return for the transfer, if the loan is not bona fide or (at least according to the IRS) if there appears to be an intention that the loan would never be repaid. (If the IRS were to be successful in that argument, the note should not be treated as an asset in the lender's estate.)

A similar issue arises with sales to grantor trust transactions in return for notes. The IRS has made the argument in some audits that the "economic realities" do not support a part sale and that a gift occurred equal to the full amount transferred unreduced by the promissory note received in return. Another possible argument is that the seller has made a transfer and retained an equity interest in the actual transferred property (thus triggering §2036) rather than just receiving a debt instrument.

B. Gift Presumption. A transfer of property in an intra-family situation will be presumed to be a gift unless the transferor can prove the receipt of "an adequate and full consideration in money or money's worth."[11]

C. Bona Fide Loan Requirement. In the context of a transfer in return for a promissory note, the gift presumption can be overcome by an affirmative showing of a bona fide loan with a "real expectation of repayment and an intention to enforce the debt."[12]

The bona fide loan issue has been addressed in various income tax cases, including cases involving bad debt deductions, and whether transfers constituted gross income even though they were made in return for promissory notes.[13] A recent case addresses the bona fide loan factors in the context of whether $400,000 transferred to an employee was taxable income or merely the proceeds of a loan from the employer.[14] The court applied seven factors in determining that there was not a bona fide loan: (1) existence of a note comporting with the substance of the transaction, (2) payment of reasonable interest, (3) fixed schedule of repayment, (4) adequate security, (5) repayment, (6) reasonable expectation of repayment in light of the economic realities, and (7) conduct of the parties indicating a debtor-creditor relationship.

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[11] Reg. §§25.2512-8; 25.2511-1(g)(1)("]t]he gift tax is not applicable to a transfer for a full and adequate consideration in money or money's worth, or to ordinary business transactions ..."). *See* Harwood v. Commissioner, 82 T.C. 239, 258 (1984), *aff'd*, 786 F,2d 1174 (9th Cir. 1986), *cert. den.*, 479 U.S. 1007 (1986).

[12] Estate of Van Anda v. Commissioner, 12 T.C. 1158, 1162 (1949).

[13] *E.g.*, Santa Monica Pictures, LLC v. Commissioner, T.C. Memo. 2005-104 (no basis was established for assumption of debt that was not a bona fide indebtedness).

[14] Todd v. Commissioner, T.C. Memo. 2011-123, *aff'd*, 110 AFTR 2d ¶ 2012-5205 (5th Cir. 2012)(unpublished decision) (appeallate decision emphasized post hoc note execution and that the loan was never repaid as supporting that the note was merely a formalized attempt to achieve a desired tax result despite a lack of substance).

The bona fide loan requirement has also been addressed in various gift tax cases. The issue was explored at length in *Miller v. Commissioner*,[15] a case in which taxpayer made various transfers to her son in return for a non-interest-bearing unsecured demand note. The court stated that "[t]he mere promise to pay a sum of money in the future accompanied by an implied understanding that such promise will not be enforced is not afforded significance for Federal tax purposes, is not deemed to have value, and does not represent adequate and full consideration in money or money's worth." The court concluded that the transfer was a gift and not a bona fide loan, on the basis of a rather detailed analysis of nine factors:

> "The determination of whether a transfer was made with a real expectation of repayment and an intention to enforce the debt depends on all the facts and circumstances, including whether: (1) There was a promissory note or other evidence of indebtedness, (2) interest was charged, (3) there was any security or collateral, (4) there was a fixed maturity date, (5) a demand for repayment was made, (6) any actual repayment was made, (7) the transferee had the ability to repay, (8) any records maintained by the transferor and/or the transferee reflected the transaction as a loan, and (9) the manner in which the transaction was reported for Federal tax purposes is consistent with a loan."[16]

Miller cites a number of cases in which those same factors have been noted to determine the existence of a bona fide loan in various contexts, and those nine factors have been listed in various subsequent cases.[17]

The risks of treating a note in a sale transaction as retained equity rather than debt were highlighted in *Karmazin v. Commissioner*,[18] in which the IRS made a number of arguments to avoid respecting a sale of limited partnership units to a grantor trust, including §2701 and 2702. In that case, the taxpayer created an FLP owning marketable securities. Taxpayer made a gift of 10% of the LP interests and sold 90% of the LP interests to two family trusts. The sales agreements contained "defined value clauses." The sales to each of the trusts were made in exchange for secured promissory notes bearing interest equal to the AFR at the time of the sale, and providing for a balloon payment in 20 years. Jerry Deener (Hackensack, New Jersey) represented the taxpayer and has reported that the IRS "threw the book" at a gift/sale to grantor trust transaction. The IRS sent a 75-page Agent's Determination Letter in which the entire transaction was disallowed. The partnership was determined to be a sham, with no substantial economic effect, and the note attributable to the sale was reclassified as equity and not debt. The result was a determination that a gift had been made of the entire undiscounted amount of assets subject to the sale. The agent's argument included: (1) the partnership was a sham; (2) Section 2703 applies to disregard the partnership; (3) the defined value adjustment clause is invalid; (4) the note is treated as equity and not debt because (i) the only assets owned by the trust are the limited partnership interests, (ii) the debt is non-recourse, (iii) commercial lenders would not enter this sale transaction without personal guaranties or a larger down payment, (iv) a nine-to-one debt equity ratio is too high, (v)

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[15] T.C. Memo. 1996-3.

[16] *Id.*

[17] *E.g.*, Estate of Lockett v. Commissioner, T.C. Memo. 2012-123.

[18] T.C. Docket No. 2127-03, filed Feb. 10, 2003)

insufficient partnership income exists to support the debt, and (vi) PLR 9535026 left open the question of whether the note was a valid debt; and (5) because the debt is recharacterized as equity, §2701 applies (the note is treated as a retention of non-periodic payments) and 2702 applies (rights to payments under the note do not constitute a qualified interest). That case was ultimately settled (favorably to the taxpayer), but the wide ranging tax effects of having the note treated as equity rather than debt were highlighted.

In *Dallas v. Commissioner*,[19] the IRS agent made arguments under §§2701 and 2702 in the audit negotiations to disregard a sale to grantor trust transaction by treating the note as retained equity rather than debt, but the IRS dropped that argument before trial and tried the case as a valuation dispute.

D. Estate Tax Context. The bona fide loan issue has also arisen in various estate tax situations.

1. Sale-Leaseback and Whether §2036 Applies. In *Estate of Maxwell v. Commissioner*[20] a sale of property to the decedent's sons for a note secured by a mortgage, with a retained use of the property under a lease, triggered inclusion under §2036. The court held that the sale-leaseback was not a bona fide sale where the decedent continued to live in the house and the purported annual rent payments were very close to the amount of the annual interest payments the son owed to the decedent on the note. The court observed that the rent payments effectively just cancelled the son's mortgage payments. The son never occupied the house or tried to sell it during the decedent's lifetime. The son never made any principal payments on the mortgage (the decedent forgave $20,000 per year, and forgave the remaining indebtedness at her death under her will). The court concluded that the alleged sale was not supported by adequate consideration even though the mortgage note was fully secured; the note was a "façade" and not a "bona fide instrument of indebtedness" because of the implied agreement (which the court characterized as an "understanding") that the son would not be asked to make payments. The Second Circuit affirmed the Tax Court's conclusion that

> "notwithstanding its form, the substance of the transaction calls for the conclusion that decedent made a transfer to her son and daughter-in-law with the understanding, at least implied, that she would continue to reside in her home until her death, that the transfer was not a bona fide sale for an adequate and full consideration in money or money's worth, and that the lease represented nothing more than an attempt to add color to the characterization of the transaction as a bona fide sale."

2. Estate Inclusion Under §§ 2033, 2035 and 2038 For Property Transferred Under Note That Is Not Respected. In *Estate of Musgrove v. United States*,[21] the decedent transferred $251,540 to his son less than a month before his death (at a time that he had a serious illness) in exchange for an interest-free, unsecured demand note, which by its terms was canceled

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[19] T.C. Memo. 2006-212.

[20] 3 F.3d 591 (2nd Cir. 1993).

[21] 33 Fed. Cl. 657 (1995).

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upon the decedent's death. The court determined that the property transferred was included in the decedent's estate under any of §§2033, 2035, or 2038. The court reasoned that the promissory note did not constitute fair consideration where there was an implied agreement that the grantor would not make a demand on the obligation and the notes were not intended to be enforced.

3. Advances from FLP Treated as Distributions Supporting Inclusion of FLP Assets Under §2036 Even Though Notes Were Given For the Advances. Assets of an FLP created by the decedent were included in the estate under §2036 in *Rosen v. Commissioner*.[22] Part of the court's reasoning was that advances to the decedent from the partnership evidenced "retained enjoyment" of the assets transferred to the FLP even though the decedent gave an unsecured demand note for the advances. The purported "loans" to the decedent were instead treated by the court as distributions from the FLP to the decedent. There was an extended discussion of actions required to establish bona fide loans.

Among the factors mentioned by the court are that the decedent never intended to repay the advances and the FLP never intended to enforce the note, the FLP never demanded repayment, there was no fixed maturity date or payment schedule, no interest (or principal) payments were made, the decedent had no ability to honor a demand for payment, repayment of the note depended solely on the FLP's success, transfers were made to meet the decedent's daily needs, and there was no collateral. The court also questioned the adequacy of interest on the note.

The specific factors analyzed in detail by the court were summarized as follows:

> "The relevant factors used to distinguish debt from equity include: (1) The name given to an instrument underlying the transfer of funds; (2) the presence or absence of a fixed maturity date and a schedule of payments; (3) the presence or absence of a fixed interest rate and actual interest payments; (4) the source of repayment; (5) the adequacy or inadequacy of capitalization; (6) the identity of interest between creditors and equity holders; (7) the security for repayment; (8) the transferee's ability to obtain financing from outside lending institutions; (9) the extent to which repayment was subordinated to the claims of outside creditors; (10) the extent to which transferred funds were used to acquire capital assets; and (11) the presence or absence of a sinking fund to provide repayment."[23]

4. Valid Debt for § 2053 Deduction. The nine factors listed above from the *Miller* cases were mentioned in *Estate of Holland v. Commissioner*,[24] to support that the decedent's estate did not owe bona fide indebtedness that

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[22] T.C. Memo. 2006-115.

[23] *Id.* For an excellent discussion of the impact of the *Rosen* case on potential estate inclusion, see Blattmachr & Zeydel, *Comparing GRATs and Installment Sales*, 41 UNIV. OF MIAMI HECKERLING INST. ON EST. PL. ¶202.3[C][2](2007).

[24] T.C. Memo. 1997-302.

could be deducted under §2053[25].Various cases have mentioned one or more of these factors in analyzing the deductibility of a debt as a claim under §2053(a)(3)[26] or of post-death interest paid on a loan as an administrative expense under §2053(a)(2).[27]

One of the requirements for being able to deduct a debt as a claim or interest on a loan as an administrative expense under §2053 is that the debt is bona fide in nature and not essentially donative in character.[28] A variety of factors apply in determine the bona fides of an obligation to certain family members or related entities.[29] Factors that are indicative (but not necessarily determinative) of a bona fide claim or expense include, but are not limited to (1) the transaction occurs in the ordinary course of business, is negotiated at arm's length, and is free from donative intent; (2) the nature of the debt is not related to an expectation or claim of inheritance; (3) there is an agreement between the parties which is substantiated with contemporaneous evidence; (4) performance is pursuant to an agreement which can be substantiated; and (5) all amounts paid are reported by each party for federal income and employment tax purposes.[30]

E. Upfront Gift If Intent to Forgive Loan?

1. IRS Position. Revenue Ruling 77-299 announced the IRS position that if a taxpayer ostensibly makes a loan and, as part of a prearranged plan, intends to forgive or not collect on the note, the note will not be considered valuable consideration and the donor will have made a gift at the time of the loan to the full extent of the loan.[31] However, if there is no prearranged plan and the intent to forgive the debt arises at a later time, the donor will have made a gift only at the time of the forgiveness.[32]

The IRS relied on the reasoning of *Deal v. Commissioner*,[33] for its conclusion in Rev. Rul. 77-299. In *Deal*, an individual transferred a

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[25] I.R.C. §2053 allows a deduction for any indebtedness, but only "to the extent that [it was] contracted bona fide and for an adequate and full consideration in money or money's worth."

[26] *E.g.*, Estate of Labombarde v. Commissioner, 58 T.C. 745. 753 (1972), *aff'd*, 502 F.2d 1158 (1st Cir. 1973)(children's support payments to their mother were not a loan because there was no note evidencing the supposed debt and no interest was ever paid); Estate of Hicks, T.C. Memo. 2007-182 (loan from father to trust for daughter funded by proceeds of tort settlement, where loan arrangement was planned in part to keep from disqualifying the daughter for Medicaid assistance, was bona fide; court observed in particular that a note was executed, interest was paid every month on the loan, and the loan resulted in the creation of real interest income on which the father really paid income tax); Estate of Ribblesdale v. Commissioner, T.C. Memo. 1964-177 (wealthy son who was annoyed with constant requests from his mother for assistance made loans to mother for her support; "bona fides of a loan are primarily established by the intention of the parties that repayment will be made pursuant to the terms of the agreement;" factors mentioned by court were that the mother signed notes requiring repayment, her executor actually repaid the principal [but not the interest], and she had substantial assets for repaying the loans even though they were not secured).

[27] *E.g.*, Estate of Duncan, T.C. Memo. 2011-255; Estate of Kahanic, T.C. Memo. 2012-81; Estate of Graegin, T.C. Memo. 1988-477.

[28] Treas. Reg. §20.2053-1(b)(2)(i).

[29] The family members, related entities, and beneficiaries to whom such debts are given special scrutiny are detailed in Treas. Reg. §20.2053-1(b)(2)(iii).

[30] Treas. Reg. §20.2053-1(b)(2)(ii).

[31] Rev. Rul. 77-299, 1977-2 C.B. 343.

[32] Rev. Rul. 81-264, 1081-2 C.B. 186.

[33] 29 T.C. 730 (1958).

remainder interest in unimproved non-income-producing property to children, and the children gave the individual noninterest-bearing, unsecured demand notes. The Tax Court held that the notes executed by the children were not intended as consideration for the transfer and, rather than a bona fide sale, the taxpayer made a gift of the remainder interest to the children.

The IRS has subsequently reiterated its position.[34]

2. Contrary Cases. The Tax Court reached a contrary result in several cases that were decided before the issuance of Rev. Rul. 77-299 (and the IRS non-acquiesced to those cases in Rev. Rul. 77-299). Those cases reasoned that there would be no gift at the time of the initial loan as long as the notes had substance. The issue is not whether the donor intended to forgive the note, but whether the note was legally enforceable.

In *Haygood v. Commissioner*,[35] a mother deeded to properties to each of her two sons and in return took a vendor's lien note from the son for the full value of the property, payable $3000 per year. In accordance with her intention when she transferred the properties, the mother canceled the $3,000 annual payments as they became due. The IRS cited the *Deal* case in support of its position that a gift was made at the outset without regard to the value of the notes received. The Tax Court distinguished the *Deal* decision: (1) *Deal* involved the transfer of property to a trust and on the same date the daughters (rather than the trust) gave notes to the transferor; and (2) the daughters gave non-interest-bearing unsecured notes at the time of the transfer to the trust as compared to secured notes that were used in *Haygood*. The court in *Haygood* held that the amount of the gift that occurred at the time of the initial transfer was reduced by the full face amount of the secured notes even though the taxpayer had no intention of enforcing payment of the notes and the taxpayer in fact forgave $3,000 per year on the notes from each of the transferees.

The Tax Court reached the same result 10 years later in *Estate of Kelley v. Commissioner*.[36] Parents transferred real estate to their three children in return for valid notes, secured by vendor's liens on the real properties. The parents extinguished the notes without payment as they became due. The IRS argued that the notes "lacked economic substance and were a mere 'façade for the principal purpose of tax avoidance.'" The court gave two answers to this argument. First, the notes and vendor's liens, without evidence showing they were a "façade," are prima facie what they purport to be. The parents reserved all rights given to them under the liens and notes until they actually forgave the notes and nothing in the record suggests that the notes were not collectible. Second, "since the notes and liens were enforceable, petitioners' gifts in 1954 were limited

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[34] *See e.g.,* Field Service Advice 1999-837 (donor makes gift of full amount of loan initially if donor intends to forgive the loan as part of a prearranged plan); Letter Rul. 200603002 (transfer of life insurance policies to trust in return for note in the amount of the difference between the combined value of the policies and the amount sheltered by gift tax annual exclusions; several months later the donors canceled the note and forgave the debt; taxpayer did not request a ruling on this issue, but IRS stated that it viewed the donors as having made a gift at the outset in the amount of the note where there was a prearranged plan that it would be canceled).

[35] 42 T.C. 936 (1964).

[36] 63 T.C. 321 (1974).

to the value of the transferred interests in excess of the face amount of the notes."

The court in *Estate of Maxwell v. Commissioner*[37] distinguished *Haygood* and *Kelley* in a §2036 case involving a transfer of property subject to a mortgage accompanied with a leaseback of the property. The court reasoned that in *Haygood* and *Kelley*, the donor intended to forgive the note payments, but under the facts of *Maxwell*, the court found that, at the time the note was executed, there was "an understanding" between the parties to the transaction that the note would be forgiven. Other cases have criticized the approach taken in *Haygood* and *Kelley* (though in a different context), observing that a mere promise to pay in the future that is accompanied by an implied understanding that the promise will not be enforced should not be given value and is not adequate and full consideration in money or money's worth.[38]

3. Which is the Best Reasoned Approach? One commentator gives various reasons in concluding that taxpayer position is the more reasoned position on this issue.

> "The IRS has not done well with this approach, and there are reasons for this. Even if the lender actually intends to gradually forgive the entire loan, (1) he is free to change his mind at any time, (2) his interest in the note can be seized by a creditor or bankruptcy trustee, who will surely enforce it, and (3) if the lender dies, his executor will be under a duty to collect the note. Therefore, if the loan is documented and administered properly, this technique should work, even if there is a periodic forgiveness plan, since the intent to make a gift in the future is not the same as making a gift in the present. However, if the conduct of the parties negates the existence of an actual bona fide debtor-creditor relationship at all, the entire loan may be recharacterized as a gift at the time the loan was made or the property lent may be included in the lender's estate, depending on whether the lender or the borrower is considered to "really" own the property.
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> …
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> If the borrower is insolvent (or otherwise clearly will not be able to pay the debt) when the loan is made, the lender may be treated as making a gift at the outset."[39]

Other commentators agree that the Tax court analysis in *Haygood* and *Kelley* is the preferable approach.[40]

4. Planning Pointers. While the cases go both ways on this issue, taxpayers can clearly expect the IRS to take the position that a loan is not bona fide and will not be recognized as an offset to the amount of the gift at the time of the initial transfer if the lender intends to forgive the note

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[37] 3 F.3d 591 (2nd Cir. 1993).

[38] *E.g.*, Miller v. Commissioner, T.C. Memo. 1996-3, *aff'd without opinion*, 113 F.3d 1241 (9th Cir. 1997); Estate of Musgrove v. United States, 33 Fed. Cl. 657, 664 (1995); Estate of Lockett v. Commissioner, T.C. Memo. 2012-123.

[39] HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶28.05[2][a](WARREN GORHAM & LAMONT 1997).

[40] *E.g.*, Zaritsky & Aucutt, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS, §12.03 (2d ed. 1997).

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payments as they become due. Where the donor intends to forgive the note payments, it is especially important to structure the loan transaction to satisfy as many of the elements as possible better discussed above in distinguishing debt from equity. In particular, there should be written loan documents, preferably the notes will be secured, and the borrower should have the ability to repay the notes. If palatable, do not forgive all payments, but have the borrowers make some of the annual payments.

III. EXECUTIVE SUMMARY OF GENERAL TAX TREATMENT OF LOANS UNDER SECTIONS 1274 AND 7872

A. Significance. Intra-family loans can be very useful in many circumstances, including as estate freezing devices in light of the historically extremely low current interest rates. A wide variety of complicating issues arise, however, in structuring intra-family loan transactions. Questions about structuring loan transactions arise repeatedly on the estate planning listservs. The following is an example of a recent ACTEC listserv dialogue. (Howard Zaritsky's answer—as always, concise and technically correct—is in the accompanying footnote).

QUESTION:

Is this a sham?

Taxpayer establishes a grantor trust, contributes $10,000 to it and loans it $1,000,000. The note is a demand note that provides for short term AFR interest. The trustee invests the funds aggressively. On December 15th of the same calendar year when the fund is $1,300,000, the grantor forgives the loan. Is the gift $1,000,000? If on December 15th of the same year when the trust fund is $700,000 the grantor calls the loan and the trustee pays the grantor $700,000, is there a gift?

Is the answer different if the initial contribution is $100,000 instead of $10,000? [41]

B. What You Really Need to Know to Avoid Complexities.

1. Structure Loan as Bona Fide Loan. The IRS presumes a transfer of money to a family member is a gift, unless the transferor can prove he received full and adequate consideration. Avoid the IRS gift presumption by affirmatively demonstrating that at the time of the transfer a bona fide creditor-debtor relationship existed by facts evidencing that the lender can demonstrate a real expectation of repayment and intention to enforce the debt. Treatment as a bona fide debt or gift depends on the facts and circumstances.

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[41] HOWARD ZARITSKY'S EXCELLENT ANSWER:

If the entire trust fund is $10,000 when the grantor lends it $1 million, there is a serious question whether the loan creates a bona fide debtor/creditor relationship, rather than constituting a gift (with a retained right to control beneficial enjoyment by "calling" the loan). There is a good discussion of the factors that show a true loan in *Todd v. Commissioner*, T.C. Memo. 2011-123, which was not an estate planning case, but still has a good discussion of this subject.

Forgiving the loan in the same year as it was made also suggests that the entire transaction is a disguised gift. That would be a gift of $1 million on the date the loan was made.

If, despite the low net worth of the borrowing trust, the loan is still a bona fide debt instrument, forgiving the loan in a later year should be a gift of the lesser of the outstanding debt or the net worth of the trust at the time of the forgiveness. The loan cannot be worth more than the debtor's total assets.

Were the initial funding $100,000, the transaction looks much more like a bona fide loan, though if it is forgiven in the same year as it was made, it could still be a disguised gift of $1 million on the date the loan was made.

Summary: *Structuring and Administration of Loan to Avoid Gift Presumption.*

- *Signed promissory note*
- *Establish a fixed repayment schedule*
- *Set a rate at or above the AFR in effect when the loan originates*
- *Secure or collateralize the debt*
- *Demand repayment*
- *Maintain records that reflect a true loan transaction*
- *Repayments are made*
- *Borrower solvency*
- *Do not have a prearranged schedule to forgive the loan*

2. Use an Interest Rate At Least Equal to the AFR for Cash Loans. The United States Supreme Court held in *Dickman v. Commissioner*,[42] that interest-free loans between family members are gifts for federal gift tax purposes, even if the loans are payable on demand. *Dickman* did not address how to value the gift. Sections 1274 and 7872 were enacted soon after the *Dickman* case. Those sections deal with valuing gifts from below market loans. The statute seems to contemplate cash loans, and the objective method for valuing the gift element under §7872 appears not to apply to loans of property other than cash.[43] However, the gift element of notes given in exchange for property is also determined under §7872 and as long as the loan bears interest at a rate equal to the AFR for the month in question, there *should* not a deemed gift attributable to the note (although there is no assurance the IRS may not argue in the future that a market rate should be used).[44] Section 7872 is not limited to loans between individuals, and the concepts of §7872 appear to apply to loans to or from trusts, although there is no explicit authority confirming that conclusion.[45]

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[42] 465 U.S. 330 (1984).

[43] *See* Jonathan Blattmachr, Elisabeth Madden, & Bridget Crawford, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. TAX'N 21 (July 2008).

[44] *See* Frazee v. Commissioner, 98 T.C. 554, 588 (1992)("Nowhere does the text of section 7872 specify that section 7872 is limited to loans of money. If it was implicit that it was so limited, it would be unnecessary to specify that section 7872 does not apply to any loan to which sections 483 or 1274 apply. The presence of section 7872(f)(8) signaled Congress' belief that section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of section 7872, but rather, to apply the provision as drafted."); True v. Commissioner, T.C. Memo. 2001-167 ("We concluded in Frazee v. Commissioner, supra at 588-589, that section 7872 does not apply solely to loans of money; it also applies to seller-provided financing for the sale of property. In our view, the fact that the deferred payment arrangement in the case at hand was contained in the buy-sell agreements, rather than in a separate note as in Frazee, does not require a different result."), *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004).

[45] *See* Letter Ruling 9418013 (series of loans from QTIP trust would not be treated as a disposition of the spouse's qualifying income interest for life under §2519 when the loans bore interest at the AFR). Section 7872 governs the effects of loans with below-market interest rates in a variety of contexts beyond just individuals, specifically including loans between employers and employees, corporation-shareholder loans, and loans to qualified continuing care facilities among others. I.R.C. § 7872(c)(1)(B-C, F). There are special exceptions that apply only to loans between individuals. I.R.C. § 7872(c)(2-3); *see* Section VIII.A-B of this outline, *infra.* Having exceptions that apply only to individual loans confirms that the section applies beyond just loans between individuals. The application of the principles of §7872 to trusts is important, for example to know that a loan or sale of assets from a GST non-exempt trust in return for an AFR note from a GST exempt trust will not cause a change in the inclusion ratio of the exempt trust.

Section 1274 provides monthly factors for short term (0-3 years), mid-term (over 3 up to 9 years), and long-term (over 9 years) notes. There are factors for annual, semiannual, or monthly compounding. If a loan bears interest at the applicable federal rate ("AFR") (using the appropriate factor based on the timing of compounding under the note) it will not be a "below market loan" under §7872 and therefore there will be no imputed gift from the lender to the borrower or imputed interest income to the lender.[46] (Technically, a below market loan is a demand loan with an interest rate lower than the AFR,[47] or a term loan for which the amount loaned exceeds the present value of all payments due under the loan.[48] Because the present value of a term loan is determined using the AFR, a demand or term loan with an interest rate at least equal to the AFR is not a below market loan.)[49] The AFR schedules are published each month on about the 20th day of the month. (One way of locating the AFR for a particular month is to search for "AFR" on the IRS website (**www.IRS.gov**).)

<u>Summary</u>*: Forgone interest is computed by comparing present value of all payments due under the loan (discounted using the appropriate AFR) with the actual loan amount; If the PV is less, there is forgone interest.*

Forgone interest is deemed to have been transferred from the lender to the borrower as a gift, and then from the borrower to the lender as interest income.

Income tax treatment: The forgone interest is imputed as interest income on the last day of each taxable year.

Gift tax treatment: For demand loans, the forgone interest each year is deemed to be given on December 31 (or when the loan is repaid). For term loans, 100% of the forgone interest is treated as a gift upfront when the loan is made.

Avoid those complexities by using an interest rate at least equal to the AFR for all loans.

3. <u>Exceptions When AFR Is Not Needed</u>. There are two special rules where interest does not have to be charged on the loan at the AFR to avoid imputed income or gift tax. (Some parents may not want their children to know that.)

   a. <u>Exception for $10,000 Loans (Gift and Income Exception)</u>. A gift loan is exempt from §7872 if it is made "directly between individuals" and "the aggregate outstanding amount of the loans between such individuals does not exceed $ 10,000."[50] All loans between the lender and borrower are aggregated regardless of their character (market or below-market), the date made, or the

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[46] Prop. Reg. § 1.7872-3(c)(1)("Section 7872 does not apply to any loan which has sufficient stated interest").

[47] I.R.C. § 7872(e)(1)(A).

[48] I.R.C. § 7872(e)(1)(B).

[49] *See* Prop. Reg. §1.7872-3(c)(1).

[50] Prop. Reg. § 1.7872-8(b)(2). A loan to a custodian under the Uniform Transfers to Minors Act is deemed to be to a natural person, but a loan to a trust does NOT qualify, even though the beneficiaries are natural persons. Prop. Reg. § 1.7872-8(b)(3). The $10,000 de minimis exception is discussed in more detail in Section III.B.3.a. of this outline, *supra*.

rate of interest (if any).[51] If the amount of loans outstanding between individuals exceeds $10,000 at some point during the year, §7872 will apply to the loan for gift tax purposes regardless of whether the borrower subsequently reduces the loan balance: the amount of deemed gift is fixed at that point.

__Summary__. *Under a de minimis exception, the rules that apply to below-market loans and the computation of foregone interest do not apply to loans between individuals if:*

the aggregate outstanding balance does not exceed $10,000

and

the loan is not directly attributable to the purchase or carrying of an income-producing asset.

No imputed interest computation is required and there are no reportable gifts.

b. Exception for $100,000 Loans (Income Exception Only). A second exception applies if the aggregate outstanding amount of gift loans between individuals does not exceed $100,000, the imputed interest amount (i.e., the amount treated as retransferred from the borrower to the lender at the end of the year) for income tax purposes is limited to the borrower's net investment income for the year.[52]

__Summary__: *This special exception limits the amount of imputed interest to be reported from loans between individuals to the borrower's Net Investment Income "NII" if the following apply:*

The aggregate outstanding balance does not exceed $100,000 and

The borrower notifies the lender in writing of the amount of his/her NII.

A de minimis rule allows the lender to report zero interest income if the borrower's NII does not exceed $1,000.

The limitation on the amount of interest applies for income tax purposes only, not gift. The full amount of imputed interest must be included as a gift.

The deduction that may be available to the borrower is limited to the amount of imputed income reported by the lender.

4. Generally Use Term Loans Rather Than Demand Loans. For a demand loan, the stated interest rate is compared to the AFR throughout the loan, and gifts will result for any period during which the stated interest rate is less than the AFR for that period. For term loans, however, the state interest rate is compared to the AFR at the time the loan is originated to determine if the loan results in a gift. In light of this treatment, using term loans has two distinct advantages.

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[51] In determining the aggregate outstanding amount of loans between individuals, loans by a husband and wife to an individual borrower are treated as made by one person.

[52] I.R.C. § 7872(d). This exception is discussed in more detail in Section III.B.3.b of this outline, *supra*..

First, there is no complexity of repeatedly determining the appropriate AFR for any particular period. The AFR at the origination of the loan controls throughout the term of the loan for determining the income and gift tax effects of whether the below-market rules of §7872 apply.

Second, during the current incredibly low interest rate environment, there will be no gift tax consequences for the entire term of the note as long as the interest rate of the term note is at least equal to the AFR when the note is originated.

Summary: *Advantages of term loans over demand loans include:*

- *Easier to administer because interest rate does not have to be redetermined periodically; and.*
- *Takes advantage of current low interest rates for the full life of the term loan.*

5. How to Determine Interest Rate for Demand Loans. For demand loans, the below-market interest amount (that is treated as transferred from lender to borrower for income and gift tax purposes) is determined for each semiannual period based on the short term AFR at the beginning of that semiannual period less the interest that is actually due under the note and paid for that period. In order to avoid having imputed income and gifts with demand loans, the note often provides that the interest rate will be the appropriate short term AFR for each relevant period so that the note is not a below-market loan.

> Drafting Interest Rate for Demand Note, Sample Language: *"…at an initial rate per annum equal to the Federal short-term rate, as published by the Internal Revenue Service pursuant to section 1274(d) of the Internal Revenue Code (hereafter the "Federal short-term rate"), in effect for the month first above written. The interest rate on the unpaid principal amount of this Promissory Note shall be adjusted as of January 1 and July 1 of each year to the Federal short-term rate in effect for such January and July, as the case may be."*[53]
>
> Drafting Interest Rate for Demand Note, More Aggressive Approach Under Proposed Regulations Example 5:
>
> *"The interest rate … shall be adjusted as of January 1 and July 1 of each year to the Federal short term rate in effect for such January and July, as the case may be. During each semiannual period (Jan. 1 – June 30 and July 1 – Dec. 31; each a Period) the interest rate shall be adjusted to the lowest Federal short-term rate during the applicable Period. (By way of example only, if the lowest Federal short-term rate for January is 4.2%, February is 4.0% and the rest of the Period (March – June) is 4.4%, the rate charged for January shall be 4.2% and for February through June shall be 4.0%.)"*[54]

If the note provides that the interest rate will be the relevant AFR for each particular period, the appropriate AFR will have to be determined

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[53] Hayes, *Intra-Family Loans: Adventures in Forgiveness and Forgetfulness*, 2007 ABA REAL PROP., TR., & EST. LAW SECTION ANNUAL SPRING SYMPOSIUM Exh. A (2007).

[54] *Id.* at Exh. B.

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over relevant periods (as described below) to calculate the amount of interest due under the note. If the demand note does not call for interest to be paid at the ever-changing relevant short term AFR, such AFR will have to be determined in any event to determine the amount of imputed income and gift from the below-market loan.

For the semiannual period in which the loan is made, the short term AFR in effect on the day the loan is made is used. For each subsequent semiannual period (January-June and July-December), the short term AFR for the first month of that semiannual period (i.e., January or July) is used.[55] (However, "Example 5" in the regulations suggests that the lowest short term rate in the semiannual period [from and after the month in which the loan is made] may be used.)[56] For loans outstanding the entire year, a blended rate is available that effectively applies the January rate for the first half of the year and the July rate for the second half of the year. The blended rate is announced in the July AFR ruling each year (that is published approximately June 20 of each year.) The blended rates for the last three years have been as follows: 2009-0.82%; 2010-0.59%; 2011-0.40%; 2012-0.22%.[57]

Accrued interest (not forgiven) is treated as a new loan and payments are applied to accrued interest first, then principal.

***Example: Below-Market Demand Loan*.**

Your client, Adam, calls you to tell you that on February 1, 2011, he loaned $200,000 to his son, Chris, for the purchase of an investment property. There were no formal loan documents drafted for this loan. Adam tells you that he received full repayment from Chris on June 30, 2012 of $200,000. Adam also gave his son a $13,000 holiday gift on December 15, 2011. The AFRs were as follows: Jan 2011 – 0.43%; Feb 2011 – 0.51%; July 2011 - 0.37%; Jan 2012 – 0.19%; 2011 Blended 0.4%

> *1. What is the imputed interest for 2011? 2012?*
>
> *2. How much does Adam show on his gift tax return as gifts to Chris 2011? 2012?*

1. What is the imputed interest for 2011 & 2012?

> ***Imputed Interest for 2011 = $728***
>
> *Jan 2011 ST AFR = 0.43% and July 2011 ST AFR = 0.37%*
>
> *[$200,000 x (0.43% x 5/12)] + [200,000 x (0.37% x 6/12)] = $728*
>
> ***Imputed Interest for 2012 = $190***
>
> *Jan 2012 ST AFR = 0.19%*
>
> *$200,000 x (0.19% x 6/12) = $190*
>
> ***Observe: Blended Rate Does Not Apply***

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[55] Prop. Treas. Reg. § 1.7872-3(b)(3)(i)(A).

[56] Prop. Treas. Reg. 1.7872-3(b)(3)(i)(B)Ex.5(iii).

[57] For the 2012 blended rate, see Rev. Rul. 2012-20, 2012-27 I.R.B. 1 (Table 6).

The loan was not outstanding for all of 2011 or all of 2012. Therefore the blended rate for a calendar year does not apply for either 2011 or 2012.

2. How much does Adam show on his gift tax return as gifts to Chris 2011? 2012?

Total reportable gift by Adam =

2011 = $13,728 ($13,000 Cash gift + $728 Imputed Interest)

2012 = $190 (Imputed Interest; assuming no other cash gifts)

Summary of Determining Interest Rate for Demand Loans

- *New Loans – the lower of the Short-term AFR in effect the month the loan is made or the 1st month of the semiannual period (January or July)*
- *Rate is reset every 6 months to the Short-term AFR for January and July*
- *For loans that remain unchanged during the year, the interest is computed using the annual Blended rate (Published annually in July AFR ruling issued about June 20 – 2012 Blended Rate is 0.22%)*

6. How to Determine Interest Rate for Term Loans. For term loans, determining the appropriate AFR is much easier. Simply use an interest rate that is equal to the AFR with the same compounding period for the month in which the loan is made. For sale transactions, the interest rate on the note can be the lowest AFR for the three-month period ending with the month there was a “binding contract in writing for such sale or exchange.” For sale transactions the appropriate AFR is based not the term of the note, but on its weighted average maturity.[58]

***Example: Below-Market Term Loan*.**

Your client, Adam, calls you again to tell you that on March 1, 2011 he loaned his daughter, Stacey, $200,000 to purchase a new home. The loan has a stated rate of 2% payable annually. It also calls for a balloon repayment of the principal due in 10 Years. Stacey makes annual interest payments of $4,000 each year. The March 2011 AFR rates were as follows: Short-term = 0.54%; Mid-term = 2.44%; Long-term = 4.30%.

1.What is the total interest income reportable by Adam for 2011?

2.What is the 2011 & 2012 gift reportable by Adam?

Step 1: Determine if this loan is a below-market loan (GIFT AMOUNT)

Calculate difference between PV of all loan payments and loan amount

March 2011 Annual Long-Term Rate = 4.30%

Present value of all payment due under the loan:

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[58] I.R.C. § 1274(d)(2)(3-month provision); Treas. Reg. § 1.1274-4(c)(weighted average maturity description). See Section XVIII.A. of this outline, *infra*.

PV of 10 annual $4,000 Interest payments and $200,000 balloon payment in 10 Years discounted using 4.3%

PV = $163,241 – Since the loan amount is greater, this is a below-market loan

Total Forgone Interest = $200,000 – 163,241 = ***$36,759***

Step 2: Calculate the forgone interest for each year (INCOME AMOUNT)

March 2011 Annual Long-Term Rate = 4.30%

Forgone Interest = Interest using AFR – Interest Payment Made

Annual Interest with AFR = ($200,000 x 4.30%) = $8,600

Annual Forgone Interest = $8,600 - $4,000 = $4,600

2011 Forgone Interest: $4,600 x 10/12 = 3,833

Answers:

1. What is the total interest income reportable by Adam for 2011?

2011 Forgone Interest = $3,833

Total interest reported in 2011 for this loan is $7,833

(Interest Paid $4,000 + Imputed Interest $3,833)

2. What is the 2011 & 2012 gift reportable by Adam?

2011 Gift is total forgone interest = $36,759

2012 Gift = None, because all forgone interest is reported as a gift in the year the loan is made

<u>Summary of Determining Interest Rate for Term Loans</u>.

- *The appropriate AFR is the rate in effect for the month the loan is made based on the term of the loan:*

3 Yrs or less	*Short-term AFR*
Over 3 to 9 Yrs	*Midterm AFR*
More than 9 Yrs	*Long-term AFR*

- *The rate continues to apply over the life of the loan despite future rates fluctuation.*
- *For sales transactions, the lowest AFR for the 3 months ending with the sale date can be used.*

7. <u>Lend to Borrowers With the Ability to Repay</u>. One of the factors in determining whether the loan is a bona fide loan rather than an equity transfer[59] is whether the borrower had the ability to repay. In *Miller v. Commissioner*,[60] there was no evidence of the borrower's ability to repay the loan. The borrower-sons both testified that they had employment income, but introduced no evidence that their income was sufficient to make the payments, after other living expenses. Moreover, while the sons had some assets, primarily their equity in their homes and some liquid investments, there was no indication that Mrs. Miller was prepared

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[59] See Section II.C of this outline, *supra.*

[60] T.C. Memo. 1996-3.

to require them to liquidate any of those assets to make payments. The ability to repay was only one of nine factors examined in *Miller*, but there is significant danger that a loan to someone without the ability to repay the loan may not be respected as a loan. Cases involving the application of §2036 to private annuities to trusts and individuals also emphasize the importance of using trusts or individuals who have the ability to repay the debt.[61]

Summary: *The borrower's ability to repay the loan is a very important factor in establishing that a bona fide debtor creditor relationship exists. This can be very important for income, gift and estate tax purposes. This includes loans to trusts; the trust should be funded with enough assets that it has the ability to repay the loan even if there is some decline in the value of the trust assets.*[62]

8. Accrued Interest Generally Must Be Recognized Each Year Even by Cash Basis Taxpayers. For below-market gift loans, the forgone interest demand loan rules apply. (Although §7872 says that a term loan with a below-market interest rate will be treated as having original issue discount ["OID"] at the time the loan is made, the proposed regulations say that for gift term loans the forgone interest demand loan rules apply.[63]) Each year, a lender must report the interest income imputed to the lender under §7872, with a statement explaining various details.[64]

What if the loan provides adequate interest so that it is not a below-market loan? There is no forgone interest to report under §7872. Nevertheless, if interest accrues but is not actually payable, the original issue discount (OID) rules will apply,[65] and they generally require that a pro rata amount[66] of the overall amount of the OID over the life of the loan must be recognized each year as ordinary income, even for cash basis taxpayers.[67] The amount of OID included in income each year is generally determined under a "constant yield method" as described in the §1272 regulations.[68]

There are a variety of exceptions from the OID rules; for example, the OID rules do not apply to a loan if it is not made in the course of a trade or business and if all outstanding loans between the lender and borrower do not exceed $10,000.[69] For seller financed notes, there are additional exceptions including sales of farms for $1 million or less by individuals or small businesses, sales of principal residences, sales involving total payments of $250,000 or less,[70] and notes given in sales transactions under a certain amount (about $3.8 million in 2012) that the buyer and

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[61] See Section XVII.C-D of this outline, *infra*.
[62] *Id.*
[63] Prop. Reg. § 1.7872-6(a).
[64] Prop. Reg. § 1.7872-11(g).
[65] See Section XI.B of this outline, *infra*.
[66] I.R.C. § 1272(a).
[67] I.R.C. §§ 1272-1273; *see generally* HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶28.04(WARREN GORHAM & LAMONT 1997).
[68] Treas. Reg. §1.1272-1(b)(1).
[69] I.R.C. §1272(a)(2)(E)(ii).
[70] I.R.C. 1274(c)(3). For a detailed discussion of these exceptions, see HARRISON MCCAWLEY, BNA INC. TAX. PORT. 535, TIME VALUE OF MONEY: OID AND IMPUTED INTEREST ¶III.C.2 (2012).

seller agree to treat as "cash method debt instruments."[71] However, in most intra-family loan situations, the OID rules will apply.

The key to this analysis is determining the overall amount of OID over the life of the loan. Original issue discount is the excess (if any) of the "stated redemption price at maturity" over the" issue price."[72]

The "stated redemption price at maturity" is the sum of all payments provided for by the debt instrument except for qualified stated interest payments[73] (but in most intra-family loan situations where there are interest accruals, there will not be any "qualified stated interest"). Therefore, in most common situations, we start with the sum of all payments provided for by the debt instrument.

From that, the "issue price" is subtracted to determine the amount of OID. For cash loans, the "issue price" is the amount loaned.[74] For seller financed transactions, there is a different more involved computation of the "imputed principal amount," but if the note has stated interest equal to the appropriate AFR,[75] the stated principal amount of the note is the issue price that is subtracted.[76] Therefore the OID would be the total interest payments that would be due under the loan over the life of the loan if the stated interest equals the relevant AFR.

Summary: *A pro rata amount of the overall amount of the OID over the life of the loan must be recognized each year as ordinary income, even for cash basis taxpayers. After working through the technical details, the OID is the total interest payments that would be due under the loan over the life of the loan if the stated interest equals the relevant AFR.*

The OID income is reported ratably over the life of the loan, whether or not the interest is paid, even if the lender is a cash basis taxpayer. The OID complications are avoided if the loan/note transaction is between a grantor and that person's grantor trust.

9. Forgiving Debt Should Not Result in Income Recognition to Borrower and May Not Result in the Seller Having to Recognize Accrued But Unpaid Interest as Income. The borrower should not have discharge of indebtedness income if the note is forgiven because §102 excludes gifts from the definition of gross income.[77]The seller may not have to recognize accrued interest as income. By negative implication, the proposed regulations indicate that accrued interest under a note providing stated interest will not be recognized as income if the accrued interest is forgiven as long as the forgiveness "include[s] in substantial part the loan principal."[78] The proposed regulations have been outstanding for decades but have never been finalized. However, these regulations

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[71] I.R.C. §1274A(c)(1).

[72] I.R.C. §1273(a)(1).

[73] Reg. §1.1273-1(b).

[74] I.R.C. § 1273(b)(2); Reg. 1.1273-2(a)(1).

[75] The test rate is generally the lowest of the AFRs for the 3-month period ending with the month in which there is a binding contract of sale. For sale-leaseback transactions, the test rate is 110% of the AFR. I.R.C. §1274(e).

[76] I.R.C. § 1274(a)(1).

[77] See Section XVI.A of this outline, *infra.*

[78] Prop. Reg. § 1.7872-11.

appear to provide a reporting position that the waived interest would not have to be recognized as imputed income by the lender.

The following are various limitations and uncertainties regarding the ability to avoid recognizing accrued but unpaid interest by forgiving the interest.[79]

a. <u>Current Year Accrued Interest Only</u>? Only the current year accrued income may avoid recognition under the forgiveness approach if any accrued interest in earlier years had to be recognized in those earlier years.[80]

b. <u>How Much Principal Must be Forgiven</u>? There is inherent ambiguity over how much of the principal must be forgiven when the accrued interest is forgiven. The regulation uses the nebulous phrasing that the forgiveness includes "*in substantial part* the loan principal." The language of the proposed regulation seems to refer to the principal forgiveness being a substantial part *of the forgiveness* and not a substantial part of the loan principal.

c. <u>Proposed Regulation</u>. This position is based merely on a proposed regulation that has never been finalized. But the fact that the proposed regulation has stood unchanged for decades and that there has been no case law rejecting this analysis over those decades provides comfort. Proposed regulations may be considered to determine if there is substantial authority for purposes of avoiding taxpayer or preparer penalties.

e. <u>Consistently Forgiving Accrued Interest Each Year May Not be Advisable</u>. If the accrued interest must be recognized each year under the OID rules, the only way to avoid the recognition of all interest under the note would be to forgive the accrued interest each year (in connection with a forgiveness in substantial part of the loan principal). However, if the accrued interest is forgiven each year, that is a factor that may be considered in refusing to recognize the loan as a bona fide loan rather than as an equity transfer.

<u>Summary</u>: *Forgiveness or cancellation of an intra-family note does not result in discharge of indebtedness income to the borrower (if the borrower is insolvent or if the forgiveness is in the forgiveness/cancellation is a gift). Proposed regulations provide an argument (by negative inference) that the lender will not have to recognize the unpaid income (that has not previously been recognized under the OID rules) that is forgiven if the forgiveness includes "in substantial part" the loan principal. Do not consistently forgive accrued interest each year; that may be a factor in determining whether there is a bona fide loan.*

10. <u>Discounting Notes in Subsequent Transactions *May* be Possible—But Not for Weak Stomachs</u>. Under gift and estate tax regulations, the value

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[79] These limitations are discussed in more detail in Section XVI.C of this outline, *infra*.

[80] See Section XI.B of this outline, i*nfra*.

of a note is the unpaid principal plus accrued interest, unless the evidence shows that the note is worth less (e.g., because of the interest rate or date of maturity) or is uncollectible in whole or in part.[81] A wide variety of cases have valued notes at a discount from face based on satisfactory evidence.[82]

Gift Tax Purposes. Under §7872, the gift amount of a below-market loan is the forgone interest, or the amount by which the interest under the note is less than the AFR. Section 7872 does not address other factors that may impact the value of the notes—it just addresses how much gift results as a result of using an interest rate that is lower than the appropriate AFR. The statute does not address the gift tax implications of a note that has an interest rate that is equal to or greater than the AFR. However, the clear implication of §7872 is that a transfer for a note that bears interest that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. Even following the adoption of §7872, the value of notes apparently can be discounted because of factors stated in the general gift tax regulations other than the interest rate used in the notes. There are no proposed regulations issued in conjunction with §7872 that purport to override the general gift tax valuation principles for notes under Reg. § 25.2512-4.

Estate Tax Purposes.

The general estate tax regulation regarding the valuation of notes provides that the estate tax value is the amount of unpaid principal plus interest accrued to the date of death, unless the executor establishes that the value is lower by satisfactory evidence that the note is worth less than the unpaid amount (e.g., because of the interest rate or the date of maturity) or that the note is uncollectible by reason of insolvency of the maker and because property pledged as security is insufficient to satisfy the obligation.[83] Therefore, the note can apparently be discounted based on the note's interest rate if interest rates generally rise by the time of the holder's death.

Even if general interest rates do not change between the time the note is given and the date of death, can the note be discounted because the AFR, which is the test rate for gift tax purposes under §7872, is an artificially low rate — the rate at which the United States government can borrow? There are no cases or rulings. A proposed regulation under §7872 suggests that such discounting, merely because the AFR is an artificially low interest rate, would not be allowed.[84] However, that regulation has never been finalized. *Be aware,* h*owever*, the IRS estate tax agent may feel that taking a discount merely for this reason is abusive (because the note was not similarly discounted for gift tax valuation purposes at the time of the sale) and may closely scrutinize every aspect of the loan or sale transaction. Also, beware that the income tax effects of discounting the note may offset or even outweigh discounting the note for estate tax

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[81] Reg. §§ 20.2031-4, 25.2512-4.

[82] See Section XV.C of this outline*, infra.*

[83] Reg. § 20.2031-4.

[84] Prop. Reg. § 20.7872-1. See Section XV.C of this outline, *infra.*

purposes. When the note is paid, the excess payment over the note's basis is generally treated as ordinary income.[85]

Summary: *For gift tax purposes, a loan is not deemed to be worth less than face value because of the interest rate as long as the interest rate is at least equal to the AFR. However, other factors can be considered (for example, the ability of the borrower to repay) in determining the value of the note, and if the note is worth less than the amount transferred, a gift results.*

For estate tax purposes, a note can be discounted because of interest rate changes or because of collectability problems (e.g., insolvency of the borrower or insufficiency of collateral). In addition, there MAY be the possibility of discounting a note merely because it uses the AFR interest rate, which is less than a commercially reasonable rate that would apply to such a loan. There is no statute or final regulation requiring that §7872 principles for valuing notes using the AFR also apply for estate tax purposes. However, the IRS fights that argument. Furthermore, when paid the excess payment over the note basis will be treated as ordinary income in most circumstances.

11. Refinancing Notes To Utilize Lower Interest Rates. There are no cases, regulations or rulings that address the gift tax effects of refinancing notes. Proposed regulations under §7872 include a section entitled "Treatment of Renegotiations," but merely reserves the subject for later guidance, which has never been issued.[86] One commentator concludes that refinancings at lower AFRs should be possible without gift consequences:

> "Although there is no case, ruling, or Code section that explicitly provides that promissory notes may be restated without gift tax effects, economic analysis of the transaction and Regulations strongly support the conclusion that it is possible to do so without a taxable gift being deemed to occur."[87]

A possible concern is that consistent refinancing of the note may be a factor in determining that the loan transaction does not result in bona fide debt, but should be treated as an equity transfer. In light of the lack of any case law or direct discussion of refinancings at lower AFRs in regulations or in any rulings, most planners suggest caution in this area, and not merely refinancing notes every time the AFR decreases.[88]

Some advisors renegotiating the terms of notes not only adopt the lower more current AFR, but also compensate the lender in some say for accepting the lower rate, "perhaps by paying down the principal amount, shortening the maturity date, or adding more attractive collateral."[89]

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[85] See Section XV.E of this outline, *infra.*

[86] Prop. Reg. § 1.7872-11(e).

[87] *See* Jonathan Blattmachr, Elisabeth Madden, & Bridget Crawford, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note,* 109 J. TAX'N 21, 26 (July 2008)(hereinafter Blattmachr et. al., *How Low Can You Go?*).

[88] *E.g.*, Benjamin Feder, *The Promissory Note Problem,* 142 TR. & ESTS. 10 (Jan. 2003).

[89] Philip J. Hayes, *Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners*, 13 CALIF. TR. & ESTS. Q 5, 7 (Summer 2007).

<u>Summary</u>: *Refinancing at lower current interest rates should be permissible, but do not get greedy and do this repeatedly. To be more conservative, make some modification in return for the lender's agreeing to refinance at the lower interest rate, such as paying down some principal, reducing the term of the loan, or adding collateral.*

C. <u>Best Practices Summary</u>. The following is a brief 10-point checklist of best practices in structuring intra-family loans.

1. Have the borrower sign a promissory note.
2. Establish a fixed repayment schedule.
3. Charge interest at or above the minimum "safe harbor" rate.
4. Request collateral from the borrower.
5. Demand repayment.
6. Have records from both parties reflecting the debt.
7. Show evidence that payments have been made.
8. Make sure that the borrower has the wherewithal to repay the loan.
9. Do not establish any plan to forgive payments as they come due.
10. Refinance with caution.[90]

IV. HISTORY AND CONTEXT OF SECTIONS 7872 AND 1274

A. <u>In the Beginning</u>. Once upon a time, life was good. Gas was 20 cents a gallon, Get Smart reruns ran daily, hard-core speed death-metal music had not been invented, personal interest was deductible, and even the most unsophisticated tax advisors knew enough to use interest-free loans to help clients drive large semi-trailers through gaping holes in the income and gift tax systems.

During this tax utopia, taxpayers used interest-free loans in a variety of ways to exploit the failure of the Internal Revenue Service ("IRS" or "Service") to at first *assert*, then later *convince* the courts, that interest-free loans should be income- and/or gift- taxable transfers. This exploitation included interest-free loans:

☐ by C corporations (usually closely-held) to shareholders (to avoid double taxation);

☐ by wealthy persons to family members in lower tax brackets to permit them to invest and receive returns taxed at lower rates;

☐ by employers to employees as a substitute for taxable compensation (and payroll taxes); and

☐ by sellers using installment sales to convert interest income to capital gain. This tax Shangri-La lasted, for the most part, from 1913 to 1984.[91]

The IRS was slow to catch on to the potential for tax avoidance, failing to strongly assert that interest-free loans should have tax consequences until 1960, when, in *Dean v. Commissioner*,[92] it made its first coherent argument. In *Dean*,

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[90] Philip Hayes, *Intra-Family Loans: Common Hazards and 10 Steps to Avoid Them,* BESSEMER TRUST PERSPECTIVES ON WEALTH MANAGEMENT Issue IV (2011).

[91] Although Congress did address installment sale abuse in 1963 with the enactment of I.R.C. § 483. More on that later.

[92] (1961) 35 T.C. 1083.

the Commissioner argued that since an interest-free loan did not require an interest payment, the borrower received the free use of the principal as an economic benefit that should be included in gross income. At first the courts were not moved by the IRS's position.[93] Eventually, however, the United States Court of Claims adopted the theory, although they were reversed.[94] Finally, in 1984, the IRS scored its breakthrough victory in this arena (albeit in the gift tax context), in *Dickman v. Commissioner*,[95] in which the U.S. Supreme Court held that the lender's right to receive interest is a "valuable property right," and that the transfer of such a right through an interest free loan is a taxable gift.

Dickman quickly touched off comprehensive below-market loan reform. Later in 1984, Congress enacted Internal Revenue Code §7872 to govern certain below-market loans. With §7872, Congress created artificial transfers of deemed interest between the borrower and the lender, to ensure that income was recognized by each party.[96] Although *Dickman* concerned only gift tax, §7872 went beyond mere codification of the *Dickman* holding, and beyond the intra-family context, to reach loans to shareholders, employees and a variety of other below-market loans, for *both* income tax and gift tax application. By enacting §7872, Congress indicated that virtually all gifts involving the transfer of money or property would be valued using the currently applicable AFR,[97] thereby replacing the traditional fair-market-value method[98] of valuing below-market loans with a discounting method.

7872 proposed regulations were issued in August 1985,[99] a portion of which were also adopted as temporary regulations.[100] Unfortunately, the statute was amended after the promulgation of the Proposed Regulations, leading to the confusing misalignment of the statute and the Proposed Regulations discussed below.

B. Section 7872, Generally. Section 7872 governs below-market loans in several circumstances, including loans between family members.[101] Section 7872 applies to any transaction that 1) is a bona-fide loan, 2) is below market, 3) falls within one of four categories of below-market loans, and 4) is not within any of several exceptions. The four categories are loans 1) from donor to a donee, 2) from an employer to an employee, 3) from a corporation to a shareholder, and 4) with interest arrangements made for tax avoidance purposes.[102] As we are concerned solely with intra-family transactions, in this article *we shall be concerned only with "gift loans."*[103]

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[93] Generally, in this era, the government was not concerned with benefits arising from the interest free use of money; *see*, e.g., the split dollar regime blessed by Rev. Rul. 64-328.

[94] *Hardee v. United States* (Ct. Cl. 1982) 82-2 U.S. Tax Cas. (CCH) P84,656, *rev'd* (Fed. Cir. 1983) 708 F.2d 661.

[95] T.C. Memo. 1980-575, *rev'd* 690 F.2d 812, (11th Cir. 1982), *aff'd*, 465 U.S. 330 (1984).

[96] At the time, the personal interest deduction made the statute essentially revenue neutral. The loss of the personal interest deduction through the enactment of I.R.C. § 163(h) under the 1986 Tax Act, however, caused income tax pain for the borrower when interest-free loans are compensatory.

[97] I.R.C. § 7872(f)(2)(B).

[98] As exemplified in *Blackburn v. Commissioner* 20 T.C. 204 (1953).

[99] All references to "Proposed Regulations" hereafter shall be to these proposed regulations issued in 1985 for I.R.C. § 7872, unless otherwise noted.

[100] Prop. Reg. §§ 1.7872-1-14.

[101] There is no I.R.C. provision, however, that specifically applies to intra-family loans.

[102] I.R.C. § 7872(c).

[103] Although intra-family loans certainly occur in other contexts (employer-employee and corporation-stockholder), the majority of intra-family loans will be gift loans.

Generally, §7872 will not impute gift or income tax consequences to a loan providing "sufficient" stated interest, which means interest at a rate no lower than the appropriate AFR, based on the appropriate compounding period.[104]

Any gift loan subject to §7872 which bears interest below the AFR may have adverse tax consequences to the lender.[105] Section 7872 treats a bona fide below-market (i.e., below-AFR) gift loan as economically equivalent to a loan bearing interest at the AFR coupled with a payment by the lender to the borrower of funds to pay the imputed interest to the lender. This "forgone interest" is treated as retransferred by the borrower to the lender as interest. Thus, the forgone interest is treated as a gift by the lender to the borrower and then treated as income to the lender from the borrower. Although income and gift taxes are implicated, the amount of the gift and income do not always align.[106]

Section 7872 is complicated, therefore not well understood, and, in practice, often ignored. The problem is exacerbated in *sales transactions*, which implicate both the income and gift-tax safe harbor of §7872 and the overlapping income tax (and gift tax?) safe harbors of Sections 483 and 1274 governing intra-family sales. *Even if the correct safe harbor is used*, the Code[107] may impute phantom income annually if the loan does not call for "qualified stated interest" (e.g., a loan that does not call for annual payment of interest will be subject to annual imputation of income under the OID rules even if the interest rate satisfies the applicable safe harbor).

V. THE GIFT LOAN: ONE TYPE OF LOAN UNDER SECTION 7872

As a reminder, an important assumption of this article is that, unless indicated otherwise, we are discussing intra-family "gift loans" under §7872(c)(1)(A), as opposed to other loans also covered by §7872, namely compensation related loans,[108] corporation-shareholder loans,[109] or tax-avoidance loans.[110] A below market loan is a "gift loan" if the forgoing of interest "is in the nature of a gift"[111] as defined under the gift tax.[112] The IRS *assumes* that a transfer of money from one family member to another is a gift.[113] A loan can be a gift loan whether the lender is a natural person or an entity and whether, apart from the loan, the parties are related or unrelated,[114] or whether the loan is direct or indirect.[115]

VI. AVOIDING BELOW-MARKET GIFT LOAN STATUS UNDER SECTION 7872

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[104] Prop. Reg. § 1.7872-3(c)(1).

[105] As opposed to the other categories of below-market loans, which have adverse tax consequences for the *borrower* and the lender. For instance, with compensation related loans, the amount of interest imputed constitutes wages to the employee.

[106] *E.g.*, under the statute, in the case of term gift loans, the amount treated as transferred from the lender to the borrower, which is subject to gift tax, and the amount of imputed interest payable by the borrower to the lender, which is subject to income tax, are computed differently.

[107] Reg. § 1.1273-1(c).

[108] I.R.C. § 7872(c)(1)(B).

[109] I.R.C. § 7872(c)(1)(C).

[110] I.R.C. § 7872(c)(1)(D).

[111] I.R.C. § 7872(f)(3).

[112] Prop. Reg. § 1.7872-4(b)(1).

[113] *See* Harwood v. Commissioner, 82 T.C. 239, 258 (1984), *aff'd,* 786 F,2d 1174 (9th Cir. 1986), *cert. den.*, 479 U.S. 1007 (1986).

[114] BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶55.2.4 (Warren, Gorham and Lamont) (Nov. 2006); Prop. Reg. §§ 1.7872-4(b)(1) and (b)(2).

[115] I.R.C. § 2511(a).

The level of many practitioners'[116] mastery of this area often begins and ends with one concern: keeping a loan from being characterized as below-market under §7872 -- and, therefore, in the context of this article, free from imputed taxable gift and taxable income consequences to the lender. The coping mechanism many have developed to blunt the awful truth about the complexity of §7872 is a cursory knowledge of §1274(d), i.e., that "a 0-3 year note is subject to the short term AFR, an over 3 to 9 year note is subject to the mid-term AFR, and an over 9 year note is subject to the long-term AFR." This level of mastery is not a springboard to intra-family loan bliss, so we will dig deeper and try to avoid confusion along the way.

As discussed above, a (bona fide) gift loan is "below market" if the lender does not charge at least the rate of interest required under §7872.[117] The rate required under §7872 is tied to the AFR, the lynchpin of the IRS below-market loan scheme.

A. <u>The AFR</u>. The AFR, set forth in §1274(d), is published monthly by the IRS, usually around the 20th day of the preceding month, based on the average yield for treasuries with the applicable remaining maturity periods for the one-month period ending on the 14th of the month.[118] There are three federal rates, a short term rate that is the AFR for obligations maturing three years or less from the issue date, a mid-term rate for the range three to nine years, and a long-term rate for obligations maturing more than nine years from issue.

The AFRs are based on annual, semiannual, quarterly, and monthly compounding of interest. The more often a loan is compounded, the more valuable it is to the lender; therefore, interest rates required by the statutes correspond to the length of the compounding period – the shorter the period, the lower the required rate. For example, nine percent compounded annually is equivalent to 8.62 percent compounded daily.

The appropriate AFR depends on the loan's terms. The shorter of the compounding period or the payment interval determines the appropriate rate.[119] If interest payments or compoundings are at intervals other than those for which rates are published, the rate for the next longest interval for which rates are published may be used. For example, the monthly rate can be used for a note providing for daily compounding, the quarterly rate can be used for bi-monthly interest payments.[120]

B. <u>Demand Loans</u>. A loan is a demand loan if it is "payable in full at any time on demand of the lender" or "within a reasonable time after the lender's demand."[121]

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[116] Present company included.

[117] Technically, a below market loan is a demand loan with an interest rate lower than the AFR, I.R.C. § 7872(e)(1)(A), or a term loan for which the amount loaned exceeds the present value of all payments due under the loan, I.R.C. § 7872(e)(1)(B). Because the present value of a term loan is determined using the AFR, a demand or term loan with an interest rate at least equal to the AFR is not a below market loan. *See* Prop. Reg. Section 1.7872-3(c)(1).

[118] One way of locating the AFR for a particular month is to search for "AFR" on the IRS website (**www.IRS.gov**). In addition, planners can register on the IRS website to receive a monthly notification of the AFR from the IRS.

[119] Prop. Reg. § 1.7872-3(b)(1).

[120] Alternatively, a rate precisely appropriate for the note's payment or compounding interval can be computed. *See* BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶53.2 (Warren, Gorham and Lamont) (Nov. 2006).

[121] I.R.C. § 7872(f)(5); Prop. Reg. § 1.7872-10(a)(1). What if a loan is payable at the earlier of a specified term or on demand? The statute and regulations do not address whether that is treated as a demand or term loan under §7872. The statute literally suggests that is a demand loan. Section 7872(f)(5) says that a demand loan "means any loan which is payable in full at any time on the demand of the lender," and Section 7872(f)(6) says a term loan is any loan that is not a demand loan. The loan described is "payable in full on the demand of the lender"; therefore, the statute literally says

As we will see, the rules of §7872 are fairly straightforward in the context of term loans. Demand loans are different story.

1. Seeking a Bright Rule Through Obscurity. Usually, the AFR for a demand loan is the federal short term rate in effect for the period the amount imputed by §7872 (referred to as "forgone interest") is being determined. This is because, by the nature of an arm's length demand loan, the lender is effectively protected against rate fluctuations.

   Section 7872 provides that interest on the hypothetical arm's length loan outstanding for any period during the calendar year is deemed paid annually on December 31. Thus, with a loan outstanding from April 4 to November 12, the lender is deemed to require payment of interest on December 31.

   Where the principal amount of a demand loan is outstanding for a full calendar year, the Proposed Regulations provide that a "blended rate" shall compute the amount of sufficient interest for the year.[122] The rate is applied to the principal balance outstanding as of January 1, and reflects semiannual compounding of the AFR effective for January, expressed on the basis of semiannual compounding. The blended rate is announced in the latter part of June.[123]

   Since the AFR is recomputed monthly, a demand note might technically be below-market for any month during which it bears interest at a rate lower than that month's AFR. However, *forgone interest* (the *measure* of the gift once the loan fails the below-market *test*) is *computed* under the Proposed Regulations with rates determined once or twice a year.[124] Unfortunately, the Proposed Regulations on the *testing* procedures were issued before the most recent amendment to §7872, which changed the statutory period for AFR adjustment from semi-annually to monthly. Therefore, there is no definite method for *testing* demand loans.

   One reputable authority infers the following procedure for testing whether a demand loan is below-market: A demand loan is not below-market for a particular semiannual period (January to June, or July to December) if it bears interest at a rate at least equal to the lesser of 1) a blended rate published annually by the IRS, or 2) the federal short-term

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it is a demand loan not a term loan. Indeed, the term may have no relationship to the economic reality; for example, what if it is a 15-year loan to lock in the benefit of the current low interest rates but the parties contemplate treating as a demand loan for which the rates will never have to fluctuate upward? A counterargument is that a loan with a fixed maturity but that can be called earlier sets a known outside limited on the term of the loan and arguably should be more akin to a term loan.

[122] Prop. Reg. § 1.7872-13(a).

[123] The blended rates for the last four years have been as follows: 2009-0.82%; 2010-0.59%; 2011-0.40%; 2012-0.22%. For the 2012 blended rate, see Rev. Rul. 2012-20, 2012-27 I.R.B. 1 (Table 6).

[124] Nomenclature alert: At the time the Proposed Regulations were drafted, the AFR was determined twice a year and was effective for the six-month period following the announcement. The Proposed Regulations refer to this as the "federal statutory rate." Soon after the Proposed Regulations were issued, the IRS decided to determine the AFR monthly. What the Proposed Regulations refer to as the "alternate rate" is this monthly AFR; the "alternative rate" became the statutory rate under § 1274(d) through an amendment to the statute in 1985 (P.L. 99-121). Thus, what the Proposed Regulations refer to as the "alternate" rate is actually the federal statutory rate. However, the (former) federal statutory rate set forth in the Proposed Regulations is still used to determine *forgone interest* under the Proposed Regulations. Effectively, since the semiannual rate is no longer determined, the IRS has adopted the January and July AFRs as substitutes for the former semiannual AFRs. And you wondered why it was so hard to understand the proposed regulations?

rate for the first month of the semiannual period (January or July). For the semiannual period during which the loan is made, the loan is not below market if the rate equals or exceeds the Federal short-term rate for the month in which the loan is made, *even if this rate is lower than both the annual blended rate and the rate for the first month of the semiannual period.*[125]

2. Variable Rate Demand Loans. As outlined above, for a demand loan, no fixed rate can be certain to be sufficient under §7872 for as long as the loan is outstanding; a loan that is above the market rate can quickly become below-market if interest rates rise and the note does not provide for periodic interest-rate adjustments.

   This problem may be solved by using a variable rate demand loan that calls for periodic revisions of the interest rate, which might be automatic.[126] Such a note may provide that 1) for each semiannual period (January to June, or July to December), the interest rate is the Federal short-term rate for the first month of the period (January or July), or 2) that the interest rate for a year is the blended rate for the year. Either determination provides, by definition, sufficient stated interest, and therefore will never be below-market.

   The Proposed Regulations provide that variable rate demand loans will provide for sufficient interest if the rate fixed by the index used is no lower than the AFR for each semiannual period or the short term AFR in effect at the beginning of the payment period (or, if the agreement so provides, at the end) of the payment or compounding period, whichever is shorter.[127] This rule applies, for example, if interest on a demand loan is compounded monthly, with the rate for each month being the federal short-term rate for the month.

3. The Simplest Safe Harbor Demand Loan. The simplest demand note would be one with a variable rate equal to the AFR in effect on the loan date with interest rate adjustments on the first day of each month. Alternatively, for simplicity, the final regulations could adopt a rule providing that there is sufficient interest when the variable rate changes at least in six-month intervals and, at the beginning of each interval, the rate is at least equal to the AFR in effect on that date. See Section III.B.5 of this outline, *supra*, for an example of such a variable rate demand loan promissory note.

VII. TERM LOANS

A term loan is a loan that is not a demand loan.[128] Under the Proposed Regulations, a term loan is a loan made under an agreement that "specifies an ascertainable period of time for which the loan is to be outstanding."[129]

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[125] See BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶55.2.3 (Warren, Gorham and Lamont) (Nov. 2006).

[126] Prop. Reg. § 1.7872-3(c)(2).

[127] Prop. Reg. § 1.7872-3(e)(2)(i).

[128] I.R.C. § 7872(f)(6).

[129] Prop. Reg. § 1.7872-10(a)(2). A period is considered ascertainable if it can be "determined actuarially." For example, a loan payable only on the borrower's death is a term loan because the borrower's life expectancy is actuarially determinable.

A term loan is below-market if "the amount loaned exceeds the present value of all payments due under the loan." The present value of the payments is determined as of the date of the loan using the AFR as the discount rate. The AFR is the Federal short-term, mid-term, or long-term rate, depending on the term of the loan, in effect on the date the loan is made.[130]

The test is simplified in the Proposed Regulations, which provide that a loan is not below market if it bears "sufficient interest," which means interest computed "on the outstanding loan balance at a rate no lower than the applicable federal rate based on a compounding period appropriate for that loan."[131] Interest may be variable, so long as the rate is at or above the AFR at the time the loan is made and is based on an objective index.[132] As opposed to a demand gift loan, which may fall in and out of below-market status (if not properly drafted), a term loan need only qualify (for gift tax purposes) as a market loan at the time the loan is made (or when the $10,000 de minimis ceiling is exceeded).

For sale transactions, the interest rate on the note can be the lowest AFR for the three-month period ending with the month there was a "binding contract in writing for such sale or exchange." For sale transactions the appropriate AFR is based not on the term of the note, but on its weighted average maturity.[133]

VIII. EXEMPTIONS FROM SECTION 7872

A. $10,000 De Minimis Exemption. In the case of gift loans there is an exception for loans where all loans between those same individuals (this exception does not apply to trusts, estates, or corporations) do not exceed $10,000. In that case, there is no deemed transfer for income or gift tax purposes for any day during which the aggregate outstanding amount of loans between those individuals does not exceed $10,000.[134] The $10,000 ceiling amount for this exception includes all loans between the same lender and borrower regardless of the rate of interest.[135] However, this exception will not apply if the loan is directly attributable to purchasing or carrying income-producing assets.[136] (Therefore, this exception applies only where the loan funds are consumed or used for non-income producing property (such as a down payment on a house or for college education).)

This exception applies on a day-to-day basis for gift loans. Even if the aggregate amount of loans between the two individuals exceeds $10,000 for some days, there will be no imputed transfers for income or gift (except as described below for term loans) purposes on any days during which the aggregate standing amount of loans between the individuals does not exceed $10,000. For gift term loans, §7872 continues to apply for gift purposes even after the aggregate loss amount is reduced back to $10,000 or less.[137] (For non-gift loans, if the amount of loans between the individuals ever exceeds $10,000, the exception does not

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[130] I.R.C. § 7872(f)(10); Prop. Reg. § 1.7872-8(b)(1).

[131] Prop. Reg. § 1.7872-3(c)(1).

[132] Prop. Reg. § 1.7872-3(e)(1).

[133] I.R.C. § 1274(d)(2)(3-month provision); Treas. Reg. § 1.1274-4(c)(weighted average maturity description). See Section XVIII.A., *infra.*

[134] I.R.C. § 7872(c)(2).

[135] I.R.C. § 7872(c)(2)(A).

[136] I.R.C. § 7872(c)(2)(B).

[137] I.R.C. § 7872(f)(10).

apply to outstanding loans between the individuals after that date even if the outstanding balance of the loans is later reduced below $10,000.)

For purposes of this exception (and all of §7872), husband and wife are treated as one person. [138] Therefore a loan from daughter to father, from father to daughter, from mother to daughter and from daughter to mother will all be counted for purposes of determining if aggregate outstanding loans between daughter and either father or mother exceed $10,000.

This de minimis exemption does not apply to any gift loan "directly attributable to the purchase or carrying of income-producing assets," which are defined in the Proposed Regulations as 1) an asset of a type that generates ordinary income, or 2) a market discount bond issued prior to June 19, 1984.[139]

B. $100,000 Exemption (Income Exception Only). If the aggregate outstanding amount of gift loans between individuals does not exceed $100,000, the imputed interest amount (i.e., the amount treated as retransferred from the borrower to the lender at the end of the year) for income tax purposes is limited to the borrower's net investment income for the year.[140] However, there is a de minimis rule: if the borrower has less than $1,000 of net investment income for the year, the net investment income for purposes of this exception is deemed to be zero (so there would be no imputed income from the loan during that year).

This exception can be helpful for below market loans to borrowers who have little net investment income. However, the amount of forgone interest (the amount of interest that is below the interest that would have been incurred if the loan had used the AFR) will be treated as a taxable gift. (If the lender is not making other taxable gifts to the borrower during the year, the amount of the gift from the below-market loan may be covered by the gift tax annual exclusion.)

This exception applies on a day-to-day basis.[141] As with the $10,000 exception, husband and wife are treated as one person. The exception does not apply if a principal purpose of the transaction is to avoid "any Federal tax."[142]

The limitation applies to both the borrower's interest deduction and the lender's interest income, except that it applies to the lender only if "the borrower notifies the lender, in a signed statement, of the amount of the borrower's net investment income properly allocable to the loan."[143]

C. Sections 483 and 1274. According to §7872(f)(8), §7872 does not apply to any loan to which Sections 483 or 1274 (pertaining to loans in connection with sales or exchanges) apply. This exception is not nearly as straightforward as the clear language of the statute implies, and there is considerable room for interpretation (and confusion). The interaction of §§483, 1274, and 7872 are discussed in more detail in Section XVIII.A of this outline, *infra*.

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[138] I.R.C. § 7872(f)(7).

[139] Prop. Reg. § 1.7872-8(b)(4).

[140] I.R.C. § 7872(d). The amount of net investment income is determined under I.R.C. § 163(d)(3). If a borrower has more than one gift loan outstanding, the borrower's net investment income is allocated among the loans in proportion to the respective amounts that would be treated as retransferred by the borrower without regard to this exception. I.R.C. § 7872(d)(1)(C).

[141] I.R.C. § 7872(d).

[142] I.R.C. § 7872(d)(1)(B).

[143] Prop. Reg. §1.7872-11(g)(3).

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IX. INCOME TAX CONSEQUENCES OF BELOW-MARKET GIFT LOANS

A. Investment Income Limitation for Gift Loans. If a below-market gift loan is made directly between individuals, and if the outstanding balance of all loans (of any kind) between them is not greater than $100,000, §7872(d)(1) limits the amount of deemed interest paid by the borrower to the lender under §7872 to the borrower's "net investment income" for the year (as defined under §163(d)(4)).[144] Note that this limitation only applies for *income tax* purposes (thus, the lender is deemed to have made a gift of the full amount of the forgone interest regardless of the borrower's net investment income). The limitation applies to both the borrower's interest deduction and the lender's interest income, except that it applies to the lender only if "the borrower notifies the lender, in a signed statement, of the amount of the borrower's net investment income properly allocable to the loan."[145]

B. Demand Loan. With a below-market demand loan, the amount of the "forgone interest" is deemed transferred from the lender to the borrower in the form of a gift, and then retransferred by the borrower to the lender as payment of interest on December 31 (or on the date the loan is repaid). The imputed interest income is in addition to any actual interest income received from the borrower. The amount of forgone interest for any calendar year (i.e., the amount of the additional payment/interest treated as loan paid to lender) is the excess of:

- the amount of interest that would have been payable in that year if interest had accrued at the AFR, over
- any interest actually payable on the loan allocable to that year.[146]

1. Demand Loan Outstanding for an Entire Calendar Year. To calculate the amount of forgone interest for a demand loan with a constant principal amount outstanding for an entire year, the forgone interest is equal to the sum of:

(1) The product of one-half of the January short-term rate based on semi-annual compounding times the principal amount of the loan; and

(2) The product of one-half of the July short-term rate based on the semiannual compounding times the sum of the principal amount of the loan and the amount described in (1).[147]

From this amount, the amount of interest actually paid during the calendar year, if any, is subtracted.

For easier computation, the IRS also publishes a "blended annual rate" that is multiplied by the principal amount of the loan outstanding to arrive at the amount from which the actual interest paid, if any, is to be subtracted.[148] This blended annual rate is published annually in July in the Revenue Procedure that announces the applicable federal rates for

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[144] I.R.C. § 7872(d)(1)(E).

[145] Prop. Reg. § 1.7872-11(g)(3).

[146] I.R.C. § 7872(e)(2)(A)-(B); Prop. Reg. § 1.7872-6; Reg. § 25.7872-1.

[147] Rev. Rul. 86-17, 1986-1 C.B. 377.

[148] *Id*.; Prop. Reg. § 1.7872-13(a). Note that in the case of *term* gift loans, the taxpayer is to use the AFR based on annual compounding in effect the day the loan is made, appropriate to the term to maturity, in lieu of the blended annual rate. Prop. Reg. § 1.7872-13(e)(1)(i).

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that month.[149] The excess amount over the interest actually paid is the forgone interest.

2. Demand Loan Outstanding for Less Than the Entire Year. If a portion of the loan principal is repaid or an additional amount is loaned during the calendar year, the calculation of the forgone interest is complicated. The amount of this interest is calculated by using the "exact method" or the "approximate method."

   a. The "Exact Method". The exact method is based upon a daily compounding of interest and calculates the interest as "the principal amount multiplied by: $(1 + I \div k)f - 1$ where:

      I = the Federal short-term rate expressed as a decimal[150]

      k = the number of accrual periods in a year; and

      f = a fraction consisting of the number of days in the period for which interest is being computed divided by the number of days in a complete accrual period."[151]

      This amount should be computed separately for each month at the short-term rate for that month.[152] The exact method *must* be used in this situation (when the loan balance is not constant throughout the year) if either of the parties is not an individual or the aggregate of loans between them exceeds $250,000.

   b. The "Approximate Method." The approximate method is available to individual lenders and borrowers when the aggregate amount of loans between them is $250,000 or less. Under this method, interest is determined by calculating the interest for a semiannual period and then prorating that amount on a daily basis to determine the amount of interest for the portion of the semiannual period the loan was outstanding.[153] The amount imputed will always be slightly larger under the approximate method.

      The Proposed Regulations include examples contrasting the exact method and the approximate method.[154]

3. Demand Loan With Fluctuating Loan Balance. This is a practical issue for most practitioners in administering a note, when the borrower-child pays as the spirit moves her. According to the Proposed Regulations,

   > [i]f a demand loan does not have a constant outstanding principal amount during a period, the amount of forgone interest shall be computed according to the principles [applying to loans

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[149] The blended rates for the last four years have been as follows: 2009-0.82%; 2010-0.59%; 2011-0.40%; 2012-0.22%. For the 2012 blended rate, see Rev. Rul. 2012-20, 2012-27 I.R.B. 1 (Table 6).

[150] Note, however, that for gift term loans, the amount of interest that would have been payable in that year if interest had accrued at the AFR is computed using the AFR based on *semi-annual* compounding in effect the day the loan is made, appropriate to the term to maturity, in lieu of the Federal short-term rate. Prop. Reg. § 1.7872-13(e)(1)(ii).

[151] Bittker & Lokken, Federal Taxation of Income, Estates and Gifts, ¶55.3.2 (Warren, Gorham and Lamont) (Nov. 2006); Prop. Reg. §§ 1.7872-13(b), (c) and (d).

[152] *Id.*

[153] *Id.*

[154] *See* Prop. Reg. § 1.7872-13(b)(3).

> outstanding less than the entire year], with each increase in the outstanding loan balance being treated as a new loan and each decrease being treated as first a repayment of accrued but unpaid interest (if any), and then a repayment of principal.[155]

The Proposed Regulations contain examples calculating the imputed income from a loan with a fluctuating balance.[156]

C. Term Loan. Although §7872(b) provides that a term loan with a below-market interest rate will be treated as having original issue discount (OID) at the time the loan is made,[157] the Proposed Regulations[158] provide that for *gift* term loans the forgone interest demand loan rules apply.[159] The OID rules rest on the premise that the present value of the borrower's promise to repay is less than the amount loaned; the OID rules are appropriate only if the borrower is assured the use of the lender's money for a fixed term.

Under the demand loan rules applied to term gift loans, as opposed to the OID scheme, forgone interest accrues on the full amount loaned, and none of the original principal is recharacterized as a non-loan payment. Congress decided that demand loan rules should also determine the income tax consequences of gift term loans "because, in light of the familial or other personal relationship that is likely to exist between the borrower and the lender, the technical provisions of the loan, such as the maturity of the loan, may not be viewed as binding by the parties." This regime relieves donors and donees of the burden of coping with the OID rules that apply to non-gift term loans.[160]

D. Reporting Requirements. Each year, a lender must report the interest income imputed to him under §7872 on his income tax return, attaching a statement:

■ Explaining that the interest income relates to an amount includible in his income by reason of §7872;

■ Providing the name, address and taxpayer identification number of each borrower;

■ Specifying the amount of imputed interest income attributable to each borrower;

■ Specifying the mathematical assumptions used (*e.g.*, 360 day calendar year, the exact method or the approximate method for computing interest for a short period) for computing the amounts imputed under §7872; and

■ Including any other information required by the return or the instructions thereto.[161]

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[155] Prop. Reg. §§ 1.7872-13(c) and (d).

[156] See Prop. Reg. § 1.7872-13(d).

[157] The lender is treated as having transferred to the borrower the excess of the amount of the loan over the present value of the payments required to be made under the terms of the loan.

[158] Prop. Reg. § 1.7872-6(a).

[159] Except for minor calculation adjustments as provided in Prop. Reg. § 1.7872-13(e)(1).

[160] BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶55.3.2 (Warren, Gorham and Lamont) (Nov. 2006), citing Staff of Joint Comm. on Tax'n, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 533 (Comm. Print 1984).

[161] Prop. Reg. § 1.7872-11(g).

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The borrower must attach a similar statement to her income tax return for a taxable year in which the borrower claims a deduction for an amount of interest expense imputed under §7872.

X. GIFT TAX CONSEQUENCES OF BELOW-MARKET GIFT LOAN

A. Demand Gift Loan. For a below-market demand gift loan, the amount of the gift is equal to the "forgone interest" treated as transferred from the lender to the borrower and retransferred from the borrower to the lender as payment of interest, calculated as provided in Section IX.B., *supra* of this outline. The gift is deemed to be made on the last day of the calendar year for each year that the loan is outstanding, or the day the loan is repaid if it is repaid during the year.[162]

B. Term Gift Loan. For income tax purposes, below-market term and demand gift loans are, for the most part, treated the same. For gift tax purposes, however, demand gift loans and term gift loans are treated differently:[163] the amount of a deemed gift is calculated using a different methodology, and the gift is recognized at a different time than the income.[164]

1. Amount. For gift tax purposes, with a term gift loan, the OID rules apply[165] and the lender is treated as making a gift to the borrower in an amount equal to the excess of the principal amount of the loan over the present value of all payments that are required to be made under the terms of the loan. Present value is as determined under §1.7872-14 of the Proposed Regulations. The discount rate for the present value computation is the AFR in effect on the day the loan is made.

$$PV = \frac{FV}{(1+i)^n}$$

The above calculates what present value (PV) would be needed to produce a certain future value (FV) if interest of i% accrues for n periods.

The simplest present value example given in the Proposed Regulations is:[166]

> "*Example (1)*
>
> (i) On July 1, 1984, corporation A makes a $200,000 interest-free three-year term loan to shareholder B. The applicable federal rate is 10-percent, compounded semiannually.
>
> (ii) The present value of this payment is $149,243.08, determined as follows: $149,243.08 = $200,000.00 ÷ (1 + (.10/2))^6.
>
> (iii) The excess of the amount loaned over the present value of all payments on the loan ($200,000.00 - $149,243.08), or $50,756.92, is

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[162] I.R.C. § 7872(a); Prop. Reg. §§ 25.7872-1 and 1.7872-6(b)(5).

[163] Prop. Reg. § 1.7872-7(a)(2).

[164] This also means that below market term loans are treated differently under the income tax and gift tax regimes.

[165] Prop. Reg. § 1.7872-7(a)(2).

[166] Although the calculation is for a below-market loan to an employee, the concepts are the same for calculating the amount of a gift for a below-market intra-family gift loan.

treated as a distribution of property (characterized according to §301) paid to B on July 1, 1984."[167]

2. Timing. The gift is treated as being made on the first day on which §7872 applies to the term loan.[168] Thus, while with a below-market *demand loan* the lender makes a gift *each year* the loan is outstanding, with a below-market *term loan* the lender makes the total gift in the first year of the loan. This can make a significant difference if the lender plans on using her gift tax annual exclusion to shelter the gift to the borrower. While the imputed gift with respect to a demand loan may be less than the annual exclusion amount, the imputed gift with respect to a term loan in the first year of the loan could exceed that amount.

XI. TIMING OF RECOGNITION OF INTEREST INCOME AND INTEREST DEDUCTIONS

A. Below-Market Gift Loans. For below-market gift loans, the §7872 rules apply to determine how much "forgone interest" is treated as transferred to the lender each year, rather than applying the OID rules. The regulations under §1274—which addresses seller financed transactions—say that §1274 does not apply to below-market loans.[169] For below-market loans, the forgone interest demand loan rules apply. (Although §7872 says that a term loan with a below-market interest rate will be treated as having original issue discount ["OID"] at the time the loan is made, the proposed regulations say that for gift term loans the forgone interest demand loan rules apply.[170]) Each year, a lender must report the interest income imputed to the lender under § 7872, with a statement explaining various details.[171] This regime relieves donors and donees of the burden of coping with the OID rules that apply to non-gift term loans.[172]

B. Loans With Adequate Interest.

1. Overview. What if the loan provides adequate interest so that it is not a below-market loan? There is no forgone interest to report under §7872. Nevertheless, if interest accrues but is not actually payable, the OID rules will generally apply.[173] The OID rules of §§1271-1275 are extremely complex with many exceptions and technical details. Only a simplified overview of the most relevant provisions is included within the scope of this outline.

An IRS response to a practitioner comment observed that the OID rules will generally apply to loans with accrued interest, even if the loans bear interest at the AFR.

> "…the holder of a debt instrument that accrues interest at a fixed rate of interest [at or above the AFR], where such interest is not payable until maturity, must include in income portions of such

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[167] Prop. Reg. § 1.7872-14(b)Ex.(1).

[168] I.R.C. § 7872(b)(1); Prop. Reg. §§ 25.7872-1 and 1.7872-7(a).

[169] Reg. § 1.1274-1(b)(3).

[170] Prop. Reg. § 1.7872-6(a).

[171] Prop. Reg. § 1.7872-11(g).

[172] BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶55.3.2 (Warren, Gorham and Lamont) (Nov. 2006), citing Staff of Joint Comm. on Tax'n, 98th Cong., 2nd Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 533 (Comm. Print 1984).

[173] I.R.C. §§ 1272-1275.

> interest under the OID provisions. See §1.1272-1(f)3)(ii) of the proposed regulations. Therefore, in the above example, the cash basis shareholder must include the deferred interest in income currently. (We recognize that a cash basis taxpayer may be less likely to be scrutinized than an accrual basis taxpayer due to less restrictive accounting requirements. This problem pervades the Code and is not peculiar to §7872)." [174]

That response from an IRS Regional Technical Coordinator interestingly points out that this issue may not receive rigorous scrutiny in audits of cash basis taxpayers. Practitioners may have planned numerous loans or notes in sale transactions in the past without advising that accrued interest must be recognized each year under the OID rules, and the issue may not have been raised in any audits. That does not mean that the OID rules do not apply.

One commentator gives the following example:

> "EXAMPLE: Mom lends Junior $1,000. The note provides that interest at the AFR accrues during the term of the loan and a balloon payment of principal plus all accrued interest is due at the end of the term. If this arrangement is bona fide, it should successfully avoid the application of the gift tax. However, for income tax purposes, the interest which is accrued but not paid will constitute OID [citing I.R.C. §1272(a).]. Assuming that no exception to the general rules applies, Mom will have to report interest income during the term of the loan, even though she is not getting paid. Junior will get to deduct the imputed interest paid, even if he is not actually paying it, if the interest is of a character that would otherwise be deductible by him."[175]

If the loan/seller financed transaction is with a grantor trust, the lender/seller does not have to recognize interest income because he or she is treated as the owner of the trust income and assets for income tax purposes.[176]

2. Exceptions. There are exceptions for various types of financial instruments, including tax-exempt obligations, United States savings bonds, debts of not more than one year, and obligations issued before March 2, 1984.[177] Several additional exceptions include the following.

    a. Small Loan Exception. The OID rules do not apply to a loan if all outstanding loans between the lender and borrower do not exceed $10,000, if the loan is between natural persons, if the loan is not made in the course of a trade or business, and if a principal purpose of the loan is not the avoidance of any federal

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[174] NSAR 08777, Vaughn # 8777 (June 24, 1991) (response of IRS Regional Technical Coordinator responding to submission from practitioner requesting amendment or clarification of §7872).

[175] KATHRYN HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶28.04 (Warren Gorham & Lamont 1997).

[176] I.R.C. § 671; *see* Rev. Rul. 85-13, 1985-1 C,B, 184.

[177] I.R.C. § 1272(a)(2)(A-D).

tax.[178] (For purposes of this exception, a husband and wife living together are treated as one person.[179])

b. Loan For Acquiring or Carrying Personal Use Property. This exception merely restricts when the OID can be deducted by the obligor, but does not relieve the lender's recognition of OID income on an annual basis.[180] (For purposes of this exception, personal use property is all property other than trade or business property or property used for the production of income.[181])

c. Loan with "Qualified Stated Interest." Having "qualified stated interest" is not really an exception to the OID rules, but effectively avoids having OID under the operation of the rules. As a practical matter, interest that is accrued beyond the taxable year is probably not "qualified stated interest" that is subtracted in determining the amount of OID for that year because there must be specified strict penalties for failing to pay the interest during a year (so strict that the interest in all likelihood will be paid each year).[182]

d. De Minimis OID. The OID is treated as zero if the total OID (i.e., the stated redemption price at maturity less the issue price, as discussed below) is less than ¼ of 1% of the stated redemption price at maturity multiplied by the number of complete years to maturity.[183]

e. Seller-Financed Property Exceptions. If a note is given in consideration for the transfer of property (i.e., not a loan for cash), §1274 applies to determine the "issue price," which is subtracted from the "stated redemption price at maturity" to determine the amount of OID. There are a variety of exceptions under §1274(c)(3), in which event there generally would be no OID.[184] These exceptions include sales of farms for $1 million or less by individuals or small businesses, sales of principal residences, and sales involving total payments of $250,000 or less.[185] See Section XI.B.4.d of this outline *infra*.

Cash Method Debt Instruments. For certain seller-financed debt instruments that do not exceed $2 million, indexed from 1989,[186] a cash-method seller who is not a dealer can agree with the buyer to treat the note as a "cash method debt instrument." In that event, the interest is taken into account by both buyer and seller

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[178] I.R.C. § 1272(a)(2)(E)(ii).
[179] I.R.C. § 1272(a)(2)(E)(iii).
[180] I.R.C. § 1275(b)(2).
[181] I.R.C. § 1275(b)(3).
[182] See the discussion in Section XI.B.4.b of this outline *infra*.
[183] I.R.C. § 1273(a)(3).
[184] I.R.C. § 1273(b)(4)(issue price is equal to the state redemption price at maturity, so there would be no OID).
[185] I.R.C. § 1274(c)(3).
[186] The 2013 test amount is $3,905,900, Rev. Rul. 2012-33, 2012-51 IRB 710, and the 2012 test amount is $3,813,800, Rev. Rul. 2011-27, 2011-48 IRB 805.

under the cash receipts and disbursements method (i.e., as actually paid).[187]

f. Transactions to Which §483 Applies. Another exception applies in connection with §483. In the limited situations in which §483 applies, there is imputed interest under §483 rather than OID under §1274, and the taxpayer's accounting method (i.e., cash or accrual) controls the timing for reporting unstated interest; interest is not included or deducted until a payment is made or due.

3. OID Must Be Reported Ratably Over Life of Loan. The aggregate OID over the life of the loan is reported under a daily proration approach.[188] The OID is included in income each year under the OID rules even for cash basis taxpayers. However, any "qualified stated interest" is included based on the taxpayer's normal method of accounting.[189]

The amount of OID included in income each year is generally determined under the "constant yield method" as described in Regulation §1.1272-1(b)(1).[190]

4. Determination of OID Amount. Original issue discount is the excess (if any) of the "stated redemption price at maturity" over the" issue price."[191] Each of these terms has very specific technical definitions.

a. Stated Redemption Price at Maturity. The stated redemption price at maturity is the sum of all payments provided for by the debt instrument except for qualified stated interest payments.[192] (Qualified stated interest is excluded from the OID calculation because it is reported separately based on the taxpayers' accounting methods.) To the extent that stated interest exceeds qualified stated interest (discussed immediately below), the excess is included in the stated redemption price at maturity.[193]

b. Qualified Stated Interest. Qualified stated interest is interest stated in the debt instrument that meets various significant restrictions, including that the note calls for interest at a fixed rate payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the instrument.[194]

Regulations clarify that the "unconditionally" requirement means that there must be reasonable legal remedies to compel timely payment of the interest or conditions are imposed that make the likelihood of late payment (other than a late payment within a reasonable grace period) of nonpayment a remote

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[187] I.R.C. § 1274A(c)(1).

[188] I.R.C. § 1272(a)("sum of the daily portions of the original issue discount for each day during the taxable year on which such holder held such debt instrument").

[189] Reg. § 1.1272-1(a)(1).

[190] I.R.C. § 1272(a).

[191] I.R.C. § 1273(a)(1).

[192] Reg. § 1.1273-1(b).

[193] Reg. § 1.1273-1(c)(4).

[194] I.R.C. § 1273(a)(2).

contingency.[195] Remedies or other terms and conditions are not taken into account if the lending transaction doesn't reflect arm's length dealing and the holder does not intend to enforce the remedies or other terms and conditions. According to a Senate Finance Committee Report, interest will be considered payable unconditionally only if the failure to pay the interest will result in consequences to the borrower that are typical in normal commercial lending transactions. Thus, in general, interest will be considered payable unconditionally only if the failure to timely pay interest results in acceleration of all amounts under the debt obligation or similar consequences.[196] Rev. Rul. 95-70, 1995-2 C.B. 124 states that if the debt instrument's terms do not provide the holder with the right to compel payment, they must provide for a penalty that is large enough to ensure that, at the time the debt instrument is issued, it is reasonably certain that the issuer will make interest payments when due.

Example: Parent loans $100,000 cash to child for a 4-year note that pays stated interest of 1% for the first two years and 6% for the last two years. Assuming there are sufficient restrictions to assure that the interest will be paid currently, the "qualified stated interest" is the 1% amount that is paid throughout the life of the loan. The stated redemption price at maturity includes the full amount of interest payments over the four years less the 1% payments that constitute qualified stated interest. As a result, the stated redemption price at maturity exceeds the issue price (which equals the amount of the cash loan, as discussed below), and the excess amount is OID. A note that has stated interest that does not constitute qualified stated interest will generally have the effect of creating or increasing OID.

c. Issue Price for Cash Loans. Section 1273 describes the definition of "issue price" for various types of debt instruments, including notes received for cash loans. (There are separate special rules under §1274 that apply to seller-financed transactions, as discussed in Section XI.B.4.d of this outline *infra*.) For cash loans, the "issue price" is the amount loaned.[197]

Example: Parent loans $1,000,000 cash to Child in return for a 4-year note with stated interest equal to the mid-term AFR on the date of the cash loan. However, the interest is not paid annually (or if the note does call for annual interest payments, there are not sufficient penalties and restrictions on non-payment of interest for the interest to constitute qualified stated interest). Because the interest is not qualified payment interest, the full amount of interest payments under the note will constitute OID, calculated as follows:

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[195] Reg. § 1.1273-1(c)(1)(iii).

[196] S Rpt No. 98-169, Vol. I (PL 98-369) pp. 253–254.

[197] I.R.C. § 1273(b)(2); Reg. § 1.1273-2(a)(1).

Stated redemption price at maturity=$1,000,000 + all interest payments required

Less Issue price = $1,000,000

OID is the amount of aggregate interest payments required under the note.

d. Issue Price for Seller Financed Transactions. Section 1274 generally applies to debt instruments given in a sale or exchange for property that is not regularly traded on an established market (other than for cash, services, or the right to use property). It applies special rules for determining the issue price. The general concept of §1274 is that all payments due on seller financed sales or exchanges of property are discounted at a minimum interest rate (the relevant AFR) to compute an imputed principal amount. The issue price is the lesser of the stated principal amount or this imputed principal amount. (If the note has stated interest equal to the AFR, the imputed principal amount will generally be the same as the stated principal amount.[198]) The difference between the total payments due under the note (excluding qualified stated interest) and this issue price is the OID that is taxable as ordinary income to the holder of the debt instrument over his holding period.

Seller-Financed Property Exceptions. There are several exceptions involving debt instruments given for sales or exchanges of property where §1274 does not apply. (In those situations, there will be no OID—the issue price is of the debt instrument is its stated redemption price at maturity.[199])

These exceptions include sales of farms by individuals or small businesses for $1 million or less, sales of principal residences, and sales involving total payments of $250,000 or less.[200]

Debt Instrument With Adequate Stated Interest. If the debt instrument has adequate stated interest, the issue price is the stated principal amount under the note (including all payments due under the note other than stated interest). There will be adequate stated interest if the debt instrument has a single stated interest rate, paid or compounded at least annually, that is equal to or greater than the test rate under §1274(d).[201] The test rate is generally the lowest of the AFRs for the 3-month period ending with the month in which there is a binding contract of sale.[202]

However, there are several exceptions in which the test rate is different than the AFR. For sale-leaseback transactions, the test rate is 110% of the AFR.[203] For "qualified debt instruments"

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[198] I.R.C. § 1274(a)(1).

[199] I.R.C. § 1273(b)(4); Reg. §1.1273-2(d).

[200] I.R.C. § 1274(c)(3). For a detailed discussion of these exceptions, see HARRISON MCCAWLEY, BNA INC. TAX. PORT. 535, TIME VALUE OF MONEY: OID AND IMPUTED INTEREST ¶III.C.2 (2012).

[201] *See* Reg. §§ 1.1274-2(c)(1) 1274-4.

[202] I.R.C. § 1274(d)(2).

[203] I.R.C. § 1274(e).

under §1274A(b) (notes under $2.8 million, indexed since 1989--$5,339,300 in 2012, for the sale or exchange of property other than new §38 property), the test rate is no greater than 9%, compounded semiannually.

Example: Parent sells property worth $1.0 million to Child in February 2012 in return for a 4-year note. The note bears interest at 1.12% (the mid-term AFR for February 2012), with all interest and principal being due at the end of 4 years (i.e., $1,045,558). The note has adequate interest. The issue price is the stated principal amount of the note, or $1,000,000. The OID calculation is as follows:

Stated redemption price at maturity	*$1,045,558*
Less issue price (stated principal amount)	*1,000,000*
OID	*45,558*

Debt Instrument That Does Not Have Adequate Stated Interest. If the debt instrument does not have adequate stated interest, its issue price is the sum of the present values of all payments, including interest, due under the instrument, using a discount rate equal to the relevant test rate under §1274(d) (as described immediately above).[204] The sum of such present values is the imputed principal amount of the note.[205]

5. Loan Transaction With Grantor Trust Not Subject to OID Complexities. If the loan/seller financed transaction is with a grantor trust, the lender/seller does not have to recognize interest income because he or she is treated as the owner of the trust income and assets for income tax purposes.[206]

XII. DEDUCTION OF INTEREST PAID UNDER LOANS

A. Overview. Under both §7872 and the OID rules of §1274, the interest element that is recognized as interest or OID taxable income in a particular year by the lender may be deducted in that same year by the borrower if the interest is of a type that is deductible under the Code.[207]

The general requirements for deducting interest are briefly summarized below.

B. Personal Interest. Interest that is not explicitly deductible under specified provisions in §163 (including, among other things, investment interest an, qualified residence interest) is treated as personal interest that is not deductible.[208]

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[204] I.R.C. § 1274(b).

[205] Reg. § 1.1274-2(c)(1).

[206] I.R.C. § 671; *see* Rev. Rul. 85-13, 1985-1 C,B, 184.

[207] *E.g.*, Reg. § 1.1273(g)(2)(ii)(referring to interest deduction under §163); Prop. Reg. § 1.7872-11(g)(3)(under the exception for loans not exceeding $100,000 limiting deemed interest paid by the borrower to the borrower's net investment income, the limitation also applies for determining the borrower's interest deduction under §163); Prop. Reg. § 1.7872-11(g)(2)(statement required by borrower who is deducting deemed transfer under §7872 as an interest deduction).

[208] I.R.C. § 163(h).

C. Investment Interest. A noncorporate taxpayer may deduct "investment interest" to the extent of "net investment income" for the taxable year.[209] An unlimited carryforward is allowed for investment interest so that it can be deducted in a succeeding taxable year to the extent the taxpayer has investment income in that succeeding year.[210] (If the taxpayer never has such an excess, the carryover dies with the taxpayer.)

Both "investment interest" and "net investment income" relate to interest expense or income related to "property held for investment," which is generally property that "produces income" in the form of interest, dividends, annuities, or royalties or is "of a type" that produces such income.[211] For example, stock is held for investment even if dividends are not received in a year because stock is a type of property that produces dividend income.[212] In addition, "property held for investment" includes an interest in a trade or business if the business is not a passive activity for purposes of §469 (such as working interests in oil and gas properties) and if the taxpayer does not materially participate in the business.[213]

"Investment interest" is interest expense that generally is deductible (*e.g.,* an expense that is not required to be capitalized) that is "properly allocable to property held for investment" other than qualified residence interest or interest expense included in computing income or loss from a passive activity subject to §469.[214] "In general, interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures."[215] Specific rules for tracing debt proceeds to specific expenditures are described in that temporary regulation.[216]

"Net investment income" is the excess of investment income over investment expense.[217] Investment income generally is gross income from property held for investment and generally includes net gain on dispositions of such property.[218] Investment expenses that must be deducted in determining net investment income includes all deductions "(other than for interest) which are directly connected with the production of investment income".[219] Gross income or expenses of a passive activity are not included in the calculation of net investment income. Net capital gain and qualified dividend income are included in investment income only to the extent the taxpayer so elects.[220] (Making this election causes such net capital gain or qualified dividend income to be treat as ordinary income,[221] but making the election is often advantageous because the effect is that the net capital gain or qualified dividend ordinary income can be offset by the investment interest deduction. A taxpayer may choose not to make the election if

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[209] I.R.C. § 163(d)(1).
[210] I.R.C. § 163(d)(2).
[211] I.R.C. §§ 163(d)(5(A)(i), 469(e)(1).
[212] Rev. Rul. 93-68, 1993-2 C.B. 72.
[213] I.R.C. § 163(d)(5)(A)(ii).
[214] I.R.C. § 163(d)(3)(A-B).
[215] Reg. § 1.163-8T(a)(3).
[216] *See e.g.,* Armacost v. Commissioner, T.C. Memo. 1998-150.
[217] I.R.C. § 163(d)(4)(A).
[218] I.R.C. § 163(d)(4)(B).
[219] I.R.C. § 163(d)(4)(C).
[220] I.R.C. § 163(d)(4)(B).
[221] I.R.C. § 1(h).

the taxpayer anticipates having ordinary investment income in excess of investment expense in an upcoming year, so that the investment interest expense offsets what would otherwise by recognized as ordinary income in the near future.)

D. Original Issue Discount. Section 163(e) provides that the issuer of a debt instrument (i.e., the borrower who gives a note) may deduct the daily portions of OID during the taxable year as determined under §1272(a) to the extent the deduction is not disallowed by some other Code provision (for example, if the proceeds of the debt instrument were used to acquire personal use property.) As with all of the OID rules, the provisions of §163(e) are quire complex.

E. Qualified Residence Interest. Interest on loans to acquire a personal residence or home equity loans secured by a personal residence can be deducted, subject to various limitations on loans amounts can be deducted if various requirements under §163(h)(3)-(4) are satisfied. One of the important requirements is that the loan must be secured by the residence. See Section XIII.B of this outline *infra*, for a summary of the requirements to be able to deduct personal residence interest.

XIII. HOME MORTGAGE NOTES

A. Significance. Parents are increasingly making loans to children to finance their acquisition of personal residences, or even second homes. In December 2012, the AFR for mid-term loans (3-9 years) is 0.95% and the AFR for long-term loans (over 9 years) is 2.40%. These incredibly low rates are significant lower than rates that the children can get from commercial lenders for home mortgage loans. More significantly, as lenders have adopted much stricter down payment and qualification standards for home mortgage loans, loans from parents may be the only alternative for the child to be able to acquire a residence desired by the child (and that the child's parents wants the child to be able to purchase).

B. Qualified Residence Interest. Interest on loans secured by personal residences (or second homes) may be deducted only if the loan meets various requirements so that the interest is "qualified personal interest."[222] The main requirement is that the loan must be secured by the personal residence. Even though the parent may be willing to make an unsecured loan, the loan should be documented with a legally binding mortgage in order for the child to be able to deduct the interest on the loan as qualified residence interest.

The major requirements for the loan to qualify so that interest on the loan is qualified interest are summarized.

1. Legally Liable; Debtor Relationship. The borrower is legally liable for the loan. There is a true debtor-creditor relationship.

2. Secured by Residence. The mortgage is secured by the borrower's principal residence (as described in §121) or a second home in which the borrower has an ownership interest.[223]

Debt is secured by a qualified residence only if (1) the residence is specific security for the loan, (2) the residence can be foreclosed on in

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[222] I.R.C. § 163(h)(3).

[223] I.R.C. § 163(h)(4)(A)(i); Reg. § 1.163-1(b)(taxpayer must be legal or equitable owner of the property).

the event of default, and (3) the security interest is recorded or otherwise perfected under state law, whether or not the deed is recorded.[224]

While the residence must be secured by the residence, the loan can still qualify even if the security interest is ineffective or the enforceability of the security interest is restricted under any applicable state or local homestead or other debtor protection law.[225] The debt can be secured by other assets in addition to the residence without violating the security requirement.[226]

Observe that a non-tax advantage of having the loan secured by the residence is that if the residence is awarded to the borrower's spouse in a divorce action, the residence continues to serve as collateral for the outstanding loan.

3. Qualified Residence. A qualified residence includes a house, condominium, mobile home, boat, house trailer, or other property that under all the facts and circumstances can be considered a residence.[227]

A residence currently under construction can be treated as a qualified residence for a period of up to 24 months if it becomes a qualified residence when it is ready for occupancy.[228]

If the residence is rented during the year, it is treated as a qualified residence only if the taxpayer uses it for personal purposes for a number of days that exceeds the greater of (i) 14 days, or (2) 10% of the number of days the unit was rented at a fair rental rate.[229] If a second residence is not rented or held out for rent during the year, it qualifies as a qualified residence even if the taxpayer does not use the residence personally during the year. I.R.C. §163(h)(4)(A)(iii).

4. Types of Qualifying Loans and Limitations on Amounts of Loans. The loan is acquisition indebtedness (i.e., debt incurred in acquiring, constructing, or substantially improving the residence,[230] or a refinancing of acquisition indebtedness, or home equity indebtedness.[231]

For acquisition indebtedness, the aggregate amount treated as acquisition indebtedness does not exceed $1.0 million ($500,000 for a married individual filing a separate return).[232] (The $1 million acquisition indebtedness limit is a "per residence" limitation, not a "per taxpayer" limitation where the residence is owned jointly by two individuals.[233])

For home equity indebtedness, the aggregate amount treated as home equity indebtedness does not exceed the fair market value of the

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[224] Temp. Reg. §1.163-10T(o)(1).

[225] I.R.C. § 163(h)(4)(C); Temp. Reg. § 1.163-10T(o)(2).

[226] *See* Ellington v. Commissioner. T.C. Memo. 2011-193; Letter Ruling 908023.

[227] Temp. Reg. § 1.163-10T(p)(3)(ii).

[228] Temp. Reg. § 1.163-10T(p)(5).

[229] I.R.C. §§ 163(h)(4)(A)(i)(II), 280A(d)(1); Tempo. Reg. § 1.163-10T(p)(3)(iii).

[230] I.R.C. § 163(h)(3)(B)(i)).

[231] I.R.C. § 163(h)(3)(A-C).

[232] I.R.C. § 163(h)(3)(B)(ii).

[233] CCA 200911007.

residence reduced by acquisition indebtedness, and does not exceed $100,000 ($50,000 for a married individual filing a separate return).[234]

The combined acquisition indebtedness and home equity indebtedness that can qualify is up to $1,100,000, or $550,000 for married individuals filing separate returns. A taxpayer who borrows more than $1 million to purchase a principal residence may deduct the interest on up to $1.1 million of the loan: $1 million as acquisition indebtedness and $100,000 as home equity indebtedness.[235]

If the debt secured by the residence exceeds the $1.1 million amount, there must be an allocation of interest that is attributable to the amount of debt that qualifies. Various allocation methods are provided in temporary regulations (that were issued before the $1.1 million limit was imposed under OBRA in 1987), and in an IRS Notice and Publication.[236] the IRS has confirmed that, based on the legislative history of § 163(h), until further it regulations are issued, taxpayers may use any reasonable method in allocating debt in excess of the acquisition and home equity debt limitation, including the exact and simplified methods in the temporary regulations, the method in Publication 936, or a reasonable approximation of these methods.[237]

5. <u>Estate or Trust</u>. For a residence held by an estate or trust, the interest can be qualified interest if the residence is a qualified residence of a beneficiary who has a present interest in such estate or trust or an interest in the residuary of such estate or trust.[238]

6. <u>Reporting Requirements</u>. If qualified residential interest is paid to an individual (such as a parent), the name, address, and TIN of the person to whom the interest is paid must be disclosed on Form 1040, Schedule A, and a $50 penalty can be assed for the failure to do so.

XIV. REFINANCING NOTES AT LOWER CURRENT AFR

A. <u>Overview</u>. There are no cases, regulations or rulings that address the gift tax effects of refinancing notes. Proposed regulations under §7872 include a section entitled "Treatment of Renegotiations," but merely reserves the subject for later guidance, which has never been issued.[239] One commentator concludes that refinancings at lower AFRS should be possible without gift consequences:

> "Although there is no case, ruling, or Code section that explicitly provides that promissory notes may be restated without gift tax effects, economic analysis of the transaction and Regulations strongly support the conclusion that it is possible to do so without a taxable gift being deemed to occur."[240]

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[234] I.R.C. § 163(h)(3)(C).

[235] Rev. Rul. 2010-25, 2010-44 I.R.B. 571.

[236] Temp. Reg. §1.163-10T(d)-(e); Notice 88-74, 1988-2 C.B. 385; Publication 936.

[237] CCA 201201017.

[238] I.R.C. § 163(h)(4)(D).

[239] Prop. Reg. § 1.7872-11(e).

[240] *See* Jonathan Blattmachr, Elisabeth Madden, & Bridget Crawford, *How Low Can You Go? Some Consequences of Substituting a Lower AFR Note for a Higher AFR Note*, 109 J. TAX'N 21, 26 (July 2008)(hereinafter Blattmachr et. al., *How Low Can You Go?*).

Other commentators have agreed, for example, concluding that "there is no gift consequence when such a loan is refinanced at a lower AFR."[241]

B. Economic Analysis If Notes Can Be Prepaid by Borrower. If the borrower can prepay the note with a penalty at any time, and if prevailing interest rates decline, the borrower would likely pay off the original note and borrow the amount on a new note at current rates. That happens daily with thousands of homeowners refinancing their mortgages as interest rates have declined. The borrower could either (i) pay off the original loan (with the higher interest rate) and borrow again at the lower rate, or (ii) give a new note (at the current AFR) in substitution for the original note (with the higher interest rate).

This phenomenon is supported by the prices at which marketable callable notes are traded. For callable bonds, the bond prices do not increase proportionally as interest rate decrease (because investors know that the issuer may likely call (i.e., prepay) the bonds that bear higher than current market rates.[242]

While it is possible that the IRS might argue that a gift results by re-characterizing the transaction as merely having the lender accept a lower AFR note in placed of a higher AFR note, there is no case law or rulings addressing the issue. One commentator reasons that logically there should be no gift tax consequences:

> "Many of the promissory notes used in the intrafamilial context are term (rather than demand) notes that provide that the borrower may, at the borrower's option, prepay all or any portion of the principal of the promissory note at any time with premium or penalty of any kind. Whether or not this right to prepay is restricted, if the borrower has the funds available, it seems that the borrower, without negative gift or income tax consequences, may repay the lender in advance of the maturity date, thereby decreasing the amount of total interest that would accrue on the borrower's debt (and, as a result, the total payment the lender expected to receive under the note in *the* absence of repayment)."[243]

C. Regulations (Including Proposed Regulations) Suggest That Refinancing to a Lower AFR Is Not A Gift. Commentators have provided cogent analysis of regulations suggesting that there should be no gift tax consequences to substituting a lower AFR note for a high rate note. The Blattmachr, Madden, Crawford article reasons as follows:[244]

(1) Proposed regulation §25.7872-1 provides a rule for valuing a term loan note, and it seems to contemplate addressing the value of the note *just at the time the loan is made.*[245] According to its heading, that proposed regulation applies only to "Certain Below-Market Loans," which would not include loans having stated interest equal to the AFR (or higher). In any event, there is no proposed regulation addressing the valuation of notes for gift tax purposes after they have been issued.

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[241] Robert Schweihs, *The AFR and the Value of Debt,* WILLAMETTE MNGT. ASSOCIATES INSIGHTS 12, 17 (SUMMER 2012)(discussing how to value notes).

[242] *See id*. at 27.

[243] Blattmachr, *How Low Can You Go?* at 26-27.

[244] *Id.* at 27-29.

[245] Prop. Reg. § 25.7872-1("…shall be treated as a gift from the lender to the borrower on the date the loan is made")

(2) Section 7872(h) (now §7872(i)) may authorize gift tax regulations regarding the valuation of intra-family notes that bear interest at the AFR in light of §7872, but none have been promulgated.

(3) The gift tax regulation that generally applies for valuing notes says that the value is" the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value." A *lower* value may be established by satisfactory evidence "that the note is worth less than the unpaid amount (because of the interest rate, or date or maturity, or other cause), or that the note is uncollectible … and that the property, if any, pledged or mortgaged as security is insufficient to satisfy it."[246]

(4) Proposed regulations under §7872 regarding the *estate tax* value of notes says that the value is the lesser of "a) the unpaid stated principal, plus accrued interest, or b) the sum of the present value of all payment due under the note (including accrual interest), using the applicable Federal rate for loans of a term equal to the remaining term of the loan in effect at the date of death."[247]

(5) Thus, the only applicable gift tax regulation, and the proposed estate tax regulation, both indicate that the value of a note as of the relevant date will not be greater than the amount of unpaid principal plus accrued interest.

(6) As a result, "a family note issued at the AFR which is higher than the current AFR has an FMV for gift tax purposes *not greater* than its face amount."[248]

(7) Therefore, there should be no gift if a lower AFR note is substituted for a pre-existing note with a higher interest rate. The "old" note has a value presumed to equal its face amount and the new note has a gift tax value under §7872 equal to its face amount (as long as the interest rate is at least equal to the AFR). Therefore, the exchanged notes have equal values for gift tax purposes, and no gift results from the exchange.

D. <u>Does Refinancing Suggest Transaction Is Not a Loan</u>? A possible concern is that consistent refinancing of the note may be a factor in determining that the loan transaction does not result in bona fide debt, but should be treated as an equity transfer.[249]

E. <u>Practical Planning Pointers</u>. In light of the lack of any case law or direct discussion of refinancings at lower AFRs in regulations or in any rulings, most planners suggest caution in this area, and not merely refinancing notes every time the AFR decreases.[250] If the planner is concerned about the treatment of a refinancing (perhaps because there have been refinancing in the past), consider having the borrower borrow money from a bank to repay the loan and several months later approaching the original lender about the possibility of borrowing money under a new note (at the lower AFR) to be able to pay off the bank. Repeated refinancings every time the AFR goes down would seem to fall clearly under the "Pigs get fat and hogs get slaughtered" proverb. Lenders in arm's length transactions are not willing to simply reduce interest rates on existing debt, at least not without getting something in return.

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[246] Reg. § 25.2512-4.

[247] Prop. Reg. § 20.7872-1.

[248] Blattmachr et. al., *How Low Can You Go?*, at 28-29.

[249] See the discussion in Section II.C of this outline *supra*.

[250] *E.g.*, Benjamin Feder, *The Promissory Note Problem,* 142 TR. & ESTS. 10 (Jan. 2003).

Some planners advise renegotiating the terms of notes not only to adopt the lower more current AFR, but also to compensate the lender in some say for accepting the lower rate, "perhaps by paying down the principal amount, shortening the maturity date, or adding more attractive collateral."[251]

Another possibility is to change the interest rate to a rate that is higher than the minimum required rate, but lower than the interest rate stated in the original loan. The rationale for this suggestion is that borrowers in the commercial context will not continue paying higher interest rates if they can refinance a debt at a significantly lower interest rate without a prepayment penalty. Refinancing, however, may incur some closing costs, but those costs maybe minimal compared to the interest savings over the remaining term of the note. If the borrower refinances the note, the original lender will then lend the funds to some other borrower, but at the current lower interest rate. A refinancing at a lower, but not quite down to market rates, may result in a win/win for both the borrower and lender.[252]

XV. DISCOUNTING OF NOTES FOR GIFT AND ESTATE TAX PURPOSES

A. Various Factors Recognized by Cases and IRS in Discounting Notes.

1. Discounting Generally Permitted Upon Showing of "Satisfactory Evidence." The gift and estate tax regulations for valuing notes generally (discussed below) provide that notes can be valued at less than face value plus accrued interest if the donor or estate demonstrates by "satisfactory evidence" that the value is lower. The IRS has conceded in Technical Advice Memoranda that notes need not necessarily be valued at their face amounts.

Technical Advice Memorandum 8229001 identified eight specific considerations for valuing mortgages and promissory notes.[253]

- Presence or lack of protective covenants (the more onerous the restrictions on the borrower, the lower the risk for the lender and the lower the required discount);
- Nature of the default provisions and the default risk (the default risk is lower [and the discount is lower] if the borrower has better coverage for making payments, evidenced by factors such as interest coverage ratios, fixed-charge coverage ratios, and debt-equity ratios; the more stringent the default provisions under the note, the lower the risk to the lender [and the discount is lower]);
- Financial strength of the issuer (the key financial ratios mentioned above and current economic conditions, including financial strength of any parties giving guarantees are important, strong financials indicate lower risk and lower discounts);
- Value of the security (the higher the value of the security, the lower the risk for the lender and the lower the discount);
- Interest rate and term of the note (the analysis goes beyond just determining in the interest rate on the note equals the current market

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[251] Philip J. Hayes, *Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners,* 13 CALIF. TR. & ESTS. Q 5, 7 (Summer 2007).

[252] Benjamin Pruett, *Loans Within the Family—Cautions and Considerations*.

[253] The impact of these factors, as summarized in the text, are addressed in Carsten Hoffmann, *The Evolution of Note Valuations,* TAX NOTES 1143, 1144-45 (September 1, 2003).

rate, an increase in market interest rates during the term of the note will decrease the value of the note, the longer the term of the note, the more exposed the holder is to interest rate increases and the greater the discount on the note [or the higher the required interest rate to offset this risk]);

- Comparable market yields (the yields from various types of financial instruments may be considered, the most comparable debt instrument is used and adjustments are made for specific risk differences from the comparable instrument, there may be few comparables for private transaction notes);
- Payment history (if payments are current and are made timely, especially if there is a lengthy history of timely payments, the risk for the lender is lower [and the discount is lower]); and
- Size of the note (there are conflicting impacts, on one hand the borrower may have more ability to repay smaller notes, on the other hand small notes are note as likely to be from larger companies with excellent financials and the universe of potential buyers of small notes is very limited; smaller notes may call for higher discounts).

Technical Advice Memorandum 9240003 valued a note for estate tax purposes. The note from the decedent's nephew had a face amount of $215,000 and was cancelled in the decedent's will. The TAM concluded that the note was worth significantly less than face value because of its uncollectability (and also determined that the cancellation did not result in taxable income to the nephew because the cancellation was in the nature of a gift).

Upon a showing of appropriate circumstances, it is clear that notes can be discounted for gift and estate tax purposes.[254]

2. <u>Cases</u>. Cases in various contexts have addressed factors that should be considered in valuing notes. Courts have applied substantial discounts to notes in a variety of estate tax cases.[255]

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[254] For general discussions of the valuation of promissory notes, see Carsten Hoffmann, *The Evolution of Note Valuations,* TAX NOTES 1143, 1144-45 (September 1, 2003); M. Read Moore & D. Alan Hungate, *Valuation Discounts for Private Debt in Estate Administration,* 25 EST. PL.(June 1998).

[255] Estate of Smith v. Commissioner, 923 F. Supp. 896 (S.D. Miss. 1996)(note from Fortune 500 company; 6% interest, annual principal payments of about 10% of face amount of note at date of death, court accepted estate appraiser's methodology which determined value of payments on discounted cash flow basis, starting with discount rate of 10.09% but adjusted to 16% rate to account for specific risk factors, and also applied 20% lack of marketability discount factor); Scher v. United States, 39 AFTR 2d 77-1580, 76-2 USTC ¶ 13163 (D.N.J. 1976) (corporate notes were valued at face value at date of death although corp. may have been insolvent at that time; notes were not worthless merely because corporation was insolvent because corporation at that time had good credit reputation, was paying notes when presented, and potential lenders would not have checked the corporation's actual financial status); Estate of Hoffman v. Commissioner, T.C. Memo. 2001-109 (unsecured 7.61% promissory notes with balloon payment of all principal and interest 18 years after the date of death; IRS and estate appraiser both used discounted cash flow approach to value the notes, difference was appropriate fair market value discount rate; court adopted IRS appraiser's approach of using a 12.5% discount rate after considering interest rates associated with various debt instruments [the prime rate was 6% and Treasury yields ranged from 3 to 6%] and that borrower had enough assets to pay off notes at maturity, and that the 12.5% discount rate incorporated the nonmarketable nature of the notes); Estate of Luton v. Commissioner, T.C. Memo. 1994-539 (court valued decedent's 41.9% interest in a liquidating trust, the primary asset of which was an unsecured 10% promissory note payable over about 11 years from a company in good financial condition [having Roy Disney as one of its principal shareholders], court rejected estate's argument for discounts due to comparison of bond yields of similar grade and for lack of control [because decedent could sue to compel trustee to sell the note it is retention was impudent under state law], court allowed 10% discount in valuing 41.9% interest in liquidating trust for

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For gift tax purposes, if gifts are made of notes themselves, the IRS has an incentive to reduce the amount of discount-to-face of the gift tax value of the notes. On the other hand, if assets are transferred in return for notes, the IRS has an incentive to increase the discount-to-face of the notes and to treat the excess value transferred over the value of the notes as gifts. Discounts have been allowed in gift tax cases.[256] Note valuations can arise in a wide variety of contexts for income tax purposes, and various income tax cases have allowed substantial discounts.[257]

3. Interrelationship of Estate and Gift Tax Values of Notes. A recurring situation is of a taxpayer who makes a transfer in return for a note, claiming that the note equals the value of the asset transferred so that there is no gift. At the taxpayer's death, the estate takes the position that a discount-to-face should be applied in valuing the note for estate tax purposes. There can certainly be situations where interest rate changes or changes in the borrower's ability to repay may justify valuation differences, but the estate should expect the IRS agent to be wary that the IRS is being whipsawed in such situations. Indeed, the IRS Estate Tax Examiner's Handbook advises agents that reporting a note from a related

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lack of marketability); Estate of Friedberg v. Commissioner, T.C. Memo. 1992-310 (corporation redeemed shares of Rule 144 restricted stock from estate for a down payment and 5-year note bearing interest at the short-term rate under §6621(b); IRS willing to allow only 1% discount on note; court allowed 32% discount from face considering the rate of interest, payment schedule, financial covenants, reporting requirements, restriction that payments could not exceed 15% of the corporation's cash flow in any year, noteholder's possible remedies, corporation financial condition, yields on comparable securities, and nature of the secondary market for private notes); Estate of Berkman v. Commisisoner, T.C. Memo. 1979-46 (gift and estate tax valuation; unsecured 6% notes from family members had 20-year term, with balloon principal payment at end of 20-year term, borrowers made timely interest payments and were good credit risks; IRS disallowed any discount from face; court allowed discount-to-face for estate tax purposes of 50-60%% of various notes focusing on low rate of interest because prime rate was 9.75% at death and long term of notes; discount for gift tax purposes was lower [15%-25%] because prime rate was only 7% at the date of the gift); Sam Broadhead Trust v. Commissioner, T.C. Memo. 1972-196 (no discount from face plus accrued interest because estate offered no evidence of lower value).

[256] Estate of Reynolds v. Commissioner, 55 T.C. 172 (1970)(units in voting trust sold to two of decedent's children for three separate $50,000 secured notes with terms of 10-15 years, interest-free except that 4% interest rate applied to late payments, $30,000 of payments were made on each of two of the notes and $27,000 of payments were made on the third note; court agreed with IRS that the value of each of the notes was only $30,000 and the excess values of the voting trust units over $30,000 constituted gifts; factors included interest-free nature of the note (until a payment default), large note amounts, ability of children to repay, fact of default on payments and that no interest was ever paid, prevailing interest rates in the years of the transfers, and no showing that any additional payments were ever made on the notes); Estate of Berkman v. Commissioner, T.C. Memo. 1979-46 (gift and estate tax valuation; unsecured 6% notes from family members had 20-year term, with balloon principal payment at end of 20-year term, borrowers made timely interest payments and were good credit risks; IRS disallowed any discount from face; court concluded that discount-to-face for gift tax purposes in three separate years was 15%-25%, lower than discounts of 50%-60% allowed for estate tax purposes, because prime rate was only 7% at the date of the gift and increased to 9.75% at the date of death).

[257] Olster v. Commissioner, 79 T.C. 456 (1982)(IRS attempted to value notes at face, court determined that the notes were worthless); Kronenberg v. Commissioner, 64 T.C. 428 (1967)(income tax case valuing issued by a company in liquidation; note was interest-free, nonnegotiable, with no set date for repayment, and debtor had limited financial resources; court allowed 37.5% discount from face); Clayton v. Commissioner, T.C. Memo. 1981-433 (80% discount on notes issued as low-interest second mortgages with terms of up to 30 years to facilitate purchase of homes by high-risk individuals who could not pay down payments and who had a history of being delinquent on payments, small balances on the notes meant that foreclosure proceedings were not economically feasible); Scott v. Commissioner, T.C. Memo. 1979-29 (taxpayer valued note at 70% discount based on sale of similar note in arm's length transaction; court concluded taxpayer did not show sufficient similarity to the prior transaction and allowed 30% discount based on nonrecourse nature of note, subordinated status of lien, limited nature of security, subsequent default of maker, and timely receipt of interest payments).

> party at less than its face amount raises strong evidence that a gift was made at the date of the issuance of the note.[258]

B. <u>Gift Tax Regulations and §7872</u>. The general regulation for valuing notes for gift tax purposes states that the value is the unpaid principal plus accrued interest, unless the evidence shows that the note is worth less (e.g., because of the interest rate or date or maturity) or is uncollectible in whole or in part. The regulation provides:

> "The fair market value of notes, secured or unsecured, is presumed to be the amount of unpaid principal, plus accrued interest to the date of the gift, unless the donor establishes a lower value. Unless returned at face value, plus accrued interest, it must be shown by satisfactory evidence that the note is worth less than the unpaid amount (because of the interest rate, or date of maturity, or other cause), or that the note is uncollectible in part (by reason of the insolvency of the party or parties liable, or for other cause), and that the property, if any, pledged or mortgaged as security is insufficient to satisfy it."[259]

Section 7872 provides rules for determining the amount of gifts incurred by making below-market loans. The gift amount is the amount of the forgone interest.[260] The statute does not address other factors that may impact the value of the notes—it just addresses how much gift results as a result of using an interest rate that is lower than the appropriate AFR. The statute does not address the gift tax implications of a note that has an interest rate that is equal to or greater than the AFR. However, the clear implication of §7872 is that a note that bears interest that is equal to or greater than the AFR will not be treated as a gift, merely because of the interest rate that is used on the note. Indeed, the IRS took that position in *Frazee v. Commissioner*[261] and has consistently applied that same position in subsequent private letter rulings.[262]

Even following the adoption of §7872, the value of notes apparently can be discounted because of factors stated in the general estate tax regulations other than the interest rate used in the notes. There are no proposed regulations issued in conjunction with §7872 that purport to override the general gift tax valuation principles for notes under Reg. § 25.2512-4. Prop. Reg. §25.7872-1, which addresses the gift tax implications of below market loans under §7872, makes no reference to discounting the value of loans for reasons other than comparison of the interest rate on the note to the AFR. Proposed regulations under § 2512, issued in conjunction with proposed regulations issued under §7872, simply make reference to §7872: "See §25.7872-1 for special rules in the case of gift loans (within the meaning of §1.7872-4(b)) made after June 6, 1984."[263]

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[258] INTERNAL REVENUE MANUAL ch. 800, §842.

[259] Reg. § 25.2512-4.

[260] I.R.C. § 7872(e)(2).

[261] 98 T.C. 554 (1992). *See also* True v. Commissioner, T.C. Memo. 2001-167 (§7872 applied to determine gift tax consequences of purchase under a buy-sell agreement providing for a deferred payment), *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004).

[262] *E.g.* Ltr. Ruls. 9535026, 9408018. *See also* True v. Commissioner, T.C. Memo. 2001-167, *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004). See SectionXVIII.A.3 *infra* of this outline for a more detailed discussion of *Frazee* and those letter rulings.

[263] Prop. Reg. § 25.2512-4.

The preamble to those proposed gift tax regulations simply states that "Proposed §25.7872-1 implements section 7872(a) by providing that the amount transferred by the lender to the borrower and characterized as a gift is subject to the gift tax provisions."

Keep in mind that a "gift loan" is a below-market loan where the forgone interest is in the nature of a gift.[264] Therefore, a loan that bears adequate interest and that is therefore not a below-market loan, by definition is not a "gift loan." Therefore, even the brief reference in gift tax proposed regulations issued in conjunction with the proposed regulations under §7872 would not apply to loans that bear interest at a rate equal to the applicable AFR or greater.

C. Estate Tax Regulations and §7872. The general estate tax regulation regarding the valuation of notes is very similar to the gift tax regulation quoted above, and provides that the estate tax value is the amount of unpaid principal plus interest accrued to the date of death, unless the executor establishes that the value if lower by satisfactory evidence that the note is worth less than the unpaid amount (e.g., because of the interest rate or the date of maturity) or that the note is uncollectible by reason of insolvency of the maker and because property pledged as security is insufficient to satisfy the obligation.[265]

If economic conditions change from the time the note was given and interest rates generally rise by the time of the holder's death, the value of the note may be discounted—based on the changed conditions—as provided in the estate tax regulations. A particularly interesting issue is whether a note providing for interest at the AFR can be discounted for estate tax purposes merely because interest at the AFR is below what the market would charge for a similar note, even if interest rates have not generally increased from the time the note was given to the date of the holder's death. We know that §7872 provides an artificially low interest rate — the rate at which the United States government can borrow. Stated differently, if the estate were to try to sell the note, with an interest rate at AFR, a hypothetical willing buyer would not pay full face value because the AFR is based on the safest of debt instruments—one from the U.S. government. Can the estate tax valuation reflect that reality?[266] The Tax Court in *Estate of Duncan v. Commissioner*[267] observed that under fiduciary principles, an irrevocable trust would be questioned for loaning money to another trust (even having the same trustee and beneficiaries) if the interest rate was not greater than the AFR, because the AFR is based on the yield on U.S. government obligations.[268]

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[264] *See* I.R.C. § 7872(c)(1)(A).

[265] Reg. § 20.2031-4.

[266] *See* Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?* 32 UNIV. MIAMI HECKERLING INST. ON EST. PL. ¶1507.1 (1998).

[267] T.C. Memo. 2011-255.

[268] *Duncan* involved whether interest paid on a "Graegin loan" could be deducted as an administrative expenses for estate tax purposes. An irrevocable trust created by the decedent's father loaned $6.5 million to the decedent's revocable trust in order to pay estate taxes. The $10.7 million of interest that was due on the loan at the end of 15 years was deducted. Among other things, the IRS argued that the 6.7% interest rate under the note exceeded the long-term AFR of 5.02% and was unreasonable. The court disagreed, stating that a note from the revocable trust is obviously a riskier investment than a government obligation and therefore a higher interest rate than the AFR is justified. Indeed, the court said that using the AFR "would have been unfair to the Walter Trust."

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While §7872 addresses gift issues, and subsequent authority recognizes that notes with interest at the AFR will not be discounted merely for gift tax purposes because of the interest rate, there is no such similar certainty for estate tax purposes. As discussed below, however, a proposed regulation under §7872 suggests that such discounting, merely because the AFR is an artificially low interest rate, would not be allowed.[269] However, that regulation has never been finalized.

Does that mean that the note can be discounted for estate tax purposes because there are no regulations on point for estate tax purposes? Because there is no coordinating regulation some attorneys take the position that general valuation principles should be applicable, and it may be possible to discount the note for estate tax purposes if the note uses the AFR as the interest rate. *Be aware, however*, the IRS estate tax agent may feel that taking a discount for this reason alone is abusive (because the note was not similarly discounted for gift tax valuation purposes at the time of the sale) and may closely scrutinize every aspect of the sale or loan transaction. Lance S. Hall, with FMV Opinions, Inc. reports one example of having appraised a note for estate tax purposes at about half the outstanding balance of the note—and having the value accepted in the estate tax audit. Hall, The FMV Solution (September 15, 2009). (In the situation described, FMV Opinions, Inc. applied a discount rate based upon required rates of return for highly rated publicly traded debt issued by REITs, adjusted for the substantial differences between the note and the public debt. Specifically, while the trust was well capitalized as of the date of death, the note was unsecured and lacked protective covenants. Additionally, both the note and the underlying assets of the trust were not readily marketable.)

Section 7872 specifically authorizes the issuance of regulations addressing the valuation of notes in light of §7872. Section 7872(i)(2) states that "[u]nder regulations prescribed by the Secretary, any loan which is made with donative intent and which is a term loan shall be taken into account for purposes of chapter 11 [the estate tax chapter] in a manner consistent with the provisions of subsection (b) [providing for the income and gift tax treatment of below-market loans.]" Commentators observe that regardless what Congress meant, it merely authorized regulations (final regulations have never been issued) "and did not write a self-executing rule." [270]

The IRS has issued a proposed regulation for estate tax purposes that directly addresses the estate tax value of a "gift term loan" following the issuance of §7872 and that may even address the value of notes having adequate interest. The proposed regulation conceivably purports to say that the value of the note could not be discounted for estate tax purposes except to make adjustments where the stated interest rate under the note is lower than the AFR in effect at the date of death or where the facts impacting the collectability of the note have changed "significantly since the time the loan was made." In this regard, the proposed regulation may impose a stricter standard for discounting notes for estate tax purposes because of uncollectability issues than the standards described

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[269] Prop. Reg. § 20.7872-1.

[270] Ronald Aucutt, *Installment Sales to Grantor Trusts*, ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 1203, at 1260 (April 2012)(hereinafter Aucutt, *Installment Sales to Grantor Trusts*).

in the general estate tax regulation for valuing notes, which do not impose the requirement of a "significant" change. Prop. Reg. §20.7872-1 provides:

> "For purposes of chapter 11 of the Internal Revenue Code, relating to estate tax, a gift term loan (within the meaning of §1.7872-4(b)) that is made after June 6, 1984, shall be valued at the lesser of:
>
> (a) The unpaid stated principal, plus accrued interest; or
>
> (b) The sum of the present value of all payments due under the note (including accrual interest), using the applicable Federal rate for loans of a term equal to the remaining term of the loan in effect at the date of death.
>
> No discount is allowed based on evidence that the loan is uncollectible unless the facts concerning collectability of the loan have changed significantly since the time the loan was made. This section applies with respect to any term loan made with donative intent after June 6, 1984, regardless of the interest rate under the loan agreement, and *regardless of whether that interest rate exceeds the applicable Federal rate in effect on the day on which the loan was made*."[271]

The proposed regulation says that it applies to valuing a "gift term loan," which would be a below market loan (with interest less than the relevant AFR). However, the last sentence says that it applies to any term loan made with donative intent *even if the interest rate exceeds the AFR* on the day the loan was made. Query, does the "with donative intent" phrase simply mean that the loan was not a compensation related loan or corporation-shareholder loan as referenced in §7872(c)(1) (B-C), or does it refer to a loan that was intended as a gift even though it had an interest rate higher than the relevant AFR? Arguably, the note given in a sale transaction does not reflect a loan "with donative intent." In any event, this regulation has never been finalized.

What is the effect of proposed regulations? The IRS may support a position by reference to proposed regulations but insists that they cannot be relied on to support a position that contradicts a position being taken by the IRS.[272] Courts view proposed regulations as merely a source of "informed judgment" and accord them "no more weight than a litigant's position."[273] However, courts may follow proposed regulations if neither the taxpayer nor the IRS challenges their validity.[274]

D. Valuation of Notes in Entity. If the note is in an entity that is valued on an asset-value basis, the note may be discounted, and the decedent's interest in the entity may subsequently be discounted as well for lack of control or lack of marketability. However, the IRS may raise objections if a note is contributed to an LLC or partnership for the sole purpose of achieving an additional "wrapper" discount. For example, if an asset is sold to a grantor trust in return for an installment note, and the if the note is contributed to an LLC and the LLC interest is given to another grantor trust with the same beneficiaries, the IRS may raise

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[271] Prop. Reg. § 20.7872-1(emphasis added).

[272] *See* Shop Talk, *What is the Legal Effect of Proposed Regs*.? 69 J. TAX'N 279 (Oct. 1988).

[273] KTA-Tator Inc. v. Commissioner, 108 T.C. 100 (1997).

[274] Arens v. Commissioner¸ T.C. Memo. 1990-241. *See generally* Rozenshteyn, *Below-Market Loans Offer Tax Arbitrage Potential*, 64 PRAC. TAX. STRAT. 260 (May 2000).

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objections if a substantial valuation discount is claimed on the value of the LLC interest that contains the note as its sole asset.

E. Income Tax Impact of Discounting Note Values. In deciding whether to take the position that a note is discounted for income tax purposes, the planner must realize that while the discount may result in estate tax savings, there may be adverse income tax implications attributable to that discount as payments are later received on the note.

If an individual inherits a note (other than an installment sale note) that is valued below face, and if the individual receive payments on the note exceeding the discounted value of the note, the excess is treated as ordinary income.[275] For example, sections 1271-1275 deal with OID by requiring the debt holder to take any discount into income as ordinary income, not as capital gain.[276] In addition, the debt holder may be required to accrue the discount over his holding period without regard to his usual method of accounting. If there is no sale or exchange of the note, there would be no capital gain element of the income recognition. An example in a respected treatise illustrates this phenomenon:

> *"EXAMPLE: Mom lends Son $1,000,000 at the then AFR of 7 percent. When she dies, the value of the note is $750,000, for whatever reason, even though $1,000,000 is still outstanding. If the note's value for estate tax purposes is $750,000, then when the $1,000,000 is paid, the recipient will have ordinary income of $250,000. If the note is distributed to Son, he will have cancellation of indebtedness income of $250,000 on the distribution.*[277]

The result should be different if an individual receives the note by gift. Under the dual basis rules of §1015, the donee's basis in the note would be the donor's basis for purposes of determining the amount of any gain. Therefore, the reduction in value of the note up to the time of the gift would not result in a decreased basis for purposes of determining later gain on the note.

If the note is an installment sales note, special rules apply if the note is satisfied at less than face value, if there is a disposition or cancellation of the note, or if related parties dispose of property purchased with the installment note within two years of the sale.[278]

XVI. EFFECT OF WAIVER, CANCELLATION OR FORGIVENESS OF NOTE LIABILITY

A. No Discharge of Indebtedness Income for Promissory Notes. If the forgiveness or cancellation of the loan (other than an installment sale note) is in the nature of a gift, there is no discharge of indebtedness income, because §102 excludes from the definition of gross income any amount received as a gift or bequest, and this overrides § 61(a).[279] The forgiveness of a family loan is typically intended as a gift. Section 108 contains special rules regarding discharge of indebtedness

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[275] I.R.C. §§ 1271(a)(1)(retirement of debt instrument treated as exchange),1276(a)(1)(gain on disposition treated as ordinary income up to the accrued market discount), 1276(a)(2)(partial principal payments treated as ordinary income to the extent the payment does not exceed accrued market discount).

[276] *E.g.,* Treas. Reg. §1.1275-1(b)(3)(treatment of market discount for calculating OID accruals).

[277] KATHRYN HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶28.06[2](WARREN GORHAM & LAMONT 1997).

[278] I.R.C. §§ 453B(a), 453(e)(1); *see generally* KATHRYN HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ch.30(WARREN GORHAM & LAMONT 1997). See Section XVIII.C.2 *infra* of this outline.

[279] I.R.C. § 102(a). *See* Helvering v. American Dental, 318 U.S. 322 (1943) (interpreting predecessors to §§102 and 61); Bosse v. Commissioner, T.C. Memo. 1970-355 (§102 applied because forgiveness was gratuitous).

income. The Senate Finance Report accompanying the passage of §108 specifically states that "debt discharge that is only a medium for some other payment, such as gift or salary, is treated as that form of payment rather than under the debt discharge rules."[280]

If the borrower is insolvent when the loan is forgiven with no further prospect of being able to repay the loan, the forgiveness may not be a gift but just a reflection of economic reality. There should be no discharge of indebtedness income if the forgiveness occurs in a bankruptcy case or when the obligor is insolvent.[281] In that circumstance, the lender may be able to take a bad debt deduction for the year in which the loan becomes worthless.[282] If the loan was made in the ordinary course of the lender's trade or business, it may result in a business bad debt deduction, which results in ordinary losses.[283] Much more common, in the intra-family loan context, is that the loan is a nonbusiness debt, which results in short term capital loss.[284] However, special scrutiny applies to intra-family loans, and unless the lender can overcome the presumption that the loan was a gift when made,[285] no bad debt deduction is allowed.

Another exception is that discharge of indebtedness income up to $2 million of mortgage debt on the taxpayer's principal residence before 2014 is excluded from gross income. This applies to the restructuring of debt, foreclosure of a principal residence, or short sale of a principal residence in which the sales proceeds are insufficient to pay off the mortgage and the lender cancels the balance.[286]

If a parent loaned cash to a non-grantor trust for the parent's children and the trust becomes insolvent, the parent should be able to cancel the note and avoid discharge of indebtedness income by the trust under §108(a)(1)(B) even without taking the position that the cancellation is a gift. Indeed, arguably the cancellation is not a gift because the note is worthless in any event. (However, if the note arose as a result of an installment sale, there are special rules that apply when installment sale notes are cancelled,[287] as discussed in Section XVIII.C.2 of this outline *infra*.)

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[280] *See generally* Rohrbach, *The Disposition of Property Secured by Recourse and Nonrecourse Debt,* 41 BAYLOR L. REV. 231, 253 (1989).

[281] Section 108 provides various exceptions in which discharge of indebtedness does not result in taxable income, including if the discharge occurs in a Title 11 bankruptcy case or when the taxpayer is insolvent. I.R.C. § 108(a)(1)(B). For a general discussion of the tax effects of canceled debts for individuals, see I.R.S. Publication 4681.

[282] *See generally* KATHRYN HENKEL, ESTATE PLANNING AND WEALTH PRESERVATION ¶28.05[2][b](WARREN GORHAM & LAMONT 1997). Courts have interpreted the wholly worthless requirement strictly in the intra-family context. *See e.g.,* Buchanan v. U.S., 87 F,3d 197 (7th Cir. 1996).

[283] I.R.C. § 166(d)(2).

[284] I.R.C. § 166(d)(1). The deduction can be taken only in the year the debt becomes totally worthless. (Because of the difficulty in pinpointing when that occurs, there is a special 7-year statute of limitations for refunds due to nonbusiness bad debt losses. I.R.C. § 6511(d)(1).) The lender will need to establish the worthlessness of the debt, perhaps by proving that the borrower is insolvent or that the lender attempted to collect on the debt with demand for repayment which was not forthcoming.

[285] See Section II.B-C of this outline *supra.*

[286] This exception was added in the Mortgage Forgiveness Debt Relief Act of 2007, and was extended for one year (2013) by the American Taxpayer Relief Act of 2012. I.R.C. §§ 108(a)(1)(E), 108(h)(2). The debt must have been used to buy, build or substantially improve the principal residence and be secured by that residence. There is no suggestion that the exception cannot apply to home mortgage loans between related parties.

[287] I.R.C. § 453B(a).

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Through 2012, a homeowner may exclude from income up to $2 million ($1 million if married filing separately) of debt incurred to buy, build or substantially improve his or her principal residence, which debt is reduced by mortgage restructuring or by forgiveness in connection with a foreclosure.[288] However, if the home mortgage arose by a loan from a family member, it is likely that the forgiveness results from a gift, in which event the full amount of debt forgiveness (even exceeding $2 million) would be excluded from income. However, a family member may in the appropriate situation take the position that the restructuring is not a gift but is in light of economic realities, and that even though the borrower may not qualify for the insolvency exception, the debt relief does not result in taxable income to the borrower.

For a grantor trust, a note from the grantor trust to the grantor (in return for a cash loan of a sale of assets) can be forgiven by the grantor without causing discharge of income taxable income because the debt is treated as owned by the grantor for income tax purposes (i.e., a loan from the grantor to the grantor).[289] That is most helpful because the exception for insolvent taxpayers under §108(a)(1)(B) would not apply even if the grantor trust was also insolvent unless the grantor were also insolvent under proposed regulations. Proposed regulations provide that grantor trusts and disregarded entities will not be considered the "taxpayer" under §108, but the grantor trust or entity owner is treated as the taxpayer.[290] Therefore, the §108 exceptions are available for grantor trusts and disregarded entities only to the extent that the owner is insolvent or undergoing bankruptcy.

B. Special Rules for Cancellation of Installment Note. There are special rules governing the cancellation or forgiveness of an installment sales note, designed to prevent a seller from being able to avoid income recognition from the initial sale.[291]

C. Possibility of Avoiding Having to Recognize Unpaid Interest Income Upon Loan Forgiveness. Even though there is not discharge of indebtedness income on the forgiveness of a loan, that does not necessarily address whether the lender must recognize accrued but unpaid interest as taxable income. Section 7872 addresses the income and gift tax implications of below-market loans, but §7872(i)(1)(A) specifically authorizes the issuance of regulations to provide that adjustments will be made to the extent necessary to carry out the purposes of §7872 if there are waivers of interest.

The proposed regulations to §7872 discuss the effect of forgiving interest payments.[292] While §7872 generally applies to below-market loans, the proposed regulation appears to apply to loans with adequate interest and that are not below-market loans. (The regulation states that it applies to loans with stated interest that initially would have been subject to §7872 had they been made without interest.)

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[288] Mortgage Forgiveness Debt Relief Act of 2007, allowing relief for cancellation of "qualified principal residence indebtedness" that is discharged before January 1, 2013. I.R.C. § 108(a)(1)(E).

[289] Rev. Rul. 85-13, 1985-1 C.B. 184.

[290] Prop. Reg. § 1.108-9.

[291] I.R.C. § 453B(a). The special rules for installment notes are discussed in Section XVIII.C.2 of this outline *infra*.

[292] Prop. Reg. § 1.7872-11.

The somewhat strangely worded regulation operates by negative implication. It says that a waiver of interest payments will be treated as if interest had been paid to the lender (requiring the lender to realize interest income) and then retransferred by the lender to the borrower (as a gift where the forgiveness is in the nature of a gift) *but only if* three conditions are satisfied:

> "(1) the loan initially would have been subject to section7872 had if been made without interest;
>
> (2) the waiver, cancellation or forgiveness does not include in substantial part the loan principal; and
>
> (3) a principal purpose of the waiver, cancellation, or forgiveness is to confer a benefit on the borrower, such as to pay compensation or make a gift, a capital contribution, a distribution of money under section 301, or a similar payment to the borrower."[293]

If a family loan is forgiven as a gift, the first and third requirements are satisfied. Therefore all three requirements will be satisfied (and the waived interest will have to be recognized as income by the lender) *only if* "the waiver, cancellation or forgiveness does not include in substantial part the loan principal." Stated a different way, this proposed regulation indicates that the lender will not be treated as having received interest that is forgiven if the forgiveness includes not only interest on the loan but also "in substantial part the loan principal."

One respected commentator reasons that forgiveness of principal and accrued interest will be treated the same as if the principal had been forgiven before the interest accrued, so that no interest income will be recognized by the lender:

> "Forgiveness of all principal and accrued interest has an economic consequence similar to an outright payment or forgiveness made before the interest accrued, and the authors of the proposed regulations apparently decided that taxpayers should neither be penalized nor given the opportunity to increase interest deductions when they execute a forgiveness later rather than sooner."[294]

There are various limitations and uncertainties regarding the ability to avoid having to recognize accrued but unpaid interest by forgiving the interest:

1. <u>Current Year Accrued Interest Only</u>? Because stated interest that is not paid in a year generally must be recognized each year under the OID rules,[295] it may be only the current year accrued interest that can avoid recognition under this forgiveness approach, because accrued interest from prior years may have already been recognized as taxable income.
2. <u>How Much Principal Must be Forgiven</u>? There is inherent ambiguity over how much of the principal must be forgiven when the accrued interest is forgiven. The regulation uses the nebulous phrasing that the forgiveness includes "*in substantial part* the loan principal." For example, if the accrued interest for the year is $30,000 on a $1 million outstanding loan, can the forgiveness be for $60,000, forgiving $30,000 of principal and the $30,000 of accrued interest? Does "substantial part"

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[293] Prop. Reg. § 1.7872-11(a)(emphasis added).

[294] BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 58.4 (2d ed. 1993). Interestingly, the third edition of this treatise does not include that helpful discussion.

[295] See Section XI.B of this outline *supra.*

mean that the forgiveness of principal is only about 25% or more of the total forgiveness? Many would say that 25% of something is a "substantial part" of that thing. Or is 50% of more required for this purpose? Or does the forgiveness have to include a substantial part of the outstanding principal on the loan (such as 25% of the full $1 million loan amount?) The language of the proposed regulation seems to refer to the principal forgiveness being a substantial part *of the forgiveness* and not a substantial part of the loan principal.

3. Proposed Regulation, But Provides Substantial Authority For Avoiding Penalties. This position is based merely on a proposed regulation that has never been finalized. But the fact that the proposed regulation has stood unchanged for decades and that there has been no case law rejecting this analysis over those decades appears to provide comfort in taking the position that the forgiveness of accrued interest in that manner can avoid ever having to recognize that accrued interest as income.

   Proposed regulations are considered in determining whether there is "substantial authority" for purposes of avoiding taxpayer or preparer penalties.[296]

4. Consistently Forgiving Accrued Interest Each Year May Not be Advisable. If the accrued interest must be recognized each year under the OID rules, the only way to avoid the recognition of all interest under the note would be to forgive the accrued interest each year (in connection with a forgiveness in substantial part of the loan principal). However, if the accrued interest is forgiven each year, that is a factor that may be considered in refusing to recognize the loan as a bona fide loan rather than as an equity transfer. The factors listed in *Miller v. Commissioner*[297] include (1) whether interest was charged, (2) whether a demand for repayment was made, and (3) whether any actual repayment was made. Consistently forgiving all interest payment would seem inconsistent with those factors.

   Furthermore, an IRS response to a letter from a practitioner suggests that having a plan to forgive the interest in each year may result in recasting the transaction as an interest-free loan under the §7872 rules, which would seem to mean that the imputed forgone interest would be recognized each year):

   > "The legislative history of section 7872 reveals that the conferees recognized that a term loan with deferred interest at a rate equal to or greater than the AFR, and a related gift to defray all or part of the interest payable on the loan, may be the economic equivalent of an interest-free loan with a principal amount equal to the sum of the actual stated amount of the loan and the amount of the gift. The conferees anticipated that under regulations, such a transaction would be treated in accordance

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[296] Reg. § 1.6662-4(d)(3)(iii)(types of authority considered in determining whether substantial authority exists for avoiding taxpayer penalty); Reg. §§ 1.6694-2(b)(1) & 1.6694-2(d)(2)(incorporating standards under §6662 regulations for determining whether substantial authority or reasonable basis standard is met to avoid preparer penalties).

[297] T.C. Memo. 1996-3, *aff'd without opinion*, 113 F.3d 1241 (9th Cir. 1997). See Section II.C. of this outline *supra for a discussion of* Miller and the other cases addressing whether the note is treated as debt or equity.

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> with its economic substance. H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 1021 (1984) 1984-3 (Vol. 2) C.B. 275."[298]

XVII. LOANS TO GRANTOR TRUSTS AND COROLLARY ISSUES REGARDING LOANS TO INDIVIDUALS

A. Overview. Loans may be made to individuals; alternatively loans may be made to grantor trusts. Many of the advantages of sale transactions to grantor trusts could also be achieved with loans to grantor trusts. (The grantor would pay income tax on the trust income, GST exemption can be allocated to the trust, etc.) Special considerations where loans are made to grantor trusts are addressed.

B. Does Demand Loan to Trust Cause Grantor Trust Treatment? Several cases have upheld arguments by the IRS that the grantor's ability to demand repayment at any time of a demand note from the trust causes the trust to be treated as a grantor trust under §674(a), at least where the loan constituted the entire trust corpus. The cases arose before the Supreme Court's decision in *Dickman*,[299] and before the passage of §7872, when interest-free loans were often used as an income shifting and wealth transfer strategy. As a separate taxpayer, the trust may have owed a very low income tax rate (the facts arose before the compressed income tax rates were applied to trusts).

Section 674(a) provides the general rule that the grantor is "treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party."

The cases conclude that the grantor's power to demand repayment of the trust assets to repay the demand loan constitutes "an independent power of disposition over the beneficial enjoyment of the corpus or income."

In *Kushner v. Commissioner*,[300] the grantor initially gave $100 to a trust for his children and a month later loaned $100,000 to the trust in return for a demand note. The loan was repaid a year later, and a new $150,000 loan was extended on a demand note. The trust earned interest income over $16,000 in each of 1982 and 1983. The IRS argued that the grantor should have reported the interest income under the grantor trust rules. The Tax Court concluded:

> "…petitioner's ability to demand payment of the loans enabled him to maintain direct dominion and control over the beneficial enjoyment of the trust's corpus. Thus, petition is to be treated as owner of the trust to the extent of the amounts which he loaned to the trust."[301]

There are no reported cases in which the IRS has made this argument following the adoption of §7872, which removed the income tax advantages of interest-free demand loans.

C. Necessity of "Seeding" Necessary for Loans to Trusts. For sales to grantor trusts, the common "folklore" is that the trust should end up with equity value of

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[298] NSAR 08777, Vaughn # 8777 (June 24, 1991) (response of IRS Regional Technical Coordinator responding to submission from practitioner requesting amendment or clarification of §7872).

[299] 465 U.S. 330 (1984).

[300] T.C. Memo. 1991-26, *aff'd*, 955 F.2d 41 (4th Cir. 1992).

[301] *Id.; see also* McGinnis v. Commissioner, T.C. Memo. 1993-45; Wysong v. Commissioner, T.C. Memo. 1988-344; Batson v. Commissioner, T.C. Memo. 1983-545.

about 10% after the sale (meaning that the note value would not exceed 9 times the equity value of the trust). There is no statue, regulations, or case law imposing that requirement, but the general theory is that the trust must have some net equity value to support that the note is worth its face amount. (Otherwise, any decline at all in the trust assets would leave the trust in a position that it could not pay the note in full.)

The same rationale would seem to apply to loans to trusts. If a parent loans $1 million cash to a trust that has an equity value of $10, the IRS might be expected to take the position that the note is not worth $1 million, and that the transaction results in a gift (and opens the possibility of an argument that §2036 applies to cause inclusion of the trust assets in the parent's estate at his or her death). A possible counterargument is that there is no necessity of having a minimum trust amount in several situations sanctioned by regulations where the trust will owe annuity payments to the grantor, such as a grantor retained annuity trust or charitable lead annuity trust.[302]

Cases addressing whether assets transferred to a trust in return for a private annuity are included in the transferor's estate under §2036 as a transfer with a retained interest have pointed to various factors, including: (i) annuity payments were limited to or substantially equal to the income generated by the assets; (ii) the obligor's personal liability for the annuity payments is in some manner limited to the income generated by the assets; (iii) the obligor lacks the economic means from which to make annuity payments other than the income generated by the assets; and (iv) the annuitant maintains managerial control over the assets.[303] Items (i)-(iii) of that list all relate to whether there are assets in the trust other than just the assets transferred in return for the private annuity.[304]

Conservative planners structure transactions for parents to make gifts to trusts and build equity value in trusts in other ways to support the value of notes that the trusts gives for subsequent cash loans or sales to the trust.[305]

D. Necessity that Individual Borrowers Have Financial Ability to Repay. A corollary question to a requirement that a trust has "seeding" to support a loan is whether the same approach should apply to cash loans to individuals? Should the individuals have sufficient net worth to have the ability to repay the loans? The ability to repay loans is not a factor under §7872 in determining the amount of gift that occurs by reason of making a below-market loan, and the proposed regulation under §7872 addressing the gift tax implications of below-market loans makes no reference to any factors other than comparison to the interest rate

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[302] Treas. Reg. §§25.2702-3 (GRATs, no limitation on needing minimum equity amount in trust above present value of annuity payments); 20.2055-2(f)(2)(iv)(testamentary CLAT, where actuarial value of annuity payments to charity exceeded amount transferred to trust, the charitable deduction was the full value contributed to the trust and there was no taxable value of the remainder).

[303] ZARITSKY, TAX PLANNING FOR FAMILY WEALTH TRANSFERS: ANALYSIS WITH FORMS ¶12.05[3][a][i] (Warren Gorham & Lamont).

[304] However, some cases have held that §2036 did not apply even though the trust that paid for assets with a private annuity was minimally funded. *E.g.,* Stern v. Commissioner, 747 F.2d 555 (9th Cir. 1984)(even though trust was minimally funded, there was no direct tie-in between trust income and annuity payment and annuitant had limited powers over trust). For cases referring to the requirement of a direct connection to paying the annuity from trust income, see Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales,* 34 UNIV. OF MIAMI HECKERLING INST. ON EST. PL.¶1601.1 n.55 (2000).

[305] *Id.* at ¶1601.1G (2000) ("…only those who are willing to take substantial risks should use a trust with no other significant assets [for sales transactions with a trust]").

on the note to the AFR.[306] The ability to repay loans is a factor that is considered in whether the transaction is respected as resulting in debt rather an equity transfer.[307] In addition, there have been cases that determined that gifts occurred when sales were made to individuals for notes where, among other factors, the individuals did not have the ability to repay the notes.[308]

Some of the cases involving transfers to individuals in return for private annuities have also applied §2036 where the individual had no ability to make the annuity payments other than with the transferred assets. Interestingly, the private annuity cases involving transfers to *individuals* in return for private annuities have not focused so closely on the net value of the individuals as compared to private annuity transactions involving trusts. However, there have been some cases that have not respected transfers for private annuities promised by individuals where the individuals did not have the financial wherewithal to pay the annuity.[309] For example, in *Hurford v. Commissioner*,[310] a mother transferred all of the limited partnership interests of a partnership to two of her children in return for private annuities from the two children. The court held that §2036(a)(1) applied for various reasons, including that the children had no ability to make the annuity payments other than from the assets in the partnership.[311]

E. Treatment of Non-Recourse Loans to Individuals. A further corollary issue is whether non-recourse loans can be made to individuals, secured only by what the individuals buy with the loan proceeds. Economically, this is no different than a recourse loan to a trust whose only assets are assets that the trust acquires with the loan proceeds. If the general thinking is that trusts should have adequate "coverage" (the rule of thumb is 10% coverage) for sales or loans, does that mean that nonrecourse loans to individuals would not be respected as having full value? Interestingly, §1274 addresses the effects of nonrecourse loans.[312] (Various tax shelter arrangements previously involved "flipping" properties acquired with nonrecourse indebtedness in excess of the fair market value of the property. Section 1274(b)(3) provides that where nonrecourse debt is used, the "issue price" for purposes of determining the amount of OID cannot exceed the value of the property transferred in return for the nonrecourse note.) However, §7872 does not address nonrecourse loans. Furthermore the cases addressing whether loan transactions are recognized as debt or equity transactions, do not

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[306] Prop. Reg. § 25.7872-1.

[307] *E.g.* Miller v. Commissioner, T.C. Memo. 1996-3, *aff'd without opinion*, 113 F.3d 1241 (9th Cir. 1997). See Section II.C of this outline *supra*.

[308] *E.g.,* Estate of Reynolds v. Commissioner, 55 TC 172 (1970)(units in voting trust sold to two of decedent's children for three separate $50,000 secured notes with terms of 10-15 years, interest-free except that 4% interest rate applied to late payments, $30,000 of payments were made on each of two of the notes and $27,000 of payments were made on the third note; court agreed with IRS that the value of each of the notes was only $30,000 and the excess values of the voting trust units over $30,000 constituted gifts; factors included interest-free nature of the note (until a payment default), large note amounts, ability of children to repay, fact of default on payments and that no interest was ever paid, prevailing interest rates in the years of the transfers, and no showing that any additional payments were ever made on the notes).

[309] *E.g.,* Estate of Mitchell v. Commissioner, T.C. Memo. 1982-185 (§2036 applied where children had no financial ability to make annuity payments and never intended to make annuity payments).

[310] T.C. Memo. 2008-278.

[311] The court pointed to other factors as well, including that the mother continued to exercise managerial control over the partnership and its assets after the transfer to the children. In addition, while the assets were transferred to two of her children, there was an understanding they would share benefits of the assets with a third child. The court applied I.R.C. §§ 2036(a)(2) and 2038 as well.

[312] I.R.C. § 1274(b)(3).

specifically address nonrecourse loans as a factor in that analysis, but they do include the borrower's ability to repay the loan as a factor, which would seem to suggest that having a nonrecourse loan would be a negative factor in the debt-equity analysis.[313]

Some cases have discounted the value of notes, in part because of the nonrecourse nature of the notes.[314]

F. <u>Guaranties</u>. A variety of commentators have addressed the impact of guaranties of note in sale to grantor trust situations. See Section XIX.A.2 of this outline for a detailed discussion of the effect of guaranties in sale to grantor trust transactions. Arguments can be made that the a guaranty by a trust beneficiary of the trust's note should not be a gift, but merely represents the beneficiary's effort to protect his or her interest in the trust.[315] However, there is uncertainty as to whether a beneficiary's guaranty of the trust's note in a sale context constitutes some kind of gratuitous transfer to the trust by the guarantor, and many planners structure sale to grantor trust transactions so that the trust pays market value for any guaranties of the trust's obligations.

There does not seem to be any difference in the analysis for loan transactions with trusts as opposed to sale transactions with trusts. Indeed, the Letter Ruling 9113009, the IRS letter ruling that initially raised concerns about the gift tax effects of loan guaranties, addressed the guaranty of *loans* (as opposed to sale notes) made by the guarantor's children. While Letter Ruling 9113009 was withdrawn by Letter Ruling 9409018, which addressed only other issues requested in the original ruling request without mention of gift tax issues, the earlier ruling nevertheless provides the IRS's analysis of why gift guaranties may include gift elements. The IRS reasoned generally that the guaranty confers an economic benefit from date they are given and the promisor of a legally enforceable promise for less than adequate and full consideration makes a completed gift on the date the promise is binding and determinable in value rather than when the promised payment is actually made.[316]

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[313] *See e.g.* Miller v. Commissioner, T.C. Memo. 1996-3, *aff'd without opinion*, 113 F.3d 1241 (9th Cir. 1997). See Section II.C of this outline *supra*.

[314] *E.g.,* Scott v. Commissioner, T.C. Memo. 1979-29 (taxpayer valued note at 70% discount based on sale of similar note in arm's length transaction; court concluded taxpayer did not show sufficient similarity to the prior transaction and for income tax purposes allowed 30% discount based on nonrecourse nature of note, subordinated status of lien, limited nature of security, subsequent default of maker, and timely receipt of interest payments).

[315] *See* Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152 (2000).

[316] The IRS's full analysis of this issue in Letter Ruling 9113009 is as follows:

> "The gift tax was designed to encompass all transfers of property and property rights having significant value. The transfer of a valuable economic right or benefit is a property interest that is subject to the gift tax. The valuable economic right is generally readily measurable by reference to current interest rates. See Dickman v. Commissioner, 465 U.S. 330 (1984). The term "gifts" was meant to be used in its broadest and most comprehensive sense in order to ". . . hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech." Commissioner v. Wemyss, 324 U.S. 303, 306 (1945).
>
> The agreements by T to guarantee payment of debts are valuable economic benefits conferred upon the shareholders of the acquiring companies and entities. You state that, without those guarantees, those shareholders (T's children) may not have obtained the loans or, in the very least, would have had to pay a higher interest rate to obtain the loans. Consequently, when T guaranteed payment of the loans, T transferred a valuable property interest to the shareholders. The promisor of a legally enforceable promise for less than adequate and full consideration makes a completed gift on the date the promise is binding and determinable in value rather than when the promised payment is actually made. *See* Rev. Rul. 84-25, 1984-1 C.B. 191.

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Cautious planners will treat the use of guaranties as a way of providing "coverage" for loans transactions the same as in sale transactions. For a discussion of further issues involving the use of guaranties, such as whether a fee must be paid for the guaranty and how to determine an appropriate amount to pay for the guaranty,[317] see Section XIX.A.2 of this outline *infra*.

XVIII. INTRA-FAMILY INSTALLMENT SALES (OTHER THAN SALES TO GRANTOR TRUSTS)

Planners have long used intra-family sales to freeze the estate tax value of the assets sold, and to provide liquidity by replacing an illiquid asset with cash.[318]

These advantages are balanced against the disadvantages of a sale, among them the recognition of gain, loss of control over the asset, and loss of income from the asset. To avoid the immediate recognition of gain, sales to family members are often structured as installment sales. The installment method permits a sale of property without the seller being required to report the gain until the actual receipt of the payments (subject to the exceptions noted).

Although the installment sale method will generally be available under §453(a),[319] there are significant exceptions. In particular, the installment sale method is not available for a sale of marketable securities and other property regularly traded on an established market.[320] It is also not available to the extent that the gain in question is depreciation recapture and may not be available at all if the sale consists of depreciable property and is to a controlled entity.[321] Finally, sales of inventory or dealer property will not generally qualify for installment treatment.[322]

Even if the installment method is available, there may be limits on its use. First, interest may be charged on the deferred tax liability if the aggregate face amount of all of the seller's installment obligations from sales during the year exceeds $5,000,000.[323] Also, a pledge of the installment note will trigger gain recognition.[324] Lastly, a gift or other disposition of the installment note, or the sale of the purchased property by a related purchaser within two years of the installment sale, may cause the balance of the deferred gain to be recognized.[325]

> Accordingly, the enforceable agreements by T to guarantee the loans on behalf of the shareholders are transfers (subject to gift tax) of the economic benefit conferred upon the shareholders on the dates they are entered into by T.
>
> Likewise, in the event that the primary obligors subsequently default on the loans and T pays any outstanding obligation under the terms of the agreements, any amounts paid by T, less any reimbursement from the primary obligors, will be gifts subject to the gift tax."

[317] *See generally* Shenkman, *Role of Guarantees and Seed Gifts in Family Installment Sales*, 37 EST. PL. 3, (Nov. 2010)(excellent discussion of various issues involving the use of guaranties in loan transactions).

[318] This Section XVIII of this outline is based on (and taken largely verbatim from) outstanding articles by Philip J. Hayes (San Francisco). Hayes, *Adventures in Forgiveness and Forgetfulness: Intra-Family Loans for Beginners*, 13 CALIF. TR. & EST. QUARTERLY 5 (Summer 2007); Hayes, *Intra-Family Loans: Adventures in Forgiveness and Forgetfulness*, ABA REAL PROP., PROB. & TR. L. SECTION SPRING MEETING (2007). The articles have an excellent detailed discussion of which interest rate safe harbor (*i.e*., under either §§483, 1274 or 7872) applies to installment sales, which discussion is not included in this article.

[319] In fact, if a disposition qualifies as an installment sale, the installment method is mandatory and automatically applies unless he taxpayer elects out under §453(d)(1).

[320] I.R.C. § 453(k)(2).

[321] I.R.C. §§ 453(i) and 453(g).

[322] I.R.C. § 453(b)(2).

[323] I.R.C. § 453A.

[324] I.R.C. § 453A(d).

[325] I.R.C. §§ 453B and 453(e).

A. Which Interest Rate Applies to Installment Sales?

There has been an interesting history of litigation over whether, for gift tax purposes, the appropriate interest rates for installment sales are to be determined under §§483, 1274, or 7872 and whether the six-percent safe harbor rate for land sales between relatives under §483(e) can apply for gift tax purposes if the AFR is over six percent.

Prior to the enactment of §7872, Congress first entered the realm of interest rate safe harbors in the context of installment sales. Congress enacted or amended income tax statutes Sections 483 (1964, amended in 1984) and 1274 (1984) to address a problem not involving the gift tax. Under these statutes, certain debt instruments issued in connection with installment sales must bear interest at the AFR to ensure that it provides "adequate stated interest." The statutes were aimed at installment sales transactions where the parties opted to inflate the sales price and impose reduced or no interest payments. This allowed the seller to convert ordinary income to capital gain and allowed the buyer to treat all payments as basis. Thus, although they employ the same methodologies for imputing interest as §7872, these sections ostensibly address not valuation issues, but rather *characterization of income*.

Section 1274. As a brief overview, §1274 provides the general rule for income tax treatment of installment sales; it applies to a note issued in a sale or exchange unless the note is excepted from its application. Section 1274(d)(2) provides that in a sale or exchange, the appropriate AFR is the lowest such rate for the three-month period ending with the month there was a "binding contract in writing for such sale or exchange." For installment sales the appropriate AFR is based not on the term of the note, but on its weighted average maturity.[326] The *weighted average maturity* of an obligation equals the sum of the amounts obtained by multiplying the number of complete years from the issue date until the payment is made by a fraction. The numerator of the fraction is the amount of each payment under the instrument (other than qualified stated interest), and the denominator is the stated redemption price at maturity.[327] Once an instrument's term is calculated, the discount rate used is the lowest AFR in effect during the three-month period ending with the first month a binding written contract for the transaction exists.

Section 7872. Section 7872(f)(8) explicitly states that §7872 does ***not*** apply to a loan given in consideration for the *sale or exchange of property*; this area is, at first glance, covered by Code Sections 483 and 1274. This is so even if Sections 483 and 1274 do not apply by reason of exceptions or safe harbor provisions.[328] This straightforward statement is modified somewhat by the regulations and proposed regulations, and transmogrified by case law (see below).

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[326] Reg. § 1.1274-4(c).

[327] *See* Reg. § 1.1273-1(f) for examples. *See* Section XI.B.4 of this outline *supra* for definitions of these terms.

[328] I.R.C. § 7872(f)(8).

In *Frazee v. Commissioner*, the court reasoned that §7872 applies in seller financing situations,[329] and acknowledged the IRS concession that §7872 applied for gift tax purposes rather than valuing the note under a market rate approach: "We find it anomalous that respondent urges as her primary position the application of Section 7872, which is more favorable to the taxpayer than the traditional fair market value approach, but we heartily welcome the concept."[330] Similarly, in *True v. Commissioner*,[331] the court held that §7872 applies to a purchase transaction under a buy-sell agreement for a deferred payment.

Private Letter Rulings 9535026 and 9408018 confirm the IRS position that §7872 will apply to the gift tax valuation of notes issued in intra-family sales transactions, regardless of the application of Sections 1274 or 483 to the transaction for income tax purposes.

The bottom line is that this issue will remain submerged so long as the AFR remains around six percent, unless Congress intervenes.[332] When the AFR climbs above six percent, in intra-family land sales transactions, careful planners will apply the AFR unless gift taxes are not an issue. Circuit level cases have split as to whether the 6 percent safe harbor applies for gift tax purposes.[333] Aggressive planners outside of the 8th and 10th circuits may always choose to use the 6 percent safe harbor, relying on the favorable case, common sense and fairness.

With intra-family sales transactions involving sales of personal use property (i.e., not land held for investment), at least under the §7872 proposed regulations, §483 is not applicable and §7872 should be used. The penalty for using the 7872 safe harbor in that case, however, is not burdensome, as the §1274 or 483 AFR (permitting the lowest of the prior three months' AFRs) is usually not substantially better than the §7872 AFR.

B. Consequences of Using Inadequate Stated Interest: Imputed Interest or OID. If either of Sections 483 or 1274 apply, and the applicable safe harbor interest rate is not utilized (the note does not call for qualified stated interest), interest will be imputed under §483 as "imputed interest" or under §1274 as "OID" (Original Interest Discount). Both are calculated in the same manner. However, they differ as to the timing of recognition of unstated interest.

1. Timing. When §1274 applies, OID is determined on a daily basis and is income to the seller and deductible by the buyer (unless the buyer is an

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[329] 98 T.C. 554 (1992).

> "Nowhere does the text of section 7872 specify that section 7872 is limited to loans of money. If it was implicit that it was so limited, it would be unnecessary to specify that section 7872 does not apply to any loan to which sections 483 or 1274 apply. The presence of section 7872(f)(8) signaled Congress' belief that section 7872 could properly be applicable to some seller financing. We are not here to judge the wisdom of section 7872, but rather, to apply the provision as drafted." 98 T.C. at 588.

[330] 98 T.C. at 590.

[331] T.C. Memo. 2001-167 ("We concluded in Frazee v. Commissioner, supra at 588-589, that section 7872 does not apply solely to loans of money; it also applies to seller-provided financing for the sale of property. In our view, the fact that the deferred payment arrangement in the case at hand was contained in the buy-sell agreements, rather than in a separate note as in Frazee, does not require a different result."), *aff'd on other grounds*, 390 F.3d 1210 (10th Cir. 2004).

[332] *See* Stephen J. Wolma, *Ambushed in a Safe Harbor*, 33 Val. U.L. Rev. 309 (1998), advocating Congressional action to resolve the conflict, short of Supreme Court intervention.

[333] The 8th and 10th circuits hold that the 6% safe harbor does not apply for gift tax purposes. *Krabbenhoft v. Commissioner*, 939 F.2d 529 (8th Cir. 1991); *Schusterman v. United States*, 63 F.3d 986 (10th Cir. 1995). The 7th circuit has held that the 6% safe harbor does apply for gift tax purposes as well. Ballard v. Commissioner, 854 F.2d 185 (7th Cir. 1988).

individual and the interest is personal interest) without regard to the taxpayer's use of the accrual or cash method. The practical effect when OID is imputed is that OID will be allocated daily, thus thwarting the tax deferral effects of the delayed interest payments. By contrast, in the limited situations in which §483 still applies, the taxpayer's accounting method (i.e., cash or accrual) controls the timing for reporting unstated interest; interest is not included or deducted until a payment is made or due.

2. Amount: Computing OID. The computation of OID is discussed in Section XI.B.4 of this outline *supra*.

C. Income Tax Implications for Seller. The following summaries assume a qualifying rate has been utilized in the installment sale.

1. Recognition of Gain or Loss. An installment sale is a disposition of property in which one or more payments are to be received after the year of the disposition.[334] Under §453(a), "income from an installment sale" is usually reported by "the installment method." With installment method, gross profit is determined by subtracting the seller's adjusted basis from the selling price. The gross profit is then divided by the selling price (less any "qualifying indebtedness" assumed or taken subject to by the buyer) to arrive at the "gross profit ratio."[335] Each payment of principal received by the seller is then multiplied by the gross profit ratio to determine the amount of each payment allocable to the gain and to nontaxable return of basis. [336]

> *Example: If property with an adjusted basis of $30 is sold for $50, payable $10 at the closing and $10 annually for four years thereafter, with interest at an adequate rate on the deferred payments, the gross profit is $20 (contract price of $50 less adjusted basis of $30), resulting in a gross profit ratio of 40 percent ($20/$50). Thus, the seller has gain for the year of sale of $4 (40 percent of $10), and 40 percent of each later installment will be similarly includable in income when the installment is collected.[337] If the selling price is less than the seller's basis, a loss would be realized, but would most likely be disallowed under §267(a) because the purchaser would likely be a member of the seller's family to whom §267(b)(1) would apply, or a trust created by the grantor to which §267(b)(4) would apply.*

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2. Disposition of Installment Note.

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[334] I.R.C. § 453(b)(1).

[335] Temp. Reg. § 15A.453-1(b)(2)(1) through (iii).

[336] Temp. Reg. § 15A.453-1(b)(2)(i).

[337] *See* BITTKER & LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶106.1.1 (Warren, Gorham and Lamont) (Nov. 2006).

a. By Seller. A potential tax issue of which practitioners should be aware is caused when the selling family member disposes of an installment obligation. In that case the seller will be required to recognize all or part of the deferred gain if the installment obligation "is satisfied at other than its face value or distributed, sold, or otherwise disposed of" before the buyer completes the payments.[338]

(1) Gift. Giving an installment note back to the obligor is also a disposition, and giving an installment obligation to a related party recognizes the entire unpaid principal balance on the note at the time of the gift.[339]

(2) Partial Forgiveness. Often a related party seller will forgive installment payments as they come due. In such case the donor/seller will be taxed on both the interest and gain portions of the forgiven installment, even though no cash is received. The forgiven gains are a taxed as a partial disposition of the obligation under §453B(f), and the donor will recognize the previously untaxed gain portion of the forgiven installment.

EXAMPLE:[340] Parent sells an asset to Child for $100,000. Parent's adjusted basis at the time of the sale is $20,000. Child gives Parent an installment note amortized by seven $20,000 annual payments and an eighth payment of $5,640, each payment including interest at the then-appropriate rate of 10 percent. Parent forgives the first installment and Parent consents to gift split. They intend to forgive each subsequent installment in the same manner. The IRS does not successfully challenge the transaction. Child's payments amortize the installment debt as follows:

Year	Payment	Principal	Interest
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1	$20,000	$10,000	$10,000
2	20,000	11,000	9,000
3	20,000	12,100	7,900
4	20,000	13,310	6,690
5	20,000	14,640	5,360
6	20,000	16,106	3,894
7	20,000	17,716	2,284
8	5,640	5,128	512

When Parent forgives the first $20,000 installment, Parent still must report $10,000 of interest income and $8,000 of long-term capital gain (the capital gain on the sale was $80,000 of the total

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[338] I.R.C. § 453B(a).

[339] I.R.C. § 453B(f).

[340] *See* ZARITSKY & AUCUTT, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS, §12.02[4][a] (2d ed. 1997).

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$100,000 sales price, so 80 percent of each principal payment is a capital gain). Assuming that Parent is in the 35 percent marginal income tax bracket, Parent must pay $4,700 of income tax in the first year, even though Parent receives no cash (35 percent × $10,000 interest) + (15 percent × $8,000 capital gain).

(3) Death. A bequest of an installment obligation that arose during the seller's lifetime to someone other than the obligor on the note does *not* trigger gain,[341] but the income is IRD -- the recipient of the obligation recognizes gain on the future payments to the extent the seller would have recognized it.[342] A bequest of an installment note to the obligor cancels the note (because a merger of interest has occurred) and accelerates the incidence of taxable IRD,[343] causing the decedent's estate to recognize the difference between the face amount and the decedent's basis in the obligation.[344] Such a bequest to an unrelated party, however, will cause the estate only to recognize the difference between the note's *fair market value* and the decedent's basis immediately before death, without regard to the actual outstanding balance.

In addition, any cancellation of such a note is treated as a transfer that triggers immediate gain on the note. If the decedent's will specifically bequeaths the note to someone other than the obligor of the note, the gain should not be triggered to the estate. If the estate elects to make a non-pro rata distribution of the assets pursuant to authority in the will or state law, and if the executor elects to distribute an installment note to someone other than the obligor, it is not clear whether recognition of the gain to the estate will be avoided. The IRS might conceivably take the position that there has been an indirect distribution of the note to the obligor.[345]

A cancellation of a note at death, or a bequest of an installment note to the obligor will trigger recognition of inherent gain on the note to the estate. However, the triggering transfer and the related reporting of gain does not occur until the earliest of (1) the executor's assent to the distribution of the note under state law, (2) the actual cancellation of the note by the executor, (3) upon the note becoming unenforceable due to the applicable statute of limitations or other state law, or (4) upon termination

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[341] I.R.C. § 453B(c). *See generally* LeDuc, *Avoiding Unintended Dispositions of Installment Obligations*, 31 EST. PL. 211 (2004).

[342] I.R.C. §§ 691(a)(4), 691(a)(5).

[343] While I.R.C. § 453B(c) contains a general exception for distributing a decedent's installment note to beneficiaries of the estate, that section applies "except as provided in section 691." Section 691(a)(5)(A)(i) provides that a transfer by the estate of a decedent's installment note to the obligor of the note will trigger recognition of gain on the note I.R.C. § 691(a)(5).

[344] If the obligor is related to the decedent, within the meaning of I.R.C. § 453(f)(1), the amount of gain triggered by the disposition will be based on the full face amount of the note instead of just the fair market value of the note, if the fair market value is lower. I.R.C. §§ 691(a)(5)(A)(iii), 691(a)(5)(B).

[345] *See* Ltr. Rul. 8806048. *See generally* Hesch, *Dispositions of Installment Obligations by Gift or Bequest*, 16 TAX MANAGEMENT-ESTATES, GIFTS AND TRUSTS JOURNAL 137 (1991).

of the estate.[346] For example, if an installment note passes by the residuary clause to the decedent's child, the accelerated gain is reported by the estate in the year in which the note is actually distributed to the child.[347]

If the estate made the sale after the decedent's death, a transfer of an installment obligation would generally cause the transferor immediately to recognize any remaining gain which has been deferred by the installment reporting method.[348] Of course, in many situations in which the estate sells an asset for an installment note, there should be little gain to recognize upon a disposition of the installment obligation due to the step-up in basis of the asset at death. If an estate asset is to be sold that has substantial appreciation above its stepped-up basis, consider distributing the asset to a beneficiary and allowing the beneficiary to make the installment sale.

b. Sale by Buyer. Under §453(e), the related buyer's sale of the purchased asset within two years of the date of the purchase is treated as a disposition by the original seller of the obligation.[349] Thus, an intra-family installment sale imposes a risk on the seller that the buyer will take some action that causes the seller's tax on the deferred gain to be accelerated.

EXAMPLE:[350] Parent sells a building to Child for $100,000. Parent's adjusted basis at the time of the sale is $20,000. Child gives Parent an installment note amortized by seven $20,000 annual payments and an eighth payment of $5,640, each payment including interest at the then-appropriate rate of 10 percent. One year (and one payment) after buying the building, Child resells it for $125,000. Parent is deemed to have received a complete payment of Child's installment note and must recognize the previously unrecognized $70,000 gain on the sale ($80,000 total gain on the sale less $10,000 gain recognized on the first installment payment). Assuming that Parent is in the 15 percent capital gains tax bracket, this produces a $10,500 capital gains tax (15% × $70,000 = $10,500).

- NOTE: A related buyer need not *resell* the purchased assets to create a problem for the seller. If the buyer's "disposition" is something other than a sale or exchange, the amount the seller is deemed to have received is the fair market value of the asset at the time of the second disposition.[351] Certain

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[346] Ltr. Rul. 8552007.

[347] Ltr. Rul. 8806048.

[348] I.R.C. § 453B(a). (The exception under I.R.C. § 435B(c) for the disposition of an installment obligation at death does not help because it applies only to installment obligations passing *from a decedent*, rather than installment notes arising after the decedent's death.) Rev. Rul. 55-159, 1955-1 C.B. 391.

[349] For this purpose, a related buyer includes the seller's spouse, child, grandchild, or parent, or a related trust, estate, partnership, or corporation. The seller's brother, sister, stepbrother, stepsister, aunt, uncle, or relative by marriage (other than the seller's spouse) is not a related party. I.R.C. § 453(f)(1).

[350] *See* Zaritsky & Aucutt, STRUCTURING ESTATE FREEZES: ANALYSIS WITH FORMS, §12.02[2] (2d ed. 1997).

[351] I.R.C. § 453(e)(4).

transactions, including the transmission of the asset at death, are not acceleration events under this rule, but gifts, notably, are dispositions.[352]

XIX. INSTALLMENT SALE TO GRANTOR TRUST

A. Description. A very effective method of freezing an individual's estate for federal estate tax purposes is to convert the appreciating assets into a fixed-yield, non-appreciating asset through an installment sale to a family member.[353] The traditional disadvantage of an installment sale is that the donor has to recognize a substantial income tax gain as the installment payments are made. The gains would typically be taxed at 15% (without considering state income taxes), and the interest would be taxed at ordinary income tax rates. If the sale is made to a trust that is treated as a grantor trust for income tax purposes, but which will not be included in the settlor's estate for federal estate tax purposes, the estate freezing advantage can be achieved without the income tax costs usually associated with a sale. In addition, care must be taken to select a "defect" that would cause the grantor to be treated as the "owner" of trust income as to both ordinary income and capital gains.

There is a trade-off in the fact that the assets transferred in the sale will have carryover basis; however, if the low basis assets are purchased by the grantor prior to death, this loss of basis step-up would be avoided.

Briefly, the steps of planning an installment sale to a grantor trust are as follows.

1. Step 1. Create and "Seed" Grantor Trust. The individual should create a trust that is treated as a grantor trust for federal income tax purposes (meaning that the grantor is the owner of the trust for income tax purposes). The trust will be structured as a grantor trust for income tax purposes, but will be structured so that the grantor is not deemed to own the trust for estate tax purposes.[354] This type of trust (which is treated as owned by the grantor for income but not estate tax purposes) is sometimes called a "defective trust".

   The grantor trust should be funded ("seeded") with meaningful assets prior to a sale.[355] There is lore that the value of equity inside the grantor trust must be 10% of the total value in order for the sale to be respected. In Letter Ruling 9535026, the IRS required the applicants to contribute trust equity of at least 10 percent of the installment purchase price in order to avoid association status for income tax purposes and to have the trust be treated as a trust.)

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[352] I.R.C. § 453(e)(6).

[353] For an excellent discussion of the issues involved with sales to grantor trusts, see Mulligan, *Sale to Defective Grantor Trust: An Alternative to a GRAT*, EST. PL. 3-10 (Jan. 1996); Mezzullo, *Freezing Techniques: Installment Sales to Grantor Trusts*, PROB. & PROP. 17-23 (Jan./Feb. 2000); Aucutt, *Installment Sales to Grantor Trusts*, ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 1203 (April 2012).

[354] For a detailed discussion of ways to structure the trust so that it is a grantor trust as to both income and principal, see Akers, Blattmachr & Boyle, *Creating Intentional Grantor Trusts*, 44 REAL PROP., PROB. & EST. LAW J. 207 (2009); Zaritsky, *Open Issues and Close Calls—Using Grantor Trusts in Modern Estate Planning*, 43 HECKERLING INST. ON EST. PL. ch. 3 (2009); Heller, *Grantor Trusts: Take Nothing For Granted*, 46 HECKERLING INST. ON EST. PL. (SPECIAL SESSION MATERIALS) (2012).

[355] For an outstanding discussion of the various issues regarding the need for seeding of the trust prior to a sale, see Shenkman, *Role of Guarantees and Seed Gifts in Family Installment Sales*, 37 EST. PL. 3 (NOV. 2010).

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Various planners have suggested that is not required absolutely, and some respected national speakers said that the equity amount could be as low as 1%--depending on the situation. One planner (who considers himself a conservative planner) has used less than 10% sometimes, and on occasions he is concerned whether 10% is enough. The legal issue is whether there is debt or equity. (For example, if it is debt, it is permissible to use the AFR as the interest rate.) The issue is whether there is comfort that the "debt" will be repaid.

McDermott v. Commissioner,[356] involved a 19.6 to 1 debt equity ratio (which translates to a 5.6% equity amount). The IRS acquiesced in *McDermott*. One attorney uses that as a base point – he never uses less than 5.6% seeding. On the other hand, there is a published ruling involving a 20% contribution, and the IRS ruled it was debt. (That was not a sale to grantor trust situation.)

In *Petter v. Commissioner*,[357] footnote 8 notes that the estate tax attorney involved in structuring the transaction "said he believed there was a rule of thumb that a trust capitalized with a gift of at least 10 percent of its assets would be viewed by the IRS as a legitimate, arm's length purchaser in the later sale." At least this is a reference to the 10% rule of thumb in a reported case.

Under the 10% rule of thumb, the trust should hold approximately 10% in value of the eventual trust assets after a purchase occurs in step 2. As an example, if a $900,000 asset will be sold to the trust, the settlor might make a gift of $100,000 to the trust. After the trust purchases the asset, it would own assets of $1,000,000, and it would have a net worth of $100,000, or 10% of the total trust assets. (This is analogous to the 10% cushion requirement in §2701(a)(4).) Stated differently, if the 10% seeding is based on analogy to the initial seeding gift should be 11.1% of the amount of the later sale to the trust (if values remain constant.) If the grantor transfers $11.10 to the trust, and later sells an asset for a $100.00 note, the "$11.10 "seeding" would be 10% of the total $111.10 assets in the trust following the sale. That means there would be a 9:1 debt equity ratio.

In determining whether the note represents debt or equity, one must consider a variety of factors, including the nature (and volatility) of assets in the trust, and the risk profile of the clients. If there is experience of assets actually increasing in value after sales to the trust and payments actually being made, when the next grantor trust sale is considered, the grantor would seem to have good reason to be more comfortable using a lower equity cushion.

Some commentators have suggested that initial seeding should not be required as long as the taxpayer can demonstrate that the purchaser will have access to the necessary funds to meet its obligations as they become due.[358] Even those authors, however, observe that the §2036 issue is an

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[356] 13 T.C. 468 (1949), *acq*. 1950-1 C.B. 3

[357] T.C. Memo. 2009-280.

[358] Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. MIAMI HECKERLING INST. ON EST. PL.,¶ 1601.1 (2000).

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intensely factual one, and that "only those who are willing to take substantial risks should use a trust with no other significant assets."[359]

The seed money can be accomplished either through gifts to the trust, or through transfers to the trust from other vehicles, such as a GRAT.

Spouses as Joint Grantors. Most planners do not use joint trusts with both spouses as grantors. There is the theoretical concern of whether one spouse might be treated as selling of the assets, which are eventually sold to the trust, to the portion of the trust treated as a grantor trust as to the spouse. If so, there would be no gain recognition on the sale (under §1041), but interest on the note would be taxable.[360] Furthermore, there is significant uncertainty regarding the effect of a subsequent divorce or death of a spouse.

2. Step 1: Can "Seeding" Be Provided by Guarantees? A guarantee by a beneficiary or a third party may possibly provide the appropriate seeding, sufficient to give the note economic viability. Beware that if the trust does not pay a fair price for the guarantee, the person giving the guaranty may be treated as making an indirect contribution to the trust, which might possibly result in the trust not being treated as owned wholly by the original grantor.[361]

Of particular concern is Letter Ruling 9113009. This letter ruling, initially raised concerns about the gift tax effects of loan guaranties made by the guarantor's children. While Letter Ruling 9113009 was withdrawn by Letter Ruling 9409018, which addressed only other issues requested in the original ruling request without mention of gift tax issues, the earlier ruling nevertheless provides the IRS's analysis of why gift guaranties may include gift elements. The IRS reasoned generally that the guaranty confers an economic benefit from date they are given and the promisor of a legally enforceable promise for less than adequate and full consideration makes a completed gift on the date the promise is binding and determinable in value rather than when the promised payment is actually made. The IRS's full analysis of this issue in Letter Ruling 9113009 is quoted in Section XVII.F of this outline *supra*.

Some commentators argue, however, that a beneficiary who guarantees an indebtedness of the trust is not making a gift until such time, if at all, that the guarantor must "make good" on the guarantee. (Otherwise, the beneficiary would be treated as making a gift to him or herself.)[362]

If the beneficiary has a real interest in the trust, and the beneficiary gives a guarantee to protect his or her own investment, the guarantee arguably is not a gift to the trust. The leading case is *Bradford v. Commissioner*,[363] in which the IRS acquiesced. (If the beneficiary is making a gift to the trust, the beneficiary is a grantor to that extent, and the trust is no longer

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[359] *Id.*

[360] *See* Gibbs v. Commissioner, T.C. Memo. 1997-196.

[361] For an outstanding discussion of the various issues regarding the need for seeding of the trust prior to a sale and of the implications of using guarantees, see Shenkman, *Role of Guarantees and Seed Gifts in Family Installment Sales,* 37 EST. PL. 3 (NOV. 2010).

[362] *See* Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts,* 92 J. TAX'N 152 (2000).

[363] 34 T.C. 1059 (1960)

a wholly grantor trust as to the original grantor, so there could be bad income tax consequences to the grantor of the trust as well as gift tax consequences to the person giving the guaranty.) The best analogy supporting that the beneficiary does not make a gift is in the life insurance area. There are various cases and acquiescences that if a beneficiary pays premiums to maintain the policy that is owned by a trust, that is not a gift to the trust. Indeed, that is an actual transfer, not just a guarantee.

The timing and amount of the gift from a beneficiary-guarantee, if any, is unclear.

> "Probably the closest commercial analogy is a bank's charge for a letter of credit. Generally, the bank makes an annual or more frequent charge for such a letter. By analogy, there will be an annual gift, probably in the range of one to two percent of the amount guaranteed, so long as the guarantee is outstanding. However, it may also be argued that a much larger, one-time taxable gift will occur at the inception of the guarantee, especially if the loan precludes prepayment. [Citing Rev. Rul. 94-25, 1994-1 C.B. 191.] The final possibility is that no gift will occur until a beneficiary actually has to make a payment under the guarantee. In this event, the measure of the gift will presumably be the amount of the payment under the guarantee. [Citing Bradford v. Commissioner, 34 T.C. 1059 (1960).]
>
> It is by no means a given that a guarantee by a beneficiary is a gift. Instead, the clear weight of authority seems to support the absence of any gift by the beneficiaries to the trust, at least where the guarantee is a bona fide obligation of the beneficiary making the guarantee, and where the beneficiary has sufficient net worth to make good on the guarantee in the event of a default by the trust."[364]

If the planner is squeamish about guarantees by beneficiaries, the trustee could pay an annual fee to the beneficiary in return for the guarantee.[365] Some planners report using a fee between 1-2%. Other planners suggest that the fee would typically be higher (about 3%). The 1-2% (or lower) fee for a typical bank letter of credit is based on having a pre-existing

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[364] Hatcher, *Planning for Existing FLPs,* 35 UNIV. OF MIAMI HECKERLING INST. ON EST. PL,, ¶302.3.B.2 (2001). *See* Hatcher and Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152 (March, 2000), which sets forth a detailed rebuttal of a taxable gift being imputed by reason of a bona fide, pro rata guarantee by a beneficiary of a defective grantor trust. Another favorable factor in avoiding a gift by a beneficiary-guaranty is where the upside potential from the beneficial interest of the guarantor-beneficiary is sufficient to warrant that guarantor-beneficiary take the downside risk posed by the guarantee.

[365] Unfortunately, there is no safe harbor for the amount to be paid for the guarantee. The safe harbor AFR rate under §1274 applies for intra-family loans, but there is no similar safe harbor for a guarantee fee.

See generally e.g. Shenkman, *Role of Guarantees and Seed Gifts in Family Installment Sales,* 37 EST. PL. 3, 16 (Nov. 2010)(excellent discussion of various approaches in determining appropriate fee, saying that some appraisers suggest guarantee fees in the range of 5% to 6%+ because of the nature of the underlying assets supporting the guarantee); Richard Oshins, *Leveraged Gifting Transactions in the New Millennium*, STATE BAR OF TEXAS ADVANCED ESTATE PLANNING STRATEGIES, ch.4 at 10 (2006) ("We take the conservative position and pay for the guarantee"); Hatcher, *Planning for Existing FLPs,* 35 UNIV. OF MIAMI HECKERLING INST. ON EST. PL., ¶302.3.B.2 (2001)(if IRS succeeds in treating guaranty as gift, by analogy to bank charge for a line of credit, annual gift would probably in the range of 1-2%, but a larger, one-time gift may occur at the inception of the guarantee, especially if the loan precludes prepayment).

relationship with a person who has substantial assets. The difficulty with paying a guaranty fee is determining what the correct amount of the fee. There may be a gift if no fee or if an insufficient fee is paid for the guarantee. (Some planners have reported using Empire Financial to value these guaranties.) One planning alternative is to file a non-transfer gift tax return reporting the guarantee transaction.

Thus, in summary, the safest course is to pay for the guarantee and the safer alternative if that is not done is to have the guarantee be made by a beneficiary rather than a third party.

3. Step 2. Sale for Installment Note; Appropriate Interest Rate. The individual will sell property to the grantor trust in return for an installment note for the full value of the property (taking into account appropriate valuation discounts). The note is typically secured by the sold asset, but it is a full recourse note. The note is often structured to provide interest only annual payments with a balloon payment at the end of the note term. The interest is typically structured to be equal to the §7872 rate. Often a longer term note is used to take advantage of the current extremely low AFRs for a number of years.. For December 2012 (when the §7520 rate for valuing GRAT annuity payments is 1.2%), the annual short-term (0-3 years) rate is 0.24%, the annual mid-term (over 3, up to 9 years) rate is 0.95%, and the long-term (over 9 years) rate is 2.40%. Typically, the note would permit prepayment of the note at any time without penalty. The note should be shorter than the seller's life expectancy in order to minimize risks that the IRS would attempt to apply §2036 to the assets transferred in return for the note payments.

Many planners are using long term notes (over 9 years) in light of the extremely low long term rate because the interest rate is still relatively low; but use a note term shorter than the seller's life expectancy. (The buyer could prepay the note if desired, but there would be the flexibility to use the low long term rate over the longer period.)

Some planners structure the transaction to leave time between the time of the "seed" gift and the subsequent sale, by analogy to the "real economic risk of a change in value" analysis in *Holman v. Commissioner.*[366] *Pierre v. Commissioner*[367] applied a step transaction analysis to aggregate the gift and sale portions of LLC interests that were transferred within 12 days of each other for valuation purposes. A possible concern (though the IRS has not made this argument in any reported case) is that the gift and sale may be aggregated and treated as a single transaction for purposes of applying §2036, which would mean that the sale portion

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[366] 120 T.C. 170 (2008), *aff'd on other grounds*, 603 F.3d 763 (8th Cir. 2010) (avoiding step transaction argument with respect to funding and gifts of interests in a family limited partnership); *see also* Heckerman v. U.S., 104 AFTR 2d 2099-5551 (W.D. Wash. 2009)(step transaction doctrine applied; funding and gift of LLC interest on same day). While the Ninth Circuit in *Linton v. U.S.*, 630 F.3d 1211 (9th Cir. 2011) held that the step transaction doctrine did not apply to treat a donor as giving assets in an LLC rather than (discounted) interests in the LLC where the funding and transfers of interests occurred on the same day, the court observed that a timing test does apply under *Holman* and remanded the case for consideration under that test.

Some respected planners suggest leaving as long as possible between the "seed" gift and the subsequent sale (e.g., 30, 60, 90 days or even wait until the following taxable year).

[367] T.C. Memo. 2010-106 (lack of control discount reduced from 10% to 8% because of aggregating gift and sale portions to treat the aggregate 50% LLC interests transferred to each of two separate trusts).

does not qualify for the bona fide sale for full consideration exception in §2036.[368]

Some planners have suggested taking the position that the lowest AFR in the month of a sale or the prior two months can be used in a sale to defective trust situation, relying on §1274(d). Section 1274(d) says that for any sale or exchange, the lowest AFR for the month of the sale or the prior two months can be used. However, relying on §1274(d) is problematic for a sale to a defective trust--because such a transaction, which is a "non-event" for income tax purposes, may not constitute a "sale or exchange" for purposes of §1274(d). The apparently unqualified incorporation of §1274(d) in §7872(f)(2) arguably gives some credibility to this technique. However, relying on a feature that depends on the existence of a "sale" as that word is used in §1274(d)(2) [in the income tax subtitle] in the context of a transaction that is intended not to be a "sale" for income tax purposes seems unwise.

Most planners use the applicable federal rate, under the auspices of §7872, as the interest rate on notes for intrafamily installment sales. Section 7872 addresses the gift tax effects of “below-market” loans, and §7872(f)(1) defines “present value” with reference to the “applicable Federal rate.” Using §7872 rates is supported by the position of the IRS in Tax Court cases and in several private rulings,[369] as discussed in Section XVIII.A. of this outline *supra*. However, the IRS could conceivably at some point take the position that a market interest rate should be used for sales.

4. <u>Step 3. Operation During Term of Note</u>. Hopefully the trust will have sufficient cash to make the interest payments on the note. If not, the trust could distribute in-kind assets of the trust in satisfaction of the interest payments. Payment of the interest, whether in cash or with appreciated property, should not generate any gain to the trust or to the grantor, because the grantor is deemed to be the owner of the trust for income tax purposes in any event.

Because the trust is a grantor trust, the grantor will owe income taxes with respect to income earned by the trust. Payment of those income taxes by the grantor is not an additional gift to the trust.[370] To the extent that the entity owned by the trust is making distributions to assist the owners in making income tax payments, the cash distributions to the trust could be used by the trust to make note payments to the grantor/seller, so that the grantor/seller will have sufficient cash to make the income tax payments.

Consider having the seller elect out of installment reporting. The theory is that the gain would then be recognized, if at all, in the first year, but there should be no income recognition in that year.[371] Death during a subsequent year of the note arguably would be a non-event for tax

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[368] See Section XIX.H.5 of this outline, *infra*.

[369] Frazee v. Commissioner, 98 T.C. 553 (1972); True v. Commissioner, T.C. Memo. 2001-67, *aff'd on other grounds,* 390 F.3d 1210 (10th Cir. 2004); Letter Rulings 9535026 & 9408018.

[370] Rev. Rul. 2004-64, 2004-2 C.B. 7.

[371] *See* Rev. Rul. 85-15, 1985-1 C.B. 132.

purposes. Some (probably most) commentators believe that installment reporting is not even available for sales to a grantor trust, because the transaction is a non-event for income tax purposes.

5. Step 4. Pay Note During Seller's Lifetime. Plan to repay the note entirely during the seller's lifetime. Income tax effects may result if the note has not been paid fully by the time of the seller's death. Income tax issues with having unpaid note payments due at the grantor's death and planning alternatives to avoid those issues are discussed in Section XIX.D.5 of this outline *infra*.

   The installment note could be structured as a self-canceling installment note ("SCIN") that is payable until the expiration of the stated term of the note or until the maker's death, whichever first occurs. SCIN transfers are discussed further in Section XX of this outline.[372]

6. Best Practices For Sales to Grantor Trusts, Particularly of Closely Held Business Interests.

   - A starting point is to create voting and non-voting units. One planner typically creates 999 non-voting shares for every 1 voting share. Non-voting shares can be transferred without fear of the client losing control of the business.
   - Gift of 10% and sale of 90%, leaving 1/9 ratio of equity to debt.
   - The installment sale allows tremendous leverage. For example, the client could make a gift of $5 million and then sell $45 million worth of closely held business interests.
   - Cash from investment assets or other assets could be used to make the gift to fund the initial equity of the trust. If possible, the gift should be cash rather than an interest in the entity that will be sold to the trust.
   - Make the gift to the trust a significant time before the sale (i.e., 30, 60 or 90 days, or even the prior taxable year).[373] John Porter suggests transferring an initial gift of cash to the trust—something other than the illiquid asset that will be sold to the trust—so that the cash is available to help fund note payments.
   - The key of using the installment sale is to get an asset into the trust that has cash flow. For example, if the business does not have cash flow, real estate that is used by the business but that is leased by the business from the business owner could be transferred to the trust because it does have cash flow.

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[372] For excellent discussions of the use of notes with self-cancelling features, including how to value such notes, see WOJNAROSKI, BNA EST. TAX PORT. 805-3RD, PRIVATE ANNUITIES AND SELF-CANCELING NOTES; Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. OF MIAMI HECKERLING INST. ON EST. PL. ¶ 1601.3.B (2000); Hayes, *Intra-Family Loans: Adventures in Forgiveness and Forgetfulness*, ABA REAL PROP., PROB. & TR. L. SECTION SPRING MEETING 41-50 (2007). A key advantage of SCINs is that the cancellation feature removes any remaining value on the note from the seller's gross estate for estate tax purposes. However, any remaining gain must be reported on the estate's fiduciary income tax return, at least under the position of the Eight Circuit. Estate of Frane v. Commissioner, 998 F.2d 567 (8th Cir. 1993).

[373] See the discussion of the *Holman*, *Heckerman*, *Linton*, and *Pierre* cases in Section XIX.A.3 of this outline, *supra.*

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- Cash flow from the business may be sufficient to assist making payments on the promissory note.
- Model anticipated cash flow from the business in structuring the note.
- For pass-through entities, cash distributed from the entity to owners so they can pay income taxes on the pass-through income will be distributed partly to the grantor trust as the owner of its interest in the entity; that cash can be used by the trust to make note payments; the grantor could use that cash to pay the income tax. This "tax distribution cash flow" may be enough to fund a substantial part of the note payments.
- The goal is to be able to pay off the note during the seller's lifetime.
- Lack of control and lack of marketability discounts would apply, based on the asset that is sold.
- Best practices for avoiding §2036, 2038 argument: Do not make entity distributions based on the timing and amount of note payments (make distributions at different times than when note payments are due and in different amounts than the note payments)(John Porter suggestion).
- Use a defined value clause to protect against gift consequences of the gift and sale of hard-to-value assets to the trust. (If a charitable entity is used for the "excess value" typically a donor advised fund from a Communities Foundation is used. It should act independently in evaluating the values. It should hire an appraiser to review the appraisal secured by the family. The donor advised fund will want to know an exit strategy for being able to sell any business interest that it acquires. An advantage of using a donor advised fund as compared to a private foundation is that it is not subject to the self-dealing prohibition, so the family is able to repurchase the business interest.)
- The interest rate is very low. For example, in February 2013 a nine-year note would have an annual interest rate of 1.01%. If there is a 30% discount, effectively the interest rate as compared to the underlying asset value is about 0.7%, so if the business has earnings/growth above that, there is a wealth shift each year.
- This approach takes advantage of opportunities that could be eliminated in the future – discounts, current large gift and GST exemption, and extremely low interest rates.

B. Basic Estate Tax Effects.

1. Note Includible In Estate. The installment note (including any accumulated interest) will be included in the grantor/seller's estate. There may be the possibility of discounting the note if the interest rate and other factors surrounding the note cause it to be worth less than face value. See Section XV of this outline *supra* regarding the possibility of discounting notes for estate tax valuation purposes.

2. Assets Sold to Trust Excluded from Estate. The asset that was sold to the trust will not be includible in the grantor's estate, regardless how long

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the grantor/seller survives. (There is some risk of estate inclusion if the note is not recognized as equity and if the grantor is deemed to have retained an interest in the underlying assets. The risk is exacerbated if a thinly capitalized trust is used – less than 10 percent equity.[374])

3. Grantor's Payment of Income Taxes. The grantor's payment of income taxes on income of the grantor trust further decreases the grantor's estate that remains at the grantor's death for estate tax purposes.

4. Question 12(e) on Form 706. A new question was added to Form 706 in October 2006 in Part 4, Question 12e.

   Question 12a asks "Were there in existence at the time of the decedent's death any trusts created by the decedent during his or her lifetime?"

   Question 12b asks: "Were there in existence at the time of the decedent's death any trusts not created by the decedent under which the decedent possessed any power, beneficial interest or trusteeship?"

   Question 12e asks: "Did decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in question 12a or 12b?"[375]

   This question underscores the advantage of reporting sales of discounted interests in closely-held entities on a gift tax return. Eventually the IRS will learn about this transaction. This Form 706 question applies retroactively to all transfers made by decedents filing the Form 706. Even so, some planners prefer not to report sales on a gift tax return. The taxpayer can obtain quality current appraisals. If the IRS contests the sales valuation when the seller dies years later, the IRS's appraisal prepared at that time (many years after the date of the sale) may have less credibility. In light of this proof issue, the likelihood of the IRS contesting the valuation years later may be significantly less than the likelihood of the IRS contesting the valuation currently if the sale is reported on a current gift tax return.

   Recognize that the Form 706 question only applies to transfers to trusts and not to transfers to individuals.

C. Basic Gift Tax Effects.

1. Initial Seed Gift. The grantor should "seed" the trust with approximately 10% of the overall value to be transferred to the trust by a combination of gift and sale. This could be accomplished with an outright gift when the grantor trust is created. Alternatively, the grantor trust could receive the

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[374] See Section XIX.G.1-2 of this outline *infra*.

[375] Interestingly, there seems to be a way around the question. The obvious way around this question, to stay "under the radar screen," would be to create the grantor trust, sell to the grantor trust, have the grantor trust pay off the note while it is still a grantor trust (so there is no income recognition) then terminate the trust before the decedent dies. The trust would not be described in Question 12a or b, so the answer to Question 12e would be no. That would seem to work if the client wants the trust to terminate during his or her lifetime. (But that is not practical in many situations.) Query whether having the trustee "decant" the assets to a new trust created by the trustee under a decanting power would avoid answering Question 12a in the affirmative?

Be careful in looking for technical ways to avoid this question. If the planner is "too clever," the IRS may say the planner is being misleading and allege a Circular 230 violation. Furthermore, even if the planner could avoid the current question, the IRS can change the form in the future in reaction to clever plans to avoid the question.

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remaining amount in a GRAT at the termination of the GRAT to provide seeding for a further installment sale.

2. <u>No Gift From Sale</u>. The sale to the trust will not be treated as a gift (assuming the values are correct, and assuming that there is sufficient equity in the trust to support valuing the note at its full face value.) There is no clear authority for using a valuation adjustment clause as exists under the regulations for GRATs.[376]

D. <u>Basic Income Tax Effects</u>.

1. <u>Initial Sale</u>. The initial sale to the trust does not cause immediate gain recognition, because the grantor is treated as the owner of the trust for income tax purposes.[377]

2. <u>Interest Payments Do Not Create Taxable Income</u>. Because the grantor is treated as the owner of the trust, interest payments from the trust to the grantor should also be a non-event for income tax purposes. (On the other hand, if there are sales between spouses, while there is no gain recognition on the sale under §1041, interest payments would constitute taxable income.[378])

3. <u>IRS Has Reconfirmed Informal Rulings That Using Crummey Trust Does Not Invalidate “Wholly Owned” Status of Grantor</u>. In order to avoid gain recognition on a sale to a grantor trust, the grantor must be treated as wholly owning the assets of the trust. Theoretically, this may be endangered if the trust contains a Crummey withdrawal clause. However, recent private letter rulings reconfirm the IRS’s position that using a Crummey clause does not endanger the grantor trust status as to the original grantor.[379]

4. <u>Grantor’s Liability for Ongoing Income Taxes of Trust</u>. The grantor will be liable for ongoing income taxes for the trust income. This can further reduce the grantor‘s estate for estate tax purposes and allow the trust to grow faster. However, the grantor must be willing to accept this liability. Giving someone the discretion to reimburse the grantor for paying

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[376] Treas. Reg. § 25.2702-3(b)(1)(ii)(B).

[377] Treas. Reg. §1.1001-2(c) Ex. 5, Rev. Rul. 85-13, 1985-1 C.B. 184 (to the extent grantor is treated as owner of trust, the trust will not be recognized as separate taxpayer capable of entering into a sales transaction with the grantor). In that ruling, the I.R.S. indicated that it would not follow *Rothstein v. U.S.*, 735 F.2d 704 (2nd Cir. 1984) to the extent it would require a different result. *See* Rev. Rul. 2007-13, 2007-1 C.B. 684 (Situation 1, of ruling reasons that the sale of a policy from one "wholly-owned" grantor trust to another "wholly-owned" grantor trust is not a transfer at all for income tax purposes because the grantor is treated as the owner of the assets of both trusts); Rev. Rul. 92-84, 1992-2 C.B. 216 (gain or loss on sale of asset by QSST, which is grantor trust, is treated as gain or loss of the grantor or other person treated as owner under the grantor trust rules and not of the trust, even if the gain or loss is allocable to corpus rather than to income).

[378] *See* Gibbs v. Commissioner, T.C. Memo. 1997-196.

[379] Ltr. Ruls. 200729005, 200729007, 200729008, 200729009, 200729010, 200729011, 200729013, 200729014, 200729015, 200729016, 200730011, 201235006.

Even if the trust does continue as a grantor trust as to the original grantor, it is not clear what happens at the grantor’s death and whether the trust becomes a grantor trust as to the Crummey beneficiary. Ltr. Rul. 9321050, revoking Ltr. Rul. 9026036 as to this issue. The IRS initially ruled that the beneficiary would be treated as the owner. Several years later, the IRS revoked that position and said the beneficiary would not be treated as the owner-with no further discussion.) At the grantor’s death, the trust may become a grantor trust as to the beneficiary, creating an extremely advantageous planning vehicle if the beneficiary also wishes to maximize transfer planning opportunities while still remaining a potential discretionary beneficiary of the trust.

income taxes of the trust may be an alternative.[380] (An additional possible alternative for the sale to grantor trust strategy is that if the grantor's spouse is a discretionary beneficiary of the trust, the trust could make a distribution to the spouse that would be sufficient to pay the income taxes that would be payable on the joint return of the grantor and the grantor's spouse.)

5. Seller Dies Before Note Paid in Full. If the seller dies before the note is paid off, the IRS may argue that gain recognition is triggered at the client's death. The better view would seem to be that gain recognition is deferred under §453 until the obligation is satisfied after the seller's death. The recipient of installment payments would treat the payments as income in respect of decedent. Presumably, the trustee would increase the trust's basis in a portion of the business interest to reflect any gain actually recognized.

The income tax effect on the trust if the grantor dies before the note is paid in full has been hotly debated among commentators.[381] A concern regarding the possibility of immediate recognition of income at death is that if grantor trust statute is terminated during the grantor's life while any part of the note is unpaid, the capital gain is accelerated and taxed immediately.[382] However, the result may be different following the death of the grantor. One of the articles addressing this issue provide the

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[380] Revenue Ruling 2004-64 held that the grantor's payment of income taxes attributable to a grantor trust is not treated as a gift to the trust beneficiaries. (Situation 1) Furthermore, the Ruling provides that a mandatory tax reimbursement clause would not have any gift consequences, but would cause "the full value of the Trust's assets" at the grantor's death to be included in the grantor's gross estate under section 2036(a)(1) because the grantor would have retained the right to have the trust assets be used to discharge the grantor's legal obligation. (Situation 2) (The statement that the "full value of the trust assets" would be includible may overstate the issue. Courts might limit the amount includible in the estate to the maximum amount that might possibly be used for the grantor's benefit at his or her death.) Observe that if a reimbursement is mandatory and it is not paid, the grantor will be treated as making a gift.

In addition, giving the trustee the discretion to reimburse the grantor for income taxes attributable to the grantor trust may risk estate inclusion if there were an understanding or pre-existing arrangement between the trustee and the grantor regarding reimbursement, or if the grantor could remove the trustee and appoint himself as successor trustee, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law. (Situation 3 of Rev. Rul. 2004-64) The Ruling provides that the IRS will not apply the estate tax holding in Situation 2 adversely to a grantor's estate with respect to any trust created before October 4, 2004. Some planners suggest allowing a third person to authorize the trustee to reimburse or to allow an independent trustee to reimburse the grantor for payment of income taxes attributable to the trust. Other planners suggest drafting the reimbursement clause to provide that the discretionary reimbursement power does not exist to the extent that it exposes the trust assets to claims of the grantor's creditors.

Some states are amending their laws to provide that the mere existence of a discretionary power by the trustee to reimburse the grantor for income taxes attributable to the trust will not give creditors access to the trust. TEX. PROP. CODE ANN. § 112.035(d) (Vernon 2004); N.H. STAT. ANN. § 564-B:5-505(a)(2)(2006). Where a discretionary reimbursement provision is used, the planner should select a state which has such a law to govern the trust.

[381] *Compare* Cantrell, *Gain is Realized at Death*, TR. & ESTS. 20 (FEB. 2010) and Dunn & Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, 95 J. TAX'N (July 2001) *with* Gans & Blattmachr, *No Gain at Death*, TR. & ESTS. 34 (Feb. 2010); Manning & Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements*, 24 TAX MGMT. EST., GIFTS & TR. J. 3 (1999); Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152, 161-64 (2000); Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (Sept. 2002).

[382] Madorin v. Commissioner, 84 T.C. 667 (1985) (trustee's renunciation of power to add charitable beneficiaries was a deemed disposition of trust assets and a realization event); Reg. §1.1001-2(c), Ex.5; Rev. Rul. 77-402, 1977-2 C.B. 222.

following arguments in its detailed analysis of why income should not be realized as payments are made on the note after the grantor's death.[383]

- No transfer to the trust occurs for income tax purposes until the grantor's death (because transactions between the grantor and the trust are ignored for income tax purposes.)
- There is no rule that treats a transfer at death as a realization event for income tax purposes, even if the transferred property is subject to an encumbrance such as an unpaid installment note.[384] However, the property does not receive a step up in basis because the property itself is not included in the decedent's estate.
- The note itself is included in the decedent's estate, and the authors argue that the note should be entitled to a step up the basis. A step up in basis is precluded only if the note constitutes income in respect to the decedent ("IRD") under §691. They argue that the note should not be treated as IRD because the existence, amount and character of IRD are determined as if "the decedent had lived and received such amount."[385] The decedent would not have recognized income if the note were paid during life,[386] so the note should not be IRD.
- This position is supported by the provisions of §§691(a)(4) & (5), which provide rules for obligations "reportable by the decedent on the installment method under section 453." The installment sale to the grantor trust was a nonevent for income tax purposes, and therefore there was nothing to report under §453.
- This position does not contradict the policy behind §691, because the income tax result is exactly the same as if the note had been paid before the grantor's death – no realization in either event.
- If the unpaid portion of the note were subject to income tax following the grantor's death, double taxation would result. The sold property, which is excluded from the grantor's estate, does not receive a stepped-up basis—so ultimately there will be an income tax payable when that property is sold.

One possible planning approach if the grantor does not expect to survive the note term is for the grantor to make a loan to the trust and use the loan proceeds to pay the installment note before the grantor's death. (A step transaction argument presumably could be avoided by having the trust borrow funds from someone other than the grantor to be able to pay off the note.)

Some authors have suggested a strategy they identify as "basis boosting."[387] If an individual sells assets to a grantor trust and the individual dies, most planners think gain should not be realized at death. But the answer is unclear. The authors suggest contributing other

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[383] Manning & Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements*, 24 TAX MGMT. EST., GIFTS & TR. J. 3 (1999)

[384] *See* Rev. Rul. 73-183, 1973-1 C.B. 364.

[385] I.R.C. § 691(a)(3).

[386] Rev. Rul. 85-13, 1985-1 C.B. 184.

[387] Dunn & Park, *Basis Boosting*, 146 TR. & EST. 22 (Feb. 2007).

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property to the grantor trust with basis sufficient to eliminate gains. Example: An individual sells an asset with a basis of 10 for note for 50. The asset appreciates to 100 before the grantor dies. The potential gain would be 50 minus 10 or 40 when the trust is no longer a grantor trust. If the grantor contributes additional assets to the grantor trust with a basis of 40, that basis could be applied and offset the gain. However, it is not yet clear that this will work. The amount realized from the relief of liability (50 in the example) might have to be allocated between the two assets. If one must allocate the amount deemed realized between the two assets, the gain would not be totally eliminated.

The result might be better if the two assets are contributed to a partnership or LLC, which would require having another partner or member to avoid being treated as a disregarded entity. There would seem to be a stronger argument that there would be no apportionment of the amount realized between the two classes of assets in that situation.

Chief Counsel Advice 200923024 concluded that a conversion from nongrantor to grantor trust status is not a taxable event (addressing what seems to be an abusive transaction). An interesting statement in the CCA is relevant to the commonly asked question of whether there is gain recognition on remaining note payments at the death of the grantor if the grantor has sold assets to a grantor trust for a note. In addressing the relevance of the authorities suggesting that a taxable event occurs if the trust loses its grantor trust status during the grantor's lifetime, the CCA observed:

> "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner ***which is generally not treated as an income tax event."***[388]

6. <u>Basis; Limitation of Basis for Loss Purposes</u>. The basis of a gifted asset under Section 1015 is the donor's basis, except that for loss purposes, the basis is limited to the asset's fair market value at the time of the gift. There is no clear answer as to the basis of assets given to a grantor trust is limited to the asset's fair market value for loss purposes (if the donor's basis exceeds the fair market value). One commentator takes the position that the loss limitation does not apply to gifts to a grantor trust.[389]

7. <u>Gift Tax Basis Adjustment</u>. If a donor makes a gift to the grantor trust in order to "seed" an installment sale, and if the donor has to pay gift tax with respect to the initial gift, can the trust claim a basis adjustment under §1015(d) for the gift tax paid? There is no definitive authority as to whether the basis adjustment is authorized, but there would seem to be a good-faith argument that the gift-tax paid basis adjustment should be permitted even though the gift was to a grantor trust.

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[388] CCA 200923024 (emphasis added).

[389] Schneider, Determining the Income Tax Basis of Property Gratuitously Transferred to Grantor Trusts, AMER. BAR. ASSN. REAL PROP. TR. & EST. LAW SECTION NEWSLETTER, available at **http://www.americanbar.org/content/dam/aba/publishing/rpte_ereport/TE_Schneider.authcheckdam.pdf**.

E. Generation-Skipping Transfer Tax Effects. Once the trust has been seeded, and GST exemption has been allocated to cover that gift, no further GST exemption need be allocated to the trust with respect to the sale (assuming that it is for full value). A potential risk, in extreme situations, is that if the sold asset is included in the transferor's estate under §2036, no GST exemption could be allocated during the ETIP.

F. Advantages of Sale to Grantor Trust Technique.

1. No Survival Requirement; Lock in Discount. The estate freeze is completed without the requirement for survival for a designated period.

   A corollary of this advantage is that the discount when selling a partial interest is locked in as a result of the sale. For example, if a client owns 100% of an entity and sells one-third of the entity to each of three trusts, with the one-third interests being valued as minority interests,[390] the discount amount is removed from the client's estate regardless when the person dies. If the sale had not occurred and the client owned the 100% interest at his or her death, no minority discount would be available.

2. Low Interest Rate. The interest rate on the note can be based on the §7872 rate (which is based on the relatively low interest rates on U.S. government obligations). However, the IRS could conceivably at some point take the position that a market interest rate should be used for sales.

3. GST Exempt. The sale can be made to a GST exempt trust, or a trust for grandchildren, so that all future appreciation following the sale will be in an exempt trust with no need for further GST exemption allocation.

4. Interest-Only Balloon Note. The installment note conceivably can be structured as an interest only-balloon note. (With a GRAT, the annuity payments cannot increase more than 120% in any year, requiring that substantial annuity payments be paid in each year.) However, the planner must judge, in the particular situation, if using an interest-only balloon note might raise the risk of a §2036 challenge by the IRS. It would seem that a §2036 challenge is much less likely if the transaction looks like a traditional commercial transaction. (Another aspect of avoiding §2036 is that the trust should not as a practical matter simply use all of its income each year to make note payments back to the seller.) While there is no requirement that even the interest be paid currently, it "may be most commercially reasonable to require the payment of interest at least annually … even if all principal balloons at the end."[391]

5. Income Tax Advantages. The estate freeze is completed without having to recognize any income tax on the sale of the assets as long as the note is repaid during the seller's lifetime. In addition, the interest payments will not have to be reported by the seller as income.

G. Risks.

1. Treatment of Note as Retained Equity Interest, Thus Causing Estate Inclusion of Transferred Asset. Under extreme circumstances, it is possible that the IRS may take the position that the note is treated as a

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[390] *See* Rev. Rul. 93-12, 1993-1 C.B. 202.

[391] Aucutt, *Installment Sales to Grantor Trusts*, ALI-CLE PLANNING TECHNIQUES FOR LARGE ESTATES 1203, 1244 (April 2012).

retained equity interest in the trust rather than as a mere note from the trust. If so, this would raise potential questions of whether some of the trust assets should be included in the grantor's estate under §2036 and §2702. It would seem that §2036 (which generally causes estate inclusion where the grantor has made a gift of an asset and retained the right to the income from that asset) should not apply to the extent that the grantor has sold (rather than gifted) the asset for full market value.[392]

If the note that is received from the trust is treated as debt rather than equity, the trust assets should not be included in the grantor/seller's gross estate under §2036. This means that the analysis of whether the note is treated as debt or as a retained equity interest is vitally important. This issue is addressed in detail in Section II of this outline *supra*. A number of cases have highlighted a variety of factors that are considered.[393]

One Technical Advice Memorandum concluded that §2036 did apply to property sold to a grantor trust in return for a note, based on the facts in that situation.[394]

Analogy to private annuity cases would suggest that §2036 should not typically apply to sale transactions. For example, the Supreme Court refused to apply the predecessor of §2036 to the assignment of life insurance policies coupled with the retention of annuity contracts, because the annuity payments were not dependent on income from the transferred policies and the obligation was not specifically charged to those policies.[395] Various cases have followed that approach (in both income and estate tax cases).[396]

One commentator has suggested that there is a significant risk of §2036(a)(1) being argued by the IRS if "the annual trust income does not exceed the accrued annual interest on the note."[397] Much of the risk of estate inclusion seems tied to the failure to have sufficient "seeding" of equity in the trust prior to the sale.

John Porter reports that he has several cases in which the IRS is taking the position that notes given by grantor trusts in exchange for partnership interests should be ignored, based on the assertion that the "economic realities of the arrangement … do not support a part sale," and that the full value of the partnership interest was a gift not reduced by any portion of the notes. (This position conflicts with Treas. Reg. § 25.2512-

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[392] *See* Letter Rulings 9436006 (stock contributed to grantor trust and other stock sold to trust for 25-year note; ruling holds §2702 does not apply); 9535026 (property sold to grantor trust for note, interest-only AFR rate for 20 years with a balloon payment at end of 20 years; held that the note is treated as debt and "debt instrument is not a 'term interest' within the meaning of §2702(c)(3);" specifically refrained from ruling on § 2036 issue).

[393] *E.g.*, Miller v. Commissioner, 71 T.C.M. 1674 (1996), *aff'd*, 113 F.3d 1241 (9th Cir. 1997); Estate of Rosen v. Commissioner, T.C. Memo. 2006-115.

[394] Tech. Adv. Memo. 9251004 (transfer of $5.0 million of stock to trust in return for $1.5 million note in "sale/gift" transaction; ruling held that §2036 applies to retained right to payments under note, reasoning that note payments would constitute a major share, if not all, of the trust income, thus causing inclusion of trust property in estate).

[395] Fidelity-Philadelphia Trust v. Smith, 356 U.S. 274, 277 (1958).

[396] For a listing of cases that have addressed the application of §2036 in the context of private annuity transactions where are the grantor is retaining the right to receive substantial payments from a trust, see Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV OF MIAMI HECKERLING INST. ON EST. PL. ¶ 1601.1 n. 55 (2000).

[397] U.S. TRUST, PRACTICAL DRAFTING 4365-4370, at 4367 (Covey, ed. Apr. 1996).

a, which provides that transfers are treated as gifts "to the extent that the value of the property transferred by the donor exceeds the value in money or money's worth of the consideration given therefore.")[398]

If the note term is longer than the seller's life expectancy, the IRS would have a stronger argument that §2036 applies.

The IRS has questioned the validity of a sale of limited partnership interests to a grantor trust in the *Karmazin* case,[399] (discussed below) which was settled in a manner that recognized the sale. The IRS argued, among other things, that commercial lenders would not make similar loans because the nine-to-one debt/equity ratio was too high, there was insufficient security (no guarantees were used in that transaction), and there was insufficient income to support the debt.

Practical Planning Pointers: Ron Aucutt summarizes planning structures to minimize the estate tax risk.

> "The reasoning in *Fidelity-Philadelphia Trust* suggests that the estate tax case is strongest when the following features are carefully observed:
>
> a. The note should be payable from the entire corpus of the trust, not just the sold property, and the entire trust corpus should be at risk.
>
> b. The note yield and payments should not be tied to the performance of the sold asset.
>
> c. The grantor should retain no control over the trust.
>
> d. The grantor should enforce all available rights as a creditor."[400]

2. Risks of Thin Capitalization. The same commentator summarizes the possible risks of thin capitalization as follows:

> "a. includibility of the gross estate under section 2036,
>
> b. a gift upon the cessation of section 2036 exposure,
>
> c. applicability of section 2702 to such a gift,
>
> d. the creation of a second class of equity in the underlying property with possible consequences under section 2701,
>
> e. possible loss of eligibility of the trust to be an S Corporation,
>
> f. treatment of the trust as an association taxable as a corporation,
>
> g. continued estate tax exposure for three years after cessation of section 2036 exposure under section 2035, and
>
> h. inability to allocate GST exemption during the ensuing ETIP.

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[398] Porter, *Current Valuation Issues*, AICPA ADV. EST. PL. CONF. ch. 42 at 51 (2004).

[399] T.C. Docket No. 2127-03, filed Feb. 10, 2003.

[400] Aucutt, *Installment Sales to Grantor Trusts*, ALI-ABA PLANNING TECHNIQUES FOR LARGE ESTATES 1579, 1631 (Oct. 2011).

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> The section 2036 problem may go away as the principal on the note is paid down, or as the value of the purchased property (the equity) appreciates, but the ETIP problem would remain."[401]

The risks of thin capitalization were highlighted in *Karmazin v. Commissioner*,[402] in which the IRS made a number of arguments to avoid respecting a sale of limited partnership units to a grantor trust, including §2701 and 2702. The IRS argued that the note in the sale transaction involved in that case should be treated as debt rather than equity for various reasons, including that (i) the only assets owned by the trust are the limited partnership interests, (ii) the debt is non-recourse, (iii) commercial lenders would not enter this sale transaction without personal guaranties or a larger down payment, (iv) a nine-to-one debt equity ratio is too high, (v) insufficient partnership income exists to support the debt.

Another potential risk of thin capitalization that is rarely mentioned is the risk of having the trust treated as an association, taxable as a corporation. The planners involved in securing Letter Ruling 9535026 indicate that the IRS required having a 10% equity interest to avoid association status in that situation.

3. <u>Potential Gain Recognition if Seller Dies Before Note Paid</u>. There is potential gain recognition if the seller dies before all of the note payments are made. The IRS may argue that the gain is accelerated to the moment of death. It would seem more likely that the gain should not be recognized until payments are actually made on the note. Credible arguments can be made for no income realization either during or after the grantor's death, as discussed in Section XIX.D.5 of this outline *supra*.

4. <u>Valuation Risk</u>. If the IRS determines that the transferred assets exceed the note amount, the difference is a gift. There is no regulatory safe harbor of a "savings clause" as there is with a GRAT. One way that might reduce the gift tax exposure risk is to describe the amount transferred in the sale transaction using a "defined value" formula approach,[403] as discussed in Section XIX.I of this outline, *infra*.

5. <u>Volatility Risk</u>. If the asset that is sold to the trust declines in value, the trust still owes the full amount of the note to the grantor. Thus, any equity that had been gifted to the trust prior to the sale could be returned to the donor or included in the donor's estate. Furthermore, if beneficiaries or others give guaranties to provide the 10% "seeding," the guarantors will have to pay the guaranteed amount to the trust if the trust is otherwise unable to pay the note.

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[401] *Id*. at 1633.

[402] T.C. Docket No. 2127-03, filed Feb. 10, 2003.

[403] Cases that have approved defined value formula allocation transfers for federal gift and estate tax purposes are McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006), *rev'g*, 120 T.C. 358 (2003); Christiansen v. Commissioner, 130 T.C. 1, 16-18 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009)(formula disclaimer that operated like defined value clause); Petter v. Commissioner, T.C. Memo. 2009-280, *aff'd,* 653 F.3d 1012 (9th Cir. 2011); Hendrix v. Commissioner, T.C. Memo. 2011-133. One case has approved a straightforward formula transfer clause, not involving an excess amount over a defined value passing to charity. Wandry v. Commissioner, T.C. Memo. 2012-88. These cases are addressed in Section XIX.I of this outline, *infra.*

Realize that equity contributed to a grantor trust is really at risk. Also, appreciation in the grantor trust is at risk if there is a subsequent reversal before the note is repaid. If the trust is used for new purchases, that can have great benefit – but it also has risks.

H. Summary of Note Structure Issues.

1. Term of Note. The term of the note usually does not exceed 15-20 years, to ensure treatment of the note as debt rather than a retained equity interest. The term of the note should be less than the grantor's life expectancy (whether or not a SCIN is used).

2. Interest Rate. The §7872 rate is typically used. However, the IRS could conceivably at some point take the position that a market interest rate should be used for sales.

3. Timing of Payments. The note typically calls for at least having the interest paid currently (annually or semi-annually). While there is no absolute requirement to have interest paid currently, doing so makes the note appear to have more "commercial-like" terms than if interest merely accrues over a long term.

4. Security. Using a secured note is permissible. In fact, having security for the note helps ensure that the value of the note equals the value of the transferred property.

5. Timing of Sale Transaction. If the gift to the trust and the subsequent sale occur close to each other, the IRS might conceivably attempt to collapse the two steps and treat the transaction as a part-sale and part-gift. However, that would not seem to change the overall result. Some planners structure the transaction to leave time between the time of the seed gift and the subsequent sale, by analogy to the "real economic risk of a change in value" analysis in *Holman v. Commissioner*.[404] (Conceivably, the IRS might argue that the combined transaction is a transfer with retained interest that is not covered by the bona fide sale for full consideration exception in §2036 because of the gift element of the combined transaction. However, there are no reported cases where the IRS has taken that position based on gifts and sales within a short period of time of each other.)

6. Defined Value Transfer. The amount transferred might be described by a defined value. See Section XIX.I. of this outline, *infra.*

7. Crummey Clause. To be totally conservative and assure that the trust is treated as a grantor trust as to the original grantor, consider not using a Crummey clause. However, the IRS has ruled numerous times that using a Crummey clause does not convert the trust to being partially a grantor trust as to the beneficiary rather than as to the owner.[405]

8. Entire Corpus Liable for Note. The entire corpus of the trust should be liable for the note, not just the property sold in return for the note.

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[404] 130 T.C. 170 (2008), *aff'd on other grounds*, 601 F.3d 763 (8th Cir. 2010) (avoiding step transaction argument with respect to funding and gifts of interests in a family limited partnership). For a further discussion of *Holman* and other relevant cases, see Section XIX.A.3 of this outline, *supra.*

[405] See Section XIX.D.3 of this outline *supra*.

9. Payments Not Based on Performance of Sold Asset. The amount and timing of payments should in no way be tied to the performance of the sold asset—or else the note has the appearance of being a retained equity interest in the property itself.

10. No Retained Control Over Sold Asset. The grantor should retain no control over the sold asset. The risk of inclusion under §2036, in a situation where the grantor is retaining payments from the transferred property, is exacerbated if the grantor also has any control over the transferred property.

11. Payments Less Than Income From Sold Asset. Preferably, the required ongoing note payments would be less than the income produced by the sold assets. Furthermore, the trust should not routinely make prepayments to distribute all trust income to the grantor as note payments.

12. Ability to Make Payments. The trust should have sufficient assets to make principal and interest payments as they become due.

13. Reporting. The existence of the notes should be reflected on financial statements and interest income and expenses must be property reported.

14. Whether to Report Sale Transactions on Gift Tax Returns. Various planners typically have not reported sales on gift tax returns. However, they must rethink that position in light of the Question 12(e) on Form 706 about whether the decedent ever sold an interest in an entity to certain types of trusts. Some planners trend toward reporting sale transactions in most circumstances, but not all.[406] If the planner decides to report the transaction, how much should be disclosed? Many planners attach copies of all of the sale documents, including any sales agreement, transfer documents, notes, security agreements, deeds of trust, UCC filings, etc. Disclosing all of that information illustrates that the transaction was treated and documented as an arms' length commercial transaction. Some attorneys also report adding to the disclosure a statement that the return and all attachments, taken together, are intended to satisfy the requirements of the adequate disclosure regulations. The intent is to communicate that the planner is ready in case the case is selected for audit.

15. Downpayment. Some attorneys prefer giving cash to comprise the "10% gift element" in order to stay under the IRS's radar screen. If a partnership interest is given to the trust, the box on Schedule A must be checked on the gift tax return (Form 709) reflecting that the asset was valued with a discount. (That may have been what triggered the audit that resulted in the *Karmazin* lawsuit, discussed in Sections II.C and XIX.G.2 of this outline *supra*.)

16. Underwater Sales. If at some point after the transaction, the value of the trust assets is less than the amount of the debt, the transaction may need to be revisited. Alternative approaches include:

    (a) renegotiating the interest rate if the AFR has become lower;

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[406] See Section XIX.B.4 of this outline, *supra*.

(b) renegotiating the principal amount of the note (but why would the grantor renegotiate for a lower principal payment?; there seems to be no advantage to the grantor unlike the typical bank renegotiation in which the bank may renegotiate in order to receive some upfront payment or more favored position; the trust has nothing "extra" to grant to the grantor in a renegotiation; this approach seems risky);

(c) have the grantor sell the note from the original grantor trust that purchased the asset to a new grantor trust (the note would presumably have a lower value than its face value; any appreciation above that value would inure to the benefit of Trust 2 even though Trust 1 ends up having to pay all of its assets on the note payments; a big disadvantage is that the new trust would have to be "seeded" and the value of the underlying asset could decrease even further so that the seeding to Trust 2 would be lost as well); or

(d) the grantor could contribute the note from the grantor trust to a new GRAT (future appreciation would inure to the benefit of the GRAT remaindermen but there would be no new "seeding" requirement which could be lost as well if there were more deprecation in the value of the underlying assets).[407]

17. <u>One Planner's Suggested Approach</u>.

- Cash gift of 10%
- Sale of assets, so that the sale portion and gift portion are in a 90/10 ratio.
- Do not report the sale on an income tax return.[408]
- Generally do not get a separate tax ID number for the grantor trust, but follow the procedures of Regulation §1.671-4(b).
- If the plan is to keep the trust in existence until the grantor's death (for example if it is a GST exempt trust), consider reporting the sale on a gift tax return. There may be lower odds of a gift tax audit than of an estate tax audit—although that may be changing in light of the increased estate tax exemption.[409]
- The general preference is to use sale to grantor trusts rather than GRATs for business interests, because a longer term is needed to make the payments out of the business's cash flow. (That planner tends to use 2-year GRATs for publicly traded securities.)

I. <u>Defined Value Structures</u>. As discussed above, a valuation risk is that a gift may result if the IRS determines that the value of the transferred asset exceeds the

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[407] *See* Hatcher, *Underwater GRATs and ISGTs,* ACTEC 2008 SUMMER MEETING.

[408] Treas. Reg. § 301.6501(c)-1(f)(4) provides that

> "[c]ompleted transfers to members of the transferor's family, as defined in section 2032A(e)(2), that are made in the ordinary course of operating a business are deemed to be adequately disclosed …, even if the transfer is not reported on a gift tax return, provided the transfer is property reported by all parties for income tax purposes."

The regulations give, as an example, the payment of compensation to a family member. The transfer of an interest in a business, however, would not be "made in the ordinary course of operating a business" and would not seem to be within the exception.

[409] For a discussion of whether to report sales on gift tax returns as non-gift transactions, see Section XIX.B.4 of this outline, *supra.*

consideration given in the sale transaction. One way that might reduce the gift tax exposure risk is to use a defined value clause—defining the amount transferred by way of a fractional allocation between an (1) irrevocable trust and (2) a charity (or the transferor's spouse, a QTIP Trust or a GRAT—some person or entity to which the transfer would not generate gift taxes). The IRS does not recognize defined value clauses, on public policy grounds but several cases have now rejected that argument where the "excess amount" passes to charity.[410] Some of the cases have directly involved sales to grantor trusts.

Petter v. Commissioner[411] involved classic inter vivos gifts and sales to grantor trusts using defined value clauses that had the effect of limiting gift tax exposure. The gift document assigned a block of units in an LLC and allocated them first to the grantor trusts up to the maximum amount that could pass free of gift tax, with the balance being allocated to charities. The sale document assigned a much larger block of units, allocating the first $4,085,190 of value to each of the grantor trusts (for which each trust gave a 20-year secured note in that same face amount) and allocating the balance to charities. The units were initially allocated based on values of the units as provided in an appraisal by a reputable independent appraiser. The IRS maintained that a lower discount should be applied, and that the initial allocation was based on inappropriate low values. The IRS and the taxpayer eventually agreed on applying a 35% discount, and the primary issue was whether the IRS was correct in refusing on public policy grounds to respect formula allocation provisions for gift tax purposes. The court held that the formula allocation provision did not violate public policy and allowed a gift tax charitable deduction in the year of the original transfer for the full value that ultimately passed to charity based on values as finally determined for gift tax purposes.

Similarly, *Hendrix v. Commissioner*[412] involved combined gifts and sales using defined value formula clauses. Parents transferred stock in a closely-held S corporation to trusts for their daughters and descendants and a charitable donor advised fund, to be allocated between them under a formula. The formula provided that shares equal to a specified dollar value were allocated to the trust and the balance of the shares passed to the charitable fund. The trust agreed to give a note for a lower specified dollar value and agreed to pay any gift tax attributable to the transfer. Under the formula, the values were determined under a hypothetical willing buyer/willing seller test. The transfer agreement provided that the transferees were to determine the allocation under the formula, not the parents.[413] The court recognized the effectiveness of the transfers of defined values under the formulas.[414]

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[410] McCord v. Commissioner, 461 F.3d 614 (5th Cir. 2006)(public policy issue not before court), *rev'g*, 120 T.C. 358 (2003); Christiansen v. Commissioner, 130 T.C. 1, 16-18 (2008), *aff'd*, 586 F.3d 1061 (8th Cir. 2009)(formula disclaimer that operated like defined value clause); Petter v. Commissioner, T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011); Hendrix v. Commissioner, T.C. Memo. 2011-133.

[411] T.C. Memo. 2009-280, *aff'd*, 653 F.3d 1012 (9th Cir. 2011).

[412] T.C. Memo. 2011-133.

[413] The trust obtained an appraisal of the shares and the charitable fund hired independent counsel and an independent appraiser to review the original appraisal. The trust and charitable fund agreed on the stock values and the number of units that passed to each. (This description is simplified; in reality, each of the parents entered into two separate transfer transactions involving a "GST trust" and an "issue trust" and the same Foundation using this formula approach.)

[414] As to the public policy argument, the court determined that the formula clauses do not immediately and severely frustrate any national or State policy. The *Procter* case was distinguished because there is no condition subsequent that would defeat the transfer and the transfers further the public policy of encouraging gifts to charity. The court observed

One case has approved a straightforward defined value gift assignment of a dollar amount of LLC units that did not involve a charitable transfer.[415] A similar structure conceivably could be structured in a sale transaction, by providing that only a defined value of assets are sold in the sale transaction in return for the note given as consideration, if the rationale of that case is accepted by other courts.

Another possible “defined value” approach to avoid (or minimize) the gift risk is to provide in the trust agreement that any gift before Date 1 passes to a gift trust. The initial “seed gift” to the trust would be made before that date. The trust would say that any gift after that date goes 10% to a completed gift trust and 90% to incomplete gift trust. If a court ultimately determines that the note does not equal the full value of the asset that is sold to the trust, 90% of the gift element would pass to an incomplete gift trust, and there would be no immediate gift taxation on that portion.

Another possibility is to use a disclaimer even for a sale to grantor trust. The trust would specifically permit a trust beneficiary to disclaim any gift to the trust and the trust would provide that the disclaimed asset passes to a charity or back to the donor or to some other transferee that does not have gift tax consequences. After a sale to the trust, the beneficiary would disclaim by a formula: “To the extent any gift made by father to me, I disclaim 99% of the gift.”

If the sale is made to a grantor trust for the client that is created by the client’s spouse, an advantage is that the client could be given a power of appointment. If the sale results in a gift element, it would be an incomplete gift. That portion of the trust would continue to be included in the grantor ‘s estate, but the client would have achieved the goal of transferring as much as possible as the lowest possible price without current gift tax exposure. Gain would not be recognized on the sale, but a downside to this approach is that the selling spouse would recognize interest income when the spouse’s grantor trust makes interest payments.[416]

XX. SCINs

A. Overview. A potential disadvantage of a basic intra-family installment sale or sale to a grantor trust is the potential inclusion, in the seller’s estate, of the unpaid obligation at its fair market value on the date of the seller’s death. One way to avoid this problem is to use a self-canceling installment note (SCIN), a debt obligation containing a provision canceling the liability upon the death of the holder.[417]

If the holder dies prior to the expiration of the term of the SCIN, the automatic cancellation feature may operate to remove a significant amount of assets from what would otherwise be includible in the estate of the holder. This feature can also be useful if the seller does not want to burden the purchaser with the continued obligation to make payments after the seller’s death.

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that there is no reason to distinguish the holding in *Christiansen v. Commissioner,* 130 T.C. 1 (2008), *aff’d,* 586 F.3d 1061 (8th Cir. 2009) that similar formula disclaimers did not violate public policy.

[415] Wandry v. Commissioner, T.C. Memo. 2012-88. *Wandry* arguably is inconsistent with *Procter v. Commissioner,* 142 F.2d 824 (4th Cir. 1944).

[416] Gibbs v. Commissioner, T.C. Memo. 1997-196.

[417] This Section XX of this outline is based on (and taken largely verbatim from) an outstanding article by Philip J. Hayes (San Francisco). Hayes, *Intra-Family Loans: Adventures in Forgiveness and Forgetfulness,* ABA REAL PROP., PROB. & TR. L. SECTION SPRING MEETING (2007).

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Planning with SCINs followed the seminal case of *Estate of Moss v. Commissioner.*[418] The Tax Court held that the remaining payments that would have been due following the maker's death under a SCIN was not includable in the decedent's gross estate under § 2033 because "[t]he cancellation provision was part of the bargained for consideration provided by decedent for the purchase of the stock" and as such "it was an integral provision of the note."[419]

The potential advantages of using SCINs for estate tax savings may be further enhanced by "backloading" the payments. That may result in a significantly smaller amount being paid to the seller during life and with a greater amount being cancelled, thus resulting in exclusion of more value from the seller's gross estate.[420] A potential disadvantage of the SCIN transaction is that if the seller outlives his or her life expectancy, the premium that is paid for the cancellation feature may result in more value being included in the seller's estate than if the cancellation provision had not been used.

As discussed below, the SCIN transaction works best when the seller/client dies prior to, and "preferably" materially prior to, his or her actuarial life expectancy. The ideal candidate is someone in poor health, but whose death is not imminent, or someone with a very poor family health history. As with all sophisticated tax planning strategies, the SCIN is not for all clients or all situations, especially since clients' actual life expectancies are never truly known in advance.

There are also numerous issues concerning the technique which have not yet been fully resolved. In addition to the obvious mortality issue, there are questions as to what base rates should be used (the Section 7520 rate or the AFR?), what life expectancies should be used (the tables used under Section 7520, the tables used under Section 72, or the seller's actual life expectancy?), how the payments should be allocated for income tax purposes (what amounts are return of basis, interest, and gain?) and the effect of the cancellation of the note upon the seller's death for income tax purposes (is the cancellation a taxable event for the debtor?).

In any event, the use of SCINs adds a whole new dimension of tax uncertainties and complexities.[421]

B. Note Terms.

1. Interest Rate. Although it is tempting to apply the below-market safe harbor of §7872 (and, arguably, §1274 (d)), there is an additional element at work with the SCIN that makes it advisable to structure the SCIN so that the value of the SCIN is at least equal to the value of the property sold.

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[418] 74 T.C. 1239 (1980), *acq. in result*, 1981-1 C.B. 2.

[419] *Id.* at 1246-47.

[420] See Section XX.I.1.d of this outline, *infra*.

[421] For an outstanding comprehensive discussion of the use of SCINs, including their valuation and tax treatment, see WOJNAROSKI, BNA EST. TAX PORT. 805-3RD, PRIVATE ANNUITIES AND SELF-CANCELING NOTES. For a discussion of planning alternatives, including the relative low mortality premium that exists under current conditions, see Maher & Laffey, *Practical Planning With Self-Cancelling Installment Notes*, TRSTS. & ESTS. 22 (April 2012).

For the value of the SCIN to equal the value of the property sold, the seller of the property must be compensated for the risk that the seller may die during the term of the note, and thus not receive the full purchase price. Since such a feature must be bargained for at arm's length to be respected, the seller must be compensated for the risk associated with the potential cancellation either by an increase in the purchase price or by a higher interest rate.[422] To calculate the premium, an advisor must determine what stream of payments are required, taking into consideration the possible death of the seller, to have the same present value as the principal amount of the promissory note.[423] There is not universal agreement on how payments under a SCIN are properly valued, for there is no clear answer concerning which mortality tables should be used and which discount rate should be applied to value the payments. Some commentators use the life expectancies in Table 90CM for May 1999-April 2009 and Table 2000CM from May 2009 forward[424] and a rate equal to the greater of 120% of the mid-term AFR, assuming annual payments, as prescribed by §7520, or the AFR for the actual term of the note, as prescribed by Section 7872.[425] Others use the annuity tables under §72[426] and the AFR as prescribed by §7872.[427] Additionally, some commentators have recommended that the actual life expectancy be used.[428]

While an advisor could determine these payment streams and resulting rates manually, or by use of a computer program, some commentators recommend that an actuary be employed.[429]

Although the matter is by no means free from doubt, some commentators are persuaded by the well-reasoned approach of *Hesch and Manning*. The §7872 AFRs are, more likely than not, appropriate, and the examples used in regard to SCINs will generally use AFRs, not §7520 rates. Nonetheless, AFRs should not be used by the faint of heart. A conservative planner probably should use the higher of the §7520 rate or the AFR for the actual term of the note, as recommended by *Covey*. Clearly, many, if not most, practitioners are using the higher of the §7520 rate or the AFR for the actual term of the note;, the estate tax risk of using a rate that is too low is simply too great.

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[422] *See* Banoff & Hartz, *Self-Canceling Installment Notes: New IRS Rules Expand Opportunities*, 65 J. TAX'N 146 (1986).

[423] *See* Covey, et al. *Q&A Session I of the Twenty-Seventh Annual Institute on Estate Planning*, 27 U. MIAMI INST. ON EST. PLAN. ¶216 (1993).

[424] Treas. Reg. § 20.2031-7(d)(7); IRS Publication 1457, *Actuarial Valuations Book Aleph* (July 1999)(Table 90CM); IRS Publication 1457, *Actuarial Valuations Version 3A* (May 2009)(Table 2000CM).

[425] *Id*. *See* Covey, et al. *Q&A Session I of the Twenty-Seventh Annual Institute on Estate Planning*, 27 U. MIAMI INST. ON EST. PLAN. ¶216 (1993).

[426] Treas. Reg. § 1.72-9, Table V.

[427] *See* Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. MIAMI HECKERLING INST. ON EST. PL.,¶ 1601.3.B(1)-(2) (2000).

[428] *See* Banoff & Hartz, *Sales of Property: Will Self-Canceling Installment Notes Make Private Annuities Obsolete?*, 59 TAXES 499, 515 (1981).

[429] *See* Covey, et al. *Q&A Session I of the Twenty-Seventh Annual Institute on Estate Planning*, 27 U. MIAMI INST. ON EST. PLAN. ¶216 (1993), and Smith & Olsen, *Fractionalized Equity Valuation Planning: Preservation of Post-Mortem Valuation Discounts*, 34 U. MIAMI HECKERLING INST. ON EST. PLAN. ¶ 1103.3(F)(2) (2000)

2. Term. The term of the SCIN should not equal or exceed the individual's life expectancy, or the SCIN might be recharacterized as a private annuity.[430] Even this conclusion is not universally accepted.[431] As noted above, however, there is a difference of opinion as to how life expectancy is to be determined. Are the 90CM estate tax tables (for May 1999-April 2009) and Table 2000CM (from May 2009 forward),[432] the Table V income tax annuity tables,[433] or the Seller's actual life expectancy to be used? While a conservative approach would be to structure the SCIN to have a term which is shorter than the shortest of all of these possible life expectancies, such a structure would materially detract from the primary advantage of the SCIN -- the likelihood that a would-be seller with health problems or a poor family health history will die before he or she is "supposed to." If the seller has a "terminal illness," however, the actuarial tables should not be used.[434] If §7520 applies for these purposes, "terminal illness" means that the individual has an "incurable illness or other deteriorating physical condition" which results in at least a 50% probability that he or she will die within one year.[435] If the person lives for 18 months or longer after the relevant valuation date, he will be presumed not to have been terminally ill at the time of the transaction, unless the existence of a terminal illness can be established by clear and convincing evidence.[436] Whether or not SCINs are technically subject to this regulation, it is probably wise not to use standard actuarial tables when a person is gravely ill.[437]

   Also, as discussed above in the context of an installment sale to a grantor trust, a SCIN term which is too long may raise debt/equity concerns, especially when the sale is to a trust with comparatively few other assets.

   The mortality component of the SCIN increases as the term of the SCIN increases, for a greater risk premium must be added to the SCIN to compensate the seller for the higher probability that the seller will die prior to the expiration of the longer term.

3. Premium on Principal. If the risk premium is not reflected in a higher interest rate, then it must be added to the sales price and reflected in a higher face amount of the SCIN. As discussed below, a principal risk premium should be treated as a capital gain to the seller and increase the basis of the property in the hands of the purchaser.

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[430] G.C.M. 39503, *supra*, Conclusion B. (Conclusion C of G.C.M. 39503 concludes that if the stated monetary amount would be received before the expiration of the transferor's life expectancy, the transaction will be treated as an installment sale rather than as an annuity.)

[431] *See* Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. MIAMI HECKERLING INST. ON EST. PL.,¶ 1601.3.A (2000)..

[432] Treas. Reg. § 20.2031-7(d)(7); IRS Publication 1457, *Actuarial Valuations Book Aleph* (July 1999)(Table 90CM); IRS Publication 1457, *Actuarial Valuations Version 3A* (May 2009)(Table 2000CM).

[433] Treas. Reg. § 1.72-9, Table V.

[434] *See* Treas. Reg. § 20.7520-3(b)(3), which may or may not apply (depending upon whether Section 7520 rates apply to SCINs).

[435] Treas. Reg. § 1.7520-3(b)(3).

[436] Treas. Reg. § 1.7520-3(b)(3).

[437] *See* Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. MIAMI HECKERLING INST. ON EST. PL.,¶ 1601.3.C (2000).

4. Comparison of Interest and Principal Premiums. If a self-amortizing note with equal principal and interest payments is used, there should be no difference for estate tax purposes between choosing an interest risk premium and a principal risk premium, as the annual payments under either structure would be the same. If, however, an interest-only SCIN or a level principal payment SCIN is used, then for estate tax purposes, the relative merits of choosing the principal premium or interest rate premium to compensate the seller for the risk of death occurring during the term of the SCIN should be analyzed, as the benefits depend upon the type of note used.

For income tax purposes, choosing to increase the principal balance of the purchase price will generally result in higher capital gains taxes and lower interest income being reported by the seller, with the buyer receiving a higher basis in the purchased asset and a lower current deduction, if any, for the payment of interest. If the asset being sold has a high basis, the seller may prefer the principal adjustment approach, because there may be minimal capital taxes payable in any event. Conversely, if the purchase price remains equal to the fair market value of the property sold and the interest rate is instead increased, then the seller will report more interest and less capital gains income. In turn, purchaser will take a lower cost basis in the acquired property, but may have a higher current deduction for the increased interest payments.[438]

C. Income Tax Consequences to Seller for Sale to Family Member or Non-Grantor Trust.

1. Availability of Installment Method. A sale of property to a family member or a non-grantor trust in exchange for a properly structured SCIN is a taxable event and, unless the seller elects otherwise, should generally result in installment sale treatment for the seller.[439] Under the installment method, it is assumed that the seller will outlive the term of the SCIN, and the maximum principal amount to be received by the seller in the SCIN transaction, including any principal premium, is the "selling price."[440] The seller's adjusted basis is then subtracted from this selling price to determine the gross profit, if the selling price exceeds the basis.[441]

A portion of each payment will also consist of interest, which may be calculated under one of two methods, depending upon whether the SCIN is treated as a maximum selling price installment sale, or as a contingent payment installment sale.[442] By treating the payment stream as a maximum selling price installment sale, the interest paid will be front-

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[438] Hesch & Manning, *Family Deferred Payment Sales, Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas*, 26 U. OF MIAMI INST. ON EST. PLAN. ¶310.3.B (1992).

[439] Temp. Reg. § 15A.453-1(c)(1).

[440] Temp. Reg. § 15A.453-1(c)(2)(i)(A).

[441] Temp. Reg. § 15A.453-1(b)(2)(v).

[442] Hesch & Manning, *Family Deferred Payment Sales, Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas*, 26 U. OF MIAMI INST. ON EST. PLAN. ¶310.3.B(4) (1992).

loaded. In contrast, if the payment stream is treated as a contingent payment installment sale, the interest paid will be back-loaded.

2. <u>Death of Seller During the Term of the SCIN</u>. If the SCIN is cancelled by reason of the death of the seller during the note term, any deferred gain will be recognized as income. The primary question is whether the deferred gain is properly includible (a) on the deceased seller's final return, in which event the resulting income tax liability should be deductible as a §2053 claim against the estate for estate tax purposes, or (b) in the initial return of the deceased seller's estate as an item of income in respect of a decedent ("IRD") under §691.[443]

When the issue arose in *Estate of Frane*, the Tax Court agreed that gain should be recognized upon the death of the seller prior to the expiration of the term of the SCIN, but held that the gain was properly reportable by the seller on the seller's final return, not by the seller's estate.[444] The Tax Court held that the income tax consequences of the cancellation were governed by §453B(f), which had been enacted, in part, to overrule the outcome of *Miller v. Usury,*[445], so that the cancellation of a SCIN would be treated as a disposition.[446] Because the cancellation was in favor of a related party, the fair market value of the obligation would be no less than the face amount of the obligation.[447] Since the Tax Court held that the gain was properly reportable on the seller's final income tax return, it also held that the Seller's estate was not taxable under the IRD rules of §691(a).

The Eighth Circuit Court of Appeals overturned the Tax Court in favor of the Service's alternate position that the decedent's estate recognizes the deferred gain on its initial income tax return as an item of IRD.[448] In *Estate of Frane*, the Eighth Circuit held that the cancellation of a SCIN is not a "disposition" which is taxed to the seller under §453B pursuant to §453B(f), but is rather a "transmission" which is taxable as IRD to the estate under §691 pursuant to §453B(c). The Eighth Circuit based this decision on the language in §691(a)(5)(iii) that "cancellation occurring at the death of obligee shall be treated as a transfer by the estate, taxable under §691(a)(2)."[449] This holding is in accord with IRS's published position.[450] The Eighth Circuit decision in *Frane* may not be the final word on the issue of whether the deferred gain is includible in income by the deceased seller on his final return or by the estate of the deceased seller on its initial return. The Eighth Circuit's position has not been

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[443] *See* Banoff & Hartz, *Self-Canceling Installment Notes: New IRS Rules Expand Opportunities*, 65 J. TAX'N 146, 150-51 (1986); Hesch & Manning, *Family Deferred Payment Sales, Installment Sales, SCINs, Private Annuity Sales, OID and Other Enigmas*, 26 U. OF MIAMI INST. ON EST. PLAN. ¶310.1.F (1992).

[444] Estate of Frane v. Commissioner, 98 T.C. 341, 354 (1992).

[445] 160 F. Supp. 368 (W.D. La. 1958).

[446] I.R.C. § 453B(f)(1).

[447] I.R.C. § 453B(f)(2).

[448] Estate of Frane v. Commissioner, 998 F.2d 567 (8th Cir. 1993).

[449] *Id*., at 572.

[450] Rev. Rul. 86-72, 1986-1 C.B. 253; G.C.M. 39503.

adopted by any other Circuits. An argument can be made that the gain should be recognized by the seller on his or her final income tax return in accordance with the Tax Court decision and §453B(f).[451] Furthermore, some commentators argue that the cancellation should not result in any income recognition.[452]

If the seller dies before all note payments have been paid, the net effect is that the amount of the unpaid payments is excluded from the gross estate for estate tax purposes, but is treated as income for income tax purposes. As the estate and income tax rates become closer in amounts, does using SCINs make sense? There is a net advantage, even if the estate and income tax rates are the same, because, the estate tax savings is based on the entire amount of the remaining payments whereas the income tax cost is based on just the amount of taxable income, which is the amount of the remaining payments less basis attributable to those payments. For example, if a high basis asset is sold, the income tax cost may be relatively small.

D. Income Tax Consequences to Seller for Sale to Grantor Trust. As in the case of a typical installment sale to a grantor trust, the trust's purchase of the seller's property in exchange for a SCIN should not be a taxable event, at least as long as the trust remains a grantor trust.

1. Cessation of Grantor Trust Status During Grantor's Lifetime. If the grantor trust ceases to be a grantor trust during the grantor's lifetime, and if the SCIN is still outstanding at the time of such cessation, a taxable event is likely to be deemed to have occurred at the time the trust ceases to be a grantor trust.[453] Presumably, any gain will be based on the excess of the amount then due under the SCIN over the adjusted basis of the grantor trust's assets.

2. Grantor's Death During Installment Note Term. The grantor's death before the end of the term of the SCIN results in the cancellation of the remaining payments otherwise due under the SCIN. Because of the cancellation feature, and because the sale never took place for income tax purposes during the life of the seller, the deferred gain that would normally be recognized upon the death of the seller under *Frane* arguably should not be recognized by the seller or the seller's estate, although the matter is not free from doubt.[454]

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[451] *See* WOJNAROSKI, BNA EST. TAX PORT. 805-3RD, PRIVATE ANNUITIES AND SELF-CANCELING NOTES, VII.A.4.C ("Taxpayers outside the Eighth Circuit may argue, in the alternative, that if the seller must recognize gain, then an estate tax deduction is available to the extent of the decedent's share of income tax liability consistent with the Tax Court's majority opinion in *Frane*").

[452] *See id.* (discussion of 5-judge dissent in *Frane* Tax Court decision taking the position that no gain results to either the decedent or the decedent's estate).

[453] *See* Treas. Reg. § 1.1001-2(c), Example (5), Madorin v. Commissioner, Rev. Rul. 77-402, 1977-2 C.B. 222, and Ltr. Rul.200010010.

[454] *See* Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. MIAMI HECKERLING INST. ON EST. PL.,¶ 1601.4 (2000); WOJNAROSKI, BNA EST. TAX PORT. 805-3RD, PRIVATE ANNUITIES AND SELF-CANCELING NOTES. VII.A.4.c. ("In addition, planners may structure a SCIN transaction with an irrevocable grantor trust as the buyer. The logical argument follows that if the seller realized no gain during life, then death during

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E. Income Tax Consequences to Purchaser for Sale to Family Member or Non-Grantor Trust.

1. Basis. If the sale is to a family member or a non-grantor trust, the first income tax consideration for the buyer-debtor is the calculation of the basis in the property received. Unfortunately, the manner in which basis is determined is not completely settled. G.C.M. 39503 concludes that the buyer-debtor acquires a basis equal to the maximum purchase price of the property. This result would be symmetrical to the treatment of cancellation at death in favor of a related party as a disposition under §453B(f) and is arguably supported by what might be dicta in the Eighth Circuit's decision in *Frane*.[455] G.C.M. 39503, and the *Frane* appellate decision in, however, both predate the final versions of Treas. Reg. sections 1.483-4 and 1.1275-4(c)(5), which provide that a purchaser only receives basis when payments are made on a contingent payment instrument, not when the contingent payment obligation is issued. Although it is not clear that a SCIN is a contingent payment instrument subject to these regulations, a conservative purchaser may choose to increase basis only to the extent that payments are made, especially because of the potential penalties under §§6662(e)(1)(A) and (h)(2) if the adjusted basis claimed exceeds 200% of the amount determined to be correct.[456]

2. Interest Deduction. The second income tax consideration for the purchaser is the amount and deductibility of interest. The amount of the interest component of each payment should be computed under one of the two methods discussed above in regard to the seller. As for the buyer's ability to deduct the interest, while G.C.M. 39503 states that "[in] the installment sale situation, …interest is fully deductible by the buyer", the purchaser will be subject to the typical limitations placed on the deductibility of interest, depending upon the nature of the assets purchased. Although the default classification of interest for an individual is non-deductible personal interest,[457] interest payments under a SCIN, unless issued in regard to the purchase of a personal use asset other than a primary or secondary residence, should generally be deductible as investment interest under §163(h)(2)(B) (subject to the limitations of §163(d)), as qualified residence interest with respect to a primary or secondary residence under §§163(h)(2)(D) and (h)(3), as

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the term of the SCIN cannot constitute a taxable event. Section 691 contemplates a realization event for income tax purposes. In effect, the gain remains deferred until the disposition by the buyer with a carryover or substitute income tax basis."). See Section XIX.D.5 of this outline *supra* regarding the income tax treatment upon the death of the seller before all payments are made on a normal installment sale to a grantor trust.

[455] *See* Estate of Frane v. Commissioner, 998 F.2d 567 (8th Cir. 1993), n.5.; Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. MIAMI HECKERLING INST. ON EST. PL.,¶ 1601.3.F (2000). Other commentators conclude that the purchaser takes a basis equal to the maximum purchase price without noting an caveats, other than noting that there is no authority of what the purchaser's basis would be if it should be determined that no gain should be recognized either to the decedent or the decedent's estate. WOJNAROSKI, BNA EST. TAX PORT. 805-3rd, PRIVATE ANNUITIES AND SELF-CANCELING NOTES, VII.B.2.

[456] *See* Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. MIAMI HECKERLING INST. ON EST. PL.,¶ 1601.3.F (2000) (SCIN should not be treated as a contingent payment obligation for these purposes).

[457] I.R.C. §§ 163(h)(1) and (2).

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passive activity interest under §§163(h)(2)(C) and 469, or as business interest under §163(h)(2)(A).

3. Cancellation of SCIN. Finally, although the death of the seller during the term of the SCIN arguably may represent cancellation of indebtedness, resulting in a reduction of the buyer's basis under §108(e) (and possibly taxable income to the buyer to the extent that the cancellation of indebtedness exceeds basis), this result does not seem to comport with the intent of §108(e).[458]

F. Income Tax Consequences to Purchaser for Sale to Grantor Trust. As in the case of a typical installment sale to a grantor trust, the trust's purchase of the seller's property in exchange for a SCIN should not be a taxable event, at least as long as the trust remains a grantor trust.

1. Cessation of Grantor Trust Status During Grantor's Lifetime. If the trust ceases to be a grantor trust during the grantor's lifetime, if the SCIN is still outstanding at the time of such cessation, and if a taxable event is deemed to have occurred at the time the trust ceases to be a grantor trust, then the trust will take either a cost basis for the purchased property, which presumably will equal the outstanding balance under the SCIN at the time the trust ceases to be a grantor trust, or possibly will take a basis for such property equal to the payments under the SCIN, as provided in the regulations for a contingent payment instrument.[459]

2. Grantor's Death During Installment Note Term. The grantor's death before the end of the term of the SCIN results in the cancellation of the remaining payments otherwise due under the SCIN. As in the case of a typical installment sale to a grantor trust, the outcome is certainly not free from doubt, but because of the cancellation feature, and because the grantor trust would not be obligated to make any payments under the SCIN after the seller's death, the trust should take a basis under §1015(b), which would typically be a carryover basis as opposed to a cost basis.[460]

G. Gift Tax Considerations. There are several gift tax considerations in regard to a SCIN transaction. These are substantially the same as those in regard to a typical installment sale to a grantor trust.

First, there is the normal valuation issue with respect to the assets sold in the transaction. Second, if the value of the SCIN received is found to be worth less than the value of the property sold (or not "substantially equal" to the value under the standard set forth in G.C.M. 39503), then the transaction will be treated as a

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[458] *Compare* Raby & Raby, *Self-Canceling Installment Notes and Private Annuities*, 2001 TAX NOTES TODAY 115-54 (2001), which takes the position that I.R.C. § 108(e) applies, *with* Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. MIAMI HECKERLING INST. ON EST. PL.,¶ 1601.3.F (2000)
and Hesch, *The SCINs Game Continues*, 2001 TAX NOTES TODAY 136-96 (2001), which make a persuasive argument that I.R.C. § 108(e) does not apply.

[459] Treas. Reg. §§ 1.483-4 & 1.1275-4(c)(5).

[460] *See* Hesch & Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 UNIV. MIAMI HECKERLING INST. ON EST. PL.,¶ 1601.4 (2000).

part sale/part gift. The potential negative implications of such a bargain sale are very similar to those discussed above with respect to a typical installment sale to a grantor trust. Not only would a taxable gift result, but if the property is sold to a trust, the gift may even cause the assets in the trust to be ultimately includible in the grantor's gross estate, for estate tax purposes, at their date of death or alternate valuation date values, including any appreciation after the initial transfer of the assets to the trust.

If a trust is the purchaser in a SCIN transaction in which a principal premium approach is used, substantially greater "seed" funding may be required to insure that the SCIN will be regarded as bona fide debt. In all probability, the total trust assets, or access to assets (taking into account bona fide guarantees), should be at least 10% (or possibly 11.1%) more than the principal obligation under the SCIN, including the principal premium. Otherwise, the transfer to the trust may be treated as an equity contribution, which almost inevitably would result in a significant taxable gift.[461]

H. Estate Tax Considerations. If the SCIN is properly structured, and if there are no other retained interests in the SCIN or in a purchasing trust which would result in inclusion, the seller's death prior to the expiration of the SCIN term should result in the inclusion in the seller's gross estate, for federal estate tax purposes, of only the payments made or due under the SCIN during the seller's life (and any income or appreciation attributable to such payments). The balance due under the SCIN, exclusive of any payments due but not made during the seller's life, will be cancelled and will escape inclusion in the seller's gross estate.[462] In this regard, G.C.M. 39503 states that "in the case of an installment sale, when a death-extinguishing provision is expressly included in the sales agreement and any attendant installment notes, the notes will not be included in the transferor's gross estate for Federal estate tax purposes." This removal of assets from the seller's gross estate is the primary motivation for using a SCIN.

The obvious tradeoff from an estate tax standpoint of a SCIN, of course, is that if the seller lives longer than he or she is "supposed to" and thus survives the end of the SCIN term, the assets included in the seller's gross estate will be greater, and possibly much greater, than if the seller had sold the property in a typical installment sale. Because of the risk premium, the SCIN payments will be materially higher than typical installment payments, and unless the payments are consumed or otherwise insulated from estate tax inclusion, they will be includible in the decedent's taxable estate. Depending upon the total return on the assets sold and interest rates, the estate tax inclusion could be even worse than if the seller had done nothing.

I. Advantages and Disadvantages of SCINs.

1. Advantages.

a. Estate Tax Savings Upon Early Death. A SCIN should be used only when the seller is expected to die prior to his or her

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[461] See Section XIX.A.1 of this outline *supra* regarding the structuring of installment sales to grantor trusts. *Cf.* Ltr. Rul. 9535026.

[462] Estate of Moss v. Commissioner, 74 T.C. 1239 (1980), *acq. in result only* 1981-1 C.B. 2.

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actuarial life expectancy. If the seller obliges by passing away prior to, and "preferably" materially prior to, his or her actuarial life expectancy, the estate tax savings can be quite substantial. In so many words, the seller in a SCIN transaction is gambling on his or her premature death.

b. Interest Deductibility by Purchaser. Unless the purchased property consists of personal use property (other than a primary or secondary residence), the interest paid by the purchaser under the SCIN should generally be deductible. This assumes that the purchaser in the SCIN transaction is not a grantor trust.

c. Purchaser's Basis. Although the issue is not free from doubt, the basis of a purchaser (other than a grantor trust) in a SCIN transaction should be the initial principal obligation under the SCIN, including any principal premium. In contrast, the purchaser's basis for property purchased in a private annuity transaction may be limited to the aggregate annuity payments, which could result in a lower basis, especially if the seller dies prematurely (as anticipated).

d. Backloading Payments. A payment deferred under either a SCIN or a private annuity is a payment that may never have to be made. Backloading of payments is much more easily structured under a SCIN, as opposed to a private annuity. Conceptually, either interest or principal should be deferrable to a date within the seller's actuarial life expectancy, but an appropriate principal premium or interest premium would have to be calculated and ultimately paid (unless the seller dies before the due date). However, in *Estate of Musgrove v. United States,*[463] a demand SCIN transaction was held to be a gift because of the absence of a real expectation of repayment (since the seller was in poor health and the purchaser did not have other funds). This permissible backloading is a distinct SCIN advantage.

e. Collateralization of Payment Obligation. The property sold in exchange for the SCIN can be used as security, thus better assuring the stream of payments if the seller is otherwise concerned that payments will not be made. In contrast, a private annuity should not be secured or guaranteed.[464]

f. Interest Rate. Although the issue is by no means free from doubt, there is a distinct possibility that the interest rate under the SCIN can be based on the generally lower AFR for the particular note pursuant to §7872, as opposed to 120% of the mid-term AFR under §7520. However, the planner must judge whether use of

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[463] 33 Fed. Cl. 657 (Fed. Cl. 1995).

[464] *See* Banoff & Hartz, *Self-Canceling Installment Notes: New IRS Rules Expand Opportunities*, 65 J. TAX'N 146 (1986).

the §7872 AFR is worth the gift tax risk and possibly the estate tax risk.[465]

2. Disadvantages.

   a. Risk of Long Life. Why there are so few SCIN transactions in practice.

   b. Tax Uncertainties. As outlined above, the SCIN transaction is replete with tax uncertainties.

   c. Income Tax Consequences for Seller or Her Estate. If the seller dies before the SCIN matures, the deferred gain will be recognized for income tax purposes, upon cancellation of the note as of the seller's death, either in the deceased seller's final return or her estate's first return. This disadvantage is much more significant as the estate and income tax rates become closer to each other. However, even if the rates are close together, there may still be a significant advantage with a SCIN because the estate tax savings is based on the entire amount that is cancelled whereas the income tax cost is based on the amount cancelled less basis that is attributable to that amount. It is less clear whether the same, or similar, income tax results will follow if the purchaser is a grantor trust; arguably, the remaining deferred gain should not be recognized by the seller or seller's estate.[466]

XXI. LOANS INVOLVING ESTATES

A. Significance. Estates often have liquidity needs for a variety of reasons, not the least of which is to be able to pay federal and state estate taxes nine months after the date of death. Other family entities may have liquid assets that would permit loans to the estate. This is a very commonly occurring situation. A very important tax issue that arises is whether the estate will be entitled to an estate tax administrative expense deduction for the interest that it pays on the loan.

On other side of the coin, (and of less importance) there may be situations in which beneficiaries need advances, before the executor is in a position to be able to make distributions. One possible scenario where this can occur is if only one beneficiary needs assets from the estate quickly, but the executor wants to make pro rata distributions when distributions are made. An advance could be made to the one beneficiary with needs until distributions can be made.

B. Estate Tax Administrative Expense Deduction for Interest Payments.

1. Generally. Section 2053 does not refer to the deduction of interest as such. To be deductible, interest must qualify as an administration

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[465] See Section XX.B.1 of this outline *supra* for a discussion of the interest rate selection issue.

[466] See Section XX.D.2 *supra* regarding installment sales to grantor trusts for a SCIN and see Section XIX.D.5 *supra* regarding traditional installment sales to grantor trusts. Presumably, the income tax treatment would be similar for these two situations.

expense.[467] Deducting interest as an estate tax deduction is not as attractive as at one time, because the interest would be recognized as income when received and the decrease in the estate tax rates reduces the amount of arbitrage on the rate differential between the estate tax savings and the income tax cost. Even so, substantial savings may be achieved because the estate tax reduction occurs nine months after date of death whereas the interest income may not be recognized until later years.

2. Post-Death Interest on Federal Estate Tax--Generally. Interest payable to the IRS on a federal estate tax deficiency is deductible as an administration expense to the extent the expense is allowable under local law.[468]

   Unlike interest payable to the IRS on deferred estate tax payments, interest on private loans used to pay estate taxes is *not* automatically deductible. The IRS recognizes that interest is deductible on amounts borrowed to pay the federal estate tax where the borrowing is necessary in order to avoid a forced sale of assets.[469] Various cases have permitted deduction of interest on amounts borrowed to pay federal estate tax, in situations where the loan was necessary to avoid a forced sale of assets.[470] The interest is deductible only for the time period for which the loan is reasonably necessary for that purpose.[471]

3. Interest on Amounts Borrowed by Executor From Family-Owned Entity to Pay Federal Estate Tax. Various cases have permitted an interest deduction where the funds were borrowed from a family-owned entity rather than being borrowed from a bank.[472] Several of the cases are described below as examples.

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[467] *See generally* Lindquist, *Making Lemonade from Lemons—Deducting Interest on the From 706*, 14 PROB. & PROP. 21-26 (May/June 2000)(outstanding general discussion); Harmon, & Kulsrud, *When is Interest Deductible as an Estate Administration Expense?*, 77 PRAC. TAX STRATEGIES 166 (Sept. 2006).

[468] *See* Estate of O'Neal v. Commissioner, 258 F.3d 1265 (11th Cir. 2001); Rev. Rul. 79-252, 1979-2 C.B. 333 (interest on estate tax deficiency). The interest expense is deductible even if the interest accrues as a result of the estate's willful delay in filing the estate tax return and in paying the estate tax. Rev. Rul. 81-154, 1981-1 C.B. 470.

[469] Rev. Rul. 84-75, 1984-1 C.B. 193 (interest on private loan obtained to pay federal estate taxes deductible because loan was obtained to avoid a forced sale of assets).

[470] Estate of Todd v. Commissioner, 57 T.C. 288 (1971), *acq.* 1973-2 C.B. 4; Estate of Sturgis v. Commissioner, T.C. Memo. 1987-415; Hipp v. United States, 1972-1 U.S.T.C. ¶12824 (D. S.C. 1971); Estate of Webster v. Commissioner, 65 T.C. 968 (1976); Estate of Graegin v. Commissioner, T.C. Memo. 1988-477; Estate of Huntington v. Commissioner, 36 B.T.A. 698, 726 (1937).

[471] Estate of Lasarzig v. Commissioner, T.C. Memo. 1999-307 (refused to allow the estate to deduct interest on borrowing to pay estate tax where the beneficiaries rather than the estate borrowed the funds after an extended period of time; court was troubled by the estate's effort to keep the case open for up to 20 years after the parties had resolved all controversies, observing that the IRS allowed deferral of payment of the estate tax for 5 years, "which seems to be a sufficient time to raise the funds to pay an agreed tax obligation").

[472] *E.g.*, Beat v. United States, 107 AFTR 2d 2011-1804 (D. Kan 2011); Estate of Murphy v. U.S., 104 AFTR 2d 2009-7703 (W.D. Ark. 2009); Keller v. U.S., 104 AFTR 2d 2009-6015 (S.D. Tex. August 20, 2009)($114 million borrowed after death from FLP on a 9-year note); Estate of Duncan v. Commissioner, T.C. Memo. 2011-255; Estate of Thompson v. Commissioner, T.C. Memo. 1998-325 (estate borrowed $2 million from irrevocable life insurance trust; court observed that regulations "do not require that an estate totally deplete its liquid assets before an interest expense can be considered necessary"); McKee v. Commissioner, T.C. Memo. 1996-362 (court refused to disallow interest deduction even though estate could have qualified for § 6166 election to defer payment of estate tax, concluding that it would not "second guess the business judgments of the executors"); Estate of Graegin v. Commissioner, T.C. Memo. 1988-477.

In *Estate of Murphy*,[473] the estate borrowed $11,040,000 from the FLP on a 9-year "Graegin" note (i.e., which had a fixed term and interest rate and which prohibited prepayment). The estate also borrowed an additional $41.8 million from a prior trust on a "regular" note (i.e., that had a floating interest rate and that permitted prepayment). The IRS argued that the interest should not be deductible for two reasons. (1) The interest was not necessarily incurred because the estate illiquidity was the result of the decedent's transfer of assets to an FLP. The court disagreed because the FLP was created "in good faith and for legitimate and significant non-tax purposes," and because decedent retained sufficient assets ($130 million) at the time the FLP was created to pay his living expenses and anticipated estate taxes. (2) The FLP could have sold some of its assets and made a distribution of cash to the estate to pay taxes. The court also rejected this argument, reasoning that "[i]f the executor acted in the best interest of the estate, the courts will not second guess the executor's business judgment. [citing *McKee*, 72 T.C.M. at 333]."

In *Beat v. United States*,[474] the estate owned largely illiquid farmland. The estate distributed the assets to the beneficiary subject to a refunding agreement, and the estate borrowed money from the beneficiary to pay estate taxes. The estate had not paid interest to the plaintiff; it was bankrupt and could not pay the interest. The court reasoned that even if the asset had not been distributed there would have had to be borrowing to pay the estate tax and that the borrowing was "necessary and beneficial to the Estate."

An interest deduction was allowed on a Graegin loan in *Estate of Duncan v. Commissioner*.[475] A revocable trust (responsible for paying estate taxes) borrowed funds from an almost identical irrevocable trust. The loan was evidenced by a 6.7%[476] 15-year balloon note that prohibited prepayment. A 15-year term was used because the volatility of oil and gas prices made income from the oil and gas businesses difficult to predict.[477] The estate claimed a deduction under § 2053 of about $10.7 million for interest that would be payable at the end of the 15-year term of the loan, which the court allowed because (i) the loan was bona fide debt,[478] (ii) the loan was actually and reasonably necessary,[479] and (iii) the amount of the interest was ascertainable with reasonable certainty.[480]

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[473] 104 AFTR 2d 2009-7703 (W.D. Ark. 2009).

[474] 107 AFTR 2d 2011-1804 (D. Kan 2011).

[475] T.C. Memo. 2011-255. In that case, the decedent had transferred a substantial part of his estate, including oil and gas businesses to a revocable trust. The decedent at his death exercised a power of appointment over an irrevocable trust that had been created by decedent's father to appoint the assets into trusts almost identical to trusts created under the revocable trust. The irrevocable trust and the revocable trust had the same trustees and beneficiaries. The irrevocable trust had liquidity; the revocable trust (which was responsible to pay the estate tax) did not.

[476] The 6.7% interest rate was the rate quoted by the banking department of one of the corporate co-trustee for a 15-year bullet loan. (At the time of the loan, the long term AFR was 5.02% and the prime rate was 8.25%.)

[477] In fact, the revocable trust ended up being able to generate to over $16 million in cash within the first three years, but the note prohibited prepayment. The revocable trust did not expect to generate sufficient cash to repay the loan within three years.

[478] Even though the lender and borrower trusts had the same trustees and beneficiaries, the loan still had economic substance because the parties were separate entities that had to be respected under state law.

[479] The revocable trust could not meet its obligations without selling its illiquid assets at reduced prices. Because of the trustee's fiduciary duty, the irrevocable trust could not merely purchase assets from the revocable trust without

A deduction was similarly allowed in *Estate of Kahanic*.[481] The estate was trying to sell the decedent's medical practice when the estate taxes were due, and did not have the liquid funds to pay the estate taxes without a forced sale of the medical practice. Immediately before paying the estate taxes, the estate had about $400,000 of cash and owed about $1.125 million of liabilities, including the federal and state estate taxes. The estate borrowed $700,000 from the decedent's ex-wife for a secured note bearing interest at the short-term AFR (4.85%). The court allowed the amount of interest that had accrued up to the time of trial because (i) the loan was bona fide debt,[482] (ii) the loan was actually and reasonably necessary,[483] and (iii) the interest will be paid by the estate.[484]

Cases have not always allowed the full estate tax deduction for interest when an estate borrows funds from a family entity.

The court rejected an interest deduction for amounts loaned from an FLP to the estate in *Estate of Black v. Commissioner*,[485] An FLP sold about one-third of its very large block of stock in a public company in a secondary offering, generating about $98 million to the FLP, and the

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requiring a discount that third parties would apply. The terms of the loan were reasonable and the court refused to second guess the business judgments of the fiduciary acting in the best interests of the trust. The 15-year term was reasonable because of the volatile nature of the anticipated income. The interest rate was reasonable; using the AFR as the interest rate would have been unfair to the irrevocable trust because the AFR represents the appropriate interest rate for extremely low risk U.S. government obligations. The IRS complained that there were no negotiations over the rate, but the court said that the trustees had made a good-faith effort to select a reasonable interest rate and that "formal negotiations would have amounted to nothing more than playacting."

[480] The IRS argued that the loan might be prepaid and that there is no economic interest to enforce the clause prohibiting prepayment. The court found that prepayment would not occur because the two trusts had to look out for their own respective economic interests. If a prepayment benefited one trust it would be a financial detriment to the other.

[481] T.C. Memo. 2012-81. Observe, this case did not involve a "Graegin" loan, discussed *infra* in Section XXI.B.5 of this outline, because the loan could be repaid at any time. Accordingly, the estate did not claim a deduction on the estate tax return for the interest that would accrue over the life of the loan. The issue was merely whether the interest that had accrued up to the time of trial could be deducted under §2053.

[482] The IRS argued that the lender never intended to create a genuine debt because she never demanded repayment and because she benefitted from the estate being able to pay its estate taxes because otherwise she would have been liable for some of the estate taxes because of transferee liability. The court responded that she did not demand payment when the loan became due because that would have exhausted the estate's funds and prevented the estate from being able to challenge the IRS's estate tax determination. The court also agreed with the estate that the ex-wife's benefiting from the estate's payment of its taxes and did not mean that she did not mean to collect the loan.
The IRS also argued that the estate never intended to repay the loan. The disagreed, believing the executor's testimony that she intended to repay the loan when it was made but the estate financially deteriorated when the medical practice could not be sold as a going concern.

[483] The IRS argued that the estate could have recovered from the ex-wife a portion of the estate tax liabilities, but the court stated that the estate did not have a right of contribution from her for estate taxes at the time they were due because the residuary estate value at that time was sufficient to pay the taxes. In addition, the IRS maintained that the estate could have sold its illiquid asses in time to pay the taxes. The court disagreed, finding that it would have had to sell the medical practice and its receivables at a deep discount.

[484] The IRS believed the estate had not shown that it could pay the interest, but the court accepted the estate's counter that based on other findings in the case, the estate taxes would be reduced to the point that it could pay the interest.

[485] 133 T.C. 340 (2009). *See generally* Liss, *Estate of Black: When Is It 'Necessary' to Pay Estate Taxes With Borrowed Funds?*, 112 J. TAX'N (June 2010).
The estate argued four reasons for allowing an interest deduction. (1) The executor exercised reasonable business judgment when he borrowed funds, (2) the FLP was not required to make a distribution or redeem a partnership interest from the estate, (3) the son was the managing partner and executor and owed fiduciary duties to both the estate and the partnership, and (4) the loan itself was a bona fide loan. The IRS argued that the loan was (1) unnecessary and (2) not bona fide (because the transaction had no economic effect other than to generate an estate tax deduction).

FLP loaned $71 million to the estate to pay various taxes, expenses, and a charitable bequest. The court found that the loan was not necessary, basing its analysis primarily on the "no economic effect" rationale that the IRS gave in its "no bona fide loan" argument.[486] The partnership had to sell the stock, and it loaned the sale proceeds to the estate. Under the court's analysis, the key factor in denying any deduction for loans obtained to pay debts and expenses seems to be that the loan was not necessary to avoid selling assets—the company stock that was owned by the FLP was in fact sold by the FLP.[487] The partnership could have redeemed the estate's interest in the FLP and the estate could have sold the assets received from the partnership to pay the estate tax.[488]

In *Estate of Stick v. Commissioner*,[489] the estate reported liquid assets of nearly $2 million and additional illiquid assets of over $1,000,000. The residuary beneficiary of the estate (a trust) borrowed $1.5 million from the Stick Foundation to satisfy the estate's federal and state estate tax liabilities. The court concluded that the estate had sufficient liquid assets to pay the estate taxes and administration expenses without borrowing, and denied a deduction of over $650,000 on interest on the loan. (This was despite the fact that the liquid assets of the estate appeared to have exceeded its obligations at the time of the borrowing by only about $220,000. That seems like a rather narrow "cushion" for an estate that owed over $1.7 million of liabilities, and other courts have been reluctant the second guess the executor's business judgment in somewhat similar situations.)

Technical Advice Memorandum 200513028 refused to allow any interest deduction for amounts borrowed from a family limited partnership to pay estate taxes.[490] The ruling gave various reasons for denying a deduction for the interest expenses. (The IRS did not refer to the creation of the FLP as a self-imposed illiquidity as one of the reasons.) First, the IRS reasoned that the loan was not necessary to the administration of the estate because one of the decedent's sons who was a co-executor of the estate was the remaining general partner of the FLP, the FLP was not engaged in any active business that would necessitate retention of liquid assets, and there was no fiduciary restraint on the co-executor's ability to

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[486] The court noted that the partnership agreement allowed modifications, and a modification permitting a distribution of stock to the partners or a partial redemption of the estate's interest would not have violated the son's fiduciary duties, as managing partner, to any of the partners. The court reasoned further that the estate had no way to repay the loan other than actually receiving a distribution from or having its partnership interest redeemed by the partnership in return for the stock, which it would then use to discharge the debt. Instead, the partnerships sold the stock and loaned the sale proceeds to the estate.

[487] The other cases cited by the taxpayer in which an interest deduction was allowed involved situations where the estate avoided a forced sale of illiquid assets or company stock.

[488] John Porter (the attorney representing the estate) points out a business judgment problem with the redemption argument. The estate's interest would be redeemed at market value, with a discount. A redemption in that fashion enhances the value of the other partners, and the executor often makes a business decision not to do that. John Porter's view is that the court in *Black* substituted its business judgment for that of the executor.

[489] T.C. Memo. 2010-192.

[490] In that situation, the decedent created a family limited partnership with 90% of his assets, and died 5 ½ years later. The estate borrowed funds from the FLP to pay federal and state estate taxes under a 10-year note with principal and all interest payable on maturity, with a prohibition against any prepayments. The stated interest rate was 1% over the prime rate and 3% more than the 15-year mortgage rate on the date of the note. The estate's 99% interest in the FLP was pledged as security for the note.

access the funds.[491] Second, the IRS reasoned that the interest may not be repaid, and even if it is, the repayment has no economic impact on the parties. The most likely scenario for paying the loan was that he FLP would distribute assets to the estate, which would then repay those assets back to the FLP in payment of the loan.[492]

Some IRS agents have indicated informally that claiming an interest deduction on a Graegin loan for borrowing from a family limited partnership will draw close scrutiny as to whether §2036 applies to include the partnership assets in the estate (without any discount).

4. Timing of Interest Deduction For Interest on Extension to Pay Federal Estate Tax. When the estates receives an extension to pay estate tax under §6161, the interest is deductible *only when it is actually paid.* In Rev. Rul. 80-250,[493] the IRS gave two reasons for refusing to allow an “up-front deduction” for the interest.[494] First, an estate can accelerate payment of the deferred tax. Second, the interest rate of the deferred amount fluctuates, which makes it impossible to accurately estimate the projected interest expense.[495]

5. *Estate of Graegin* Approved Up-Front Deduction. In *Estate of Graegin v. Commissioner,*[496] the Tax Court in a memorandum decision allowed an estate to deduct projected interest on a loan that was obtained to avoid the sale of stock in a closely-held corporation.
The court reasoned that the amount of the interest was sufficiently

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[491] The IRS rejected the notion that the estate could not require a distribution from the partnership since the estate possessed only a 99% assignee interest:

> “It seems clear that the same parties (closely related family members whose proportionate interests in the Estate are virtually identical to their proportionate interests in the partnership) stood on all sides of this transaction. Thus, the assets held in Partnership were readily available for the purposes of paying the federal estate tax. Rather, we believe that in view of the availability of the liquid assets to the Estate and its beneficiaries, and in view of the structure of the loan (10-year term with prepayment prohibited), the only reason the loan transaction was entered into was to obtain an ‘upfront’ estate tax deduction for the interest expense (an expense, which, as discussed below, is largely illusory.)”

[492] The limitation of the deduction for amounts actually paid “ensures that the expense has a real economic impact on the amount ultimately passing to the estate beneficiaries.” In this case the interest payments have no economic effect on the beneficiaries. If the estate has any funds for making payments, the estate would make the payments to the FLP to pay the interest, which would proportionately increase the value of the beneficiaries’ interests in the FLP. More likely, the FLP will distribute assets to the estate, which will then repay those assets back to the FLP in payment of the loan. “Since the parties have virtually identical interests in the Estate and the partnership, there is no change in the relative net worth of these parties as a result of the loan transaction. Rather, other than the favorable tax treatment resulting from the transaction, it is difficult to see what benefit will be derived from this circular transfer of funds.”

The IRS attempted to further support this argument by analogizing to income tax cases, where the courts declined to allow an income tax deduction for interest under similar circumstances involving circular transfers for making payments on purported loan transactions.

[493] 1980-2 C.B. 278.

[494] The Ruling actually involved interest payments on a §6166 payout rather than an extension under §6161. The law has since changed so that interest on a §6166 extensions is not deductible, but the interest rate is only 45% of the normal IRS rate on underpayments (effectively allowing the benefit of a deduction at what was then a 55% marginal rate) However, the Ruling still gives the IRS’s reasons for not allowing an “upfront” deduction for interest payments on payment extensions.

[495] Various courts agreed with the IRS’s concerns, and refused to allow an upfront deduction of the estimated interest because of the fluctuating interest rate and the possibility of prepayment (or forced acceleration) of the deferred payments. Estate of Bailly v. Commissioner, 81 T.C. 246, *modified*, 81 T.C. 949 (1983); Estate of Harrison v. Commissioner, 1987 T.C. Memo. 8; Estate of Spillar v. Commissioner, 1985 T.C. Memo. 529.

[496] T.C. Memo. 1988-477. *See generally* Harrison, *Borrowing to Pay Estate Tax*, Tr. & Ests. 46 (May 2009).

ascertainable to be currently deductible because of the fixed term of the note and because of the substantial prepayment penalty provisions in the note. The court observed that it was "disturbed by the fact that the note requires only a single payment of principal and interest", but determined that such a repayment term was not unreasonable given the decedent's post-mortem asset arrangement. The court observed that it was "mindful of the potential for abuse presented by the facts in this case", but found the executor's testimony regarding his intention with respect to repayment of the note credible. The court specifically pointed to the fact that there was an outside shareholder who would complain if the loan was not timely paid.

The IRS has approved the upfront deduction of interest in several Graegin loan situations.[497] The IRS's position in the letter rulings that all interest that would have been owed for the entire loan term must be paid upon default of the note may present usury problems in some states. An alternative planning possibility may be to have the lender waive the right to accelerate the note in the event of default.[498] Other IRS rulings involving Graegin loans have refused to allow the interest deduction.[499]

Most of the cases involving Graegin loans have allowed the up-front interest deduction, in situations where the estate could establish a reason for the borrowing other than to generate the estate tax deduction, and courts are reluctant to second guess the business judgment of the executor.[500] A few cases have also disallowed interest deductions in Graegin loan situations, where the estate could not demonstrate the necessity for the borrowing over the life of the loan.[501]

IRS officials have stated informally that the IRS is continuing to look for vehicles to contest Graegin loans, particularly in situations involving family limited partnerships. The IRS's concern is that a deduction will

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[497] *E.g.*, Ltr. Ruls. 200020011 (allows a current deduction for the projected interest payments after the loan is amended to provide that it cannot be prepaid and that upon default all interest that would have been owed throughout the loan term must be paid at the time of default); 199952039 (ten year note providing for annual interest payments with a balloon principal payment at the end of ten years); 199903038.

[498] Therefore, if there is a default, the terms of the note would continue to apply, and interest would continue to run to the end of the term of the loan.

[499] Technical Advice Memorandum 200513028 (refused to allow any interest deduction for amounts borrowed from a family limited partnership to pay estate taxes). TAM 200513028 is discussed in detail in Section XXI.B.3 of this outline *supra*.

[500] *E.g.*, Estate of Murphy v. U.S., 104 AFTR 2d 2009-7703 (W.D. Ark. 2009); Keller v. U.S., 104 AFTR 2d 2009-6015 (S.D. Tex. August 20, 2009)($114 million borrowed after death from FLP on a 9-year note); Estate of Duncan v. Commissioner, T.C. Memo. 2011-255; Estate of Gilman v. Commissioner, T.C. Memo. 2004-286 (estate borrowed funds to pay (i) federal and state estate taxes, (ii) compensation to executors [who were also employees of the estate's closely held business and the will specified that they were not to receive executor's commissions but should continue to receive compensation from the business], and (iii) miscellaneous expenses; court concluded that loan was necessary because of estate's illiquidity and allowed interest deduction through date the notes were due); *cf.* McKee v. Commissioner, T.C. Memo. 1996-362 (court refused to disallow interest deduction even though estate could have qualified for § 6166 election to defer payment of estate tax, concluding that it would not "second guess the business judgments of the executors").

[501] *E.g.*, Estate of Black v. Commissioner, 133 T.C. 340 (2009); Estate of Lasarzig v. Commissioner, T.C. Memo. 1999-307 (court observed that no prior cases had allowed such deduction in a situation in which a taxpayer "seeks an extended delay (up to 20 years) so that a nonparty (family trusts of beneficiaries) can benefit from improved market conditions that may or may not occur").

be allowed but the interest in fact will not have to be paid over the entire term of the note.

6. <u>Example of Extremely Favorable Results of Up-Front Deduction.</u> The economics of this up-front deduction can be staggering. For example, assume a $10 million taxable estate. Assume the marginal estate tax bracket is 45%. If sufficient lifetime gifts have been made so that the estate is in a 45% bracket, the estate would owe $4.5 million in estate taxes. However, assume the estate borrows $1.493 million [this amount is calculated in an interrelated calculation] from a closely-held company under a 15 year note, at 12.0% interest, with a balloon payment at the end of the 15 year period. The accumulated interest payment due at the end of the 15 years would be $6.681 million. Under the *Graegin* analysis, the interest expense would be currently deductible, yielding a taxable estate of $10 - $6.681 or $3.319 million, which would result in a federal estate tax (at a 45% rate) of $1.493 million. The $6.681 million of interest would be paid to the company (which in turn, is owned primarily by family members.) The overall result is a very considerable estate tax savings. **The estate tax that is due 9 months after the date of death is reduced from $4.5 million to a little under $1.5 million.**

   The interest income would be subject to income tax over the 15-year period, and the IRS will take the position that the interest on loans to pay taxes is nondeductible personal interest. However, many families are willing to pay income taxes over the payment period if they can reduce the estate taxes that are due nine months after the date of death. Be aware that if a QTIP trust or funded revocable trust is the borrower rather than a probate estate, the IRS may argue that under §2503(b) only interest actually paid within the estate tax statute of limitations period may be deducted.

7. <u>New Regulation Project Considering Applying Present Value of Administration Expenses and Claims; Graegin Loans</u>. The §2053 final regulations do not seem to impact *Graegin* loans at all. However, the Treasury Priority Guidance Plans for 2009-2013 include a project to address when present value concepts should be applied to claims and administration expenses (including, for example, attorneys' fees, Tax Court litigation expenses, etc.).[502] Graegin notes are also in the scope of that project.

8. <u>Comparison of Alternative Borrowing Approaches to Pay Estate Taxes</u>.
   Alternatives for generating cash to pay estate taxes include (1) selling estate assets, (2) obtaining a §6166 deferral (in effect, borrowing from the government), (3) borrowing from a related family entity with a Graegin loan, and (4) (4) borrowing from a third-party vendor with a Graegin loan.

   Advantages and disadvantages of the various approaches are summarized.

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[502] Joint Treasury, IRS 2012-2013 Priority Guidance Plan (released Nov. 19, 2012), available at **http://www.irs.gov/uac/Priority-Guidance-Plan** ("Guidance under §2053 regarding personal guarantees and the application of present value concepts in determining the deductible amount of expenses and claims against the estate").

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Selling assets. Advantages are that there are no financing costs and there should be minimal capital gains (because of the basis step up at death). Disadvantages are that the estate gives up potential future appreciation from the sold assets, and valuation discounts associated with those assets may be jeopardized by a quick sale after death.

Section 6166 deferral. Advantages are that there would be no impact on valuation discount for estate assets, and the loan could be prepaid at any time without penalty. Disadvantages are that the term and interest rates are not negotiable (though the interest rate is very low-being 45% of the normal IRS underpayment interest rate), and the interest rate is a variable rate rather than being able to lock in the current very low rates over a long-term period.

Intra-family Graegin loan. Advantages are that the interest rate can be tied to the AFR (but it could be higher if desired to generate a higher estate tax deduction as long as it is still commercially reasonable), and there is more flexibility in negotiating terms of the note with a related entity (collateral requirements, financial covenants, etc.). A disadvantage is that the family related entity gives up the potential future appreciation on the assets used to fund the loan. Another disadvantage is that an intrafamily Graegin loan comes under much greater scrutiny from the IRS than a loan from a third party lender.

Third-party lender Graegin loan. A significant advantage is that there is less scrutiny from the IRS regarding the deductibility of interest as an estate tax administration expense. A disadvantage is that there will obviously be significant negotiations regarding terms of the note with a third party lender. Typical restrictions include that the estate not incur any additional indebtedness, the estate cannot create any additional liens against estate assets, that you liquid assets of the estate (to which the bank will be looking for repayment of the loan) maintain certain liquidity levels, and typically no distributions are allowed to beneficiaries until the loan is repaid.

ARE THE PASSIVE LOSS MATERIAL PARTICIPATION REGULATIONS INVALID?

By: Dan G. Baucum[1]

The Tax Reform Act of 1986 added new section 469 to the Internal Revenue Code in order to prevent investors from using tax losses from investments against income from active trades or businesses—so-called passive losses. In order to determine whether a taxpayer is active in a trade or business rather than a passive investor section 469 requires that the taxpayer materially participate in the business. Material participation is defined as regular, continuous and substantial involvement in the business activity by the Code.[2] But section 469 doesn't stop there. It also directs the Secretary of the Treasury, through its rule making authority, to define material participation (among other things) by regulations.[3] In February, 1988, the Secretary and its delegate, the Internal Revenue Service, issued temporary regulations containing seven tests whether a taxpayer materially participates in an activity.[4] These regulations were effective retroactive from December 31, 1986, and thereafter upon issuance. Although these regulations were published as both temporary and proposed regulations in the Federal Register, it is unclear if a public hearing was ever held or comments from tax practitioners entertained. What is clear is that these proposed regulations were never finalized; they remain temporary regulations given the full force and effect of law to this day—twenty-five years later.

Treasury and the Service regard tax regulations as only interpretive in nature and not subject to the Administrative Procedure Act ("APA") or Executive Orders, which impact rulemaking by other federal agencies. Treasury issues tax regulations based on its general interpretive authority under section 7805(a) of the Internal Revenue Code.[5] Generally ignored is Executive Order

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[2] I.R.C. § 469(h)(1)(A), (B), & (C).

[3] I.R.C. § 469(l)(1).

[4] T.D. 8175 (Feb. 19, 1988).

[5] "[t]he Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue." I.R.C. § 7805(a). Under a section in the preamble to the issuance of the material participation temporary regulations entitled "Special Analysis" the following explanation as to why the APA was not followed is contained: "The Commissioner of Internal Revenue has determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553 for temporary regulations. Accordingly, the temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6)." Curiously, this exculpatory language only refers to temporary regulations when explaining their APA exempt status even though the Preamble's Summary paragraph states that the "[t]ext of the temporary regulations set forth in this document also serve as the text of proposed regulations for the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the Federal Register."

12866, issued by President Clinton in 1993, and rule making requirements contained in the Administrative Procedure Act.[6] Executive Order 12866 instructs federal agencies to open the rulemaking process to public participation and make the results as non-intrusive as possible. Regulatory action is defined in the executive order as "substantive action by an agency" that encompasses any generally applicable agency statement intended "to have the force and effect of law," including all types of regulations, whether temporary, proposed, or final. [7] In addition Executive Order 12866 directs agencies to follow the APA. Treasury reasons that its regulations simply implement the statute and that any intrusion created is caused by the underlying statute; thus interpretive rulemaking is not substantive action and not to blame for the resulting effects. Thus Treasury's rulemaking is not described by Executive Order 12866 and there is no need to comply with it or the APA, although Treasury often does through the use of Notices of Proposed Rulemaking, hearings and comment review. After which proposed regulations are finalized. This is particularly true when the regulation are legislative in nature because Congress has specifically delegated authority to Treasury to effectuate a set of rules such as the consolidated return regulations under section 1502 of the Code.[8] In situations where administrative rules are not followed, such as with the material participation temporary regulations, Treasury and the Service should have a harder time upholding their validity.

The Supreme Court in Mayo Foundation for Medical Ed. & Research v. United States,[9] holds that the appropriate standard for reviewing tax rules and regulations is the two-step test set forth in Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.,[10]where the "agency uses full notice—and—comment procedures to promulgate the rule. . . ."[11] The Court went on to state that "[t]he Department issued the full-time employee rule [in *Mayo*] only after notice-and – comment procedures . . . , again a consideration identified in our precedents as a 'significant sign' that a rule merits *Chevron* deference." The Supreme Court bluntly states that tax rules are subject to administrative law procedures such as proper notice of proposed rulemaking and the right of the public to comment. If these procedures are met *Chevron* deference is merited.

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[6] 5 U.S.C. § 553 Rule Making.

[7] Jerome Coder, "Why Treasury Tax Regulations are Rarely 'Significant,'" Tax Notes Today, Tax Analysts (August 20, 2012). *See also* Shamik Trivedi, "APA Front and Center After Dominion Resources," 2012 TNT 107-4; and Kristin E. Hickman, "Coloring Outside the Lines: Examining Treasury's (Lack of) Compliance with Administrative Procedure Act Rulemaking Requirements," 82 Notre Dame L. Rev. 1727 (2007).

[8] *Id. See also* Treas. Reg. §601.601(a)(2) and (b), and the Internal Revenue Manual §§32.1.2.3 ("Several Federal administrative laws and procedures apply to the regulatory process. . . . The Administrative Procedures Act (APA) requires agencies to publish Notices of Proposed Rulemaking in the Federal Register and permit the public to submit comments.") Section 469(l) of the Code provides that the Secretary [of the Treasury] shall prescribe such regulations as necessary or appropriate to carry out provision of this section, including relations (1) which specify what constitutes . . . material participation. . . ." Any regulations defining material participation are required by Congress and thus are legislative in nature, subject to section 553 of the Administrative Procedures Act

[9] ____ U.S. ____, 131 S.Ct. 704, 107 AFTR 2d 2011-341 (2011).

[10] 467 U.S. 837 (1984). The *Chevron* two steps are (i) whether Congress has directly addressed the precise question at issue; and (ii) if not, the Court may not disturb an agency rule unless it is arbitrary or capricious in substance, or manifestly contrary to statute.

[11] Part II. B. of the opinion.

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Treasury's claimed exemption from notice—and—comment appears misplaced, even if the regulations at issue are merely interpretive. Assertions by Treasury that the APA does not apply in a particular circumstance absent detailed justifications for an exception are not likely to hold sway going forward. The United States Court of Appeals for the District of Columbia in Cohen v. United States,[12] held that taxpayers can challenge an IRS notice in district court by invoking the APA and that the judicial review provisions of the APA apply to the Service. In addition, the United States Supreme Court in Judulang v. Holder,[13] while not a tax case, clarified the relationship between the standard of review to be applied to administrative (*e.g.* tax) regulations (*Chevron* deference) that was addressed in *Mayo* and its effect on review under the APA. In *Judulang* the Supreme Court confirmed that the APA's arbitrary or capricious standard is equivalent to the step-two analysis in *Chevron*.

As stated previously, section 469(l)(1) of the Code requires the Secretary to prescribe regulations as shall be necessary or appropriate to specify what constitutes material participation. Material participation is defined in the Code as regular, continuous and substantial participation in an activity. Whether the temporary regulations are legislative in nature or merely interpretive may no longer make much difference since proper notice—and—comment was not provided the public. *Mayo* places much stock in allowing public notice and comment through the mechanisms that other regulatory agencies follow, that is to say the APA. In its own words, "Absent a justification to do so, this Court is not inclined to apply a less deferential framework to evaluate Treasury Department regulations than it uses to review rules adopted by any other agency."[14] The public had no formal input into the material participation temporary regulations. No forum was provided to question whether the mechanical approach makes sense, or how the regulations might more readily carry out the intent of the statutory language, which is simply quoted verbatim in test seven. It has been my experience that these seven regulatory tests can produce arbitrary and to my mind inappropriate results, particularly in regards to taxpayers in real property trades or businesses. In this and other instances tax lawyers may wish to consider whether the material participation regulations should be given *Chevron* deference in light of *Mayo*.

END

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[12] 650 F.3d 717 (D.C. Cir. 2011).
[13] ___U.S. ___, 132 S. Ct. 476 (2011).
[14] ___ U.S. ___, 131 S.Ct. 707-08.

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THE TAX COURT PRO BONO PROGRAM

By Bob Probasco, Thompson & Knight LLP
Chair, Pro Bono Committee

The complexity of the American legal system makes pro bono efforts an important part of our obligations as lawyers. The website for the State Bar of Texas states: "The lawyers of the State of Texas are committed to Equal Access to Justice for All and to giving back to the justice system, their state, and their local communities." One of the ways that the State Bar of Texas, Section of Taxation does that is through our Tax Court Pro Bono program.

Most cases in the United States Tax Court are filed by taxpayers who are not represented by counsel. *Pro se* petitioners are unfamiliar with tax law and court procedures; even what we consider basic fundamentals are mysteries to them. As a result, they often get worse results than they might with representation. Recognizing a need, Elizabeth Copeland developed our program in 2008. It covers all five Texas cities that the Tax Court visits – Dallas, El Paso, Houston, Lubbock, and San Antonio. Our program was the first state-wide program of its kind. One of the best indications of the importance and value of the program is the national recognition and publicity that it has received. It was featured at the September 2008 meeting of the Section of Taxation of the ABA, where Elizabeth described our program to representatives from other states. Our Pro Bono Committee assisted the Maryland Bar in setting up a similar program. The program was also featured prominently when the ABA Section of Taxation awarded Elizabeth the 2009 Janet Spragens Pro Bono award, and when Tax Analysts named her one of the national finalists for the 2012 Tax Person of the Year.

Our program provides volunteers to help the taxpayers evaluate the case, negotiate with IRS Counsel, and prepare for trial. Occasionally volunteers may enter an appearance and assist at trial, but that is entirely at the discretion of the volunteer. It's usually not as difficult or complicated as this description may sound. Many of our volunteers are experienced tax litigators, but even those who aren't have found that they can add real value.

In 2012, we assisted 41 taxpayers. We first hear about the case the morning of the calendar call and some of the taxpayers don't have a very strong case, so we didn't always get a good result for them. But often we did make a difference. Here are just a few examples from 2012:

- The taxpayer's case involved several substantiation issues. However, little progress had been made before the trial date. **Jaime Vasquez** entered an appearance, obtained a continuance, and then worked with the taxpayer and IRS Counsel to resolve many of those issues. Those efforts reduced the deficiency by about $9,400, or more than half. In addition, Jaime also helped negotiate language in the decision document regarding an investment; this will help the taxpayer claim a bad debt deduction in subsequent years. Congratulations, Jaime!

- The taxpayer's daughter and two grandchildren had lived with her for most of the year, and she provided all their support. She claimed head of household filing status, three

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dependents, and Earned Income credit. But she was unaware that her daughter had filed a joint return for that year, which invalidated all of that. I helped her through the stress of a short trial, but the law was clear and the judge had to rule for the government. **Lee Meyercord** offered to assist her for negotiations with Collections. Lee persuaded the Revenue Officer to place the deficiency in "uncollectible" status. Congratulations, Lee!

- As part of a divorce decree, the taxpayer's husband was ordered to pay credit card bills in her name. When the ex-husband didn't pay, the credit card company issued a Form 1099 to the taxpayer and IRS issued a notice of deficiency based on cancellation of indebtedness income. The income was clearly hers for tax purposes, despite the divorce decree, so the government's case looked strong. But **Dustin Whittenburg** spotted an issue – the cancellation of the debt actually took place in an earlier year, which was now closed. He coached the taxpayer in how to present evidence to the court and raise the statute of limitations issue. After the judge heard the evidence and told IRS Counsel that a ruling would not be in the government's favor, the case immediately settled. Congratulations, Dustin!

- The taxpayer real estate developer did not file a return and claimed additional business and personal deductions after the IRS prepared a substitute for return. This was a substantiation issue, and the taxpayer and IRS Counsel had agreed on a motion to continue in order to gather additional information. But the judge denied the motion on the basis that "this has gone on too long." **David Gair** met with the taxpayer and determined that he was unprepared and would lose if the case went to trial that day. David helped him prepare an effective motion to reconsider, which persuaded the judge to grant the taxpayer a continuance. The parties eventually filed a stipulated decision reflecting no deficiency. In David's words, "Never thought that I would feel like getting a motion to continue granted would be a big victory – but it was in this case." Congratulations, David!

The taxpayers whom we assist, even if we can't help them get a good result, genuinely appreciate our assistance. If nothing more, we help make a mystifying process less intimidating. The Tax Court judges like the program as well; they believe a pro bono attorney helps a more effective resolution of cases. Even IRS Counsel like to see us at the calendar calls. Their job is not to advocate for taxpayers, but they genuinely want to see the right result. Inserting a neutral third party into the process helps with communication, and pro se taxpayers sometimes are more comfortable accepting an assessment of their case if they hear it from us rather than from the IRS attorney. Many of the positive results we get for taxpayers could not have been achieved without a cooperative attitude from IRS Counsel.

The strength of our program is the attorneys who volunteer their time to come to the calendar calls and advise the taxpayers. Our volunteers in 2012 were:

- In Dallas: **Nancy Allred**, **Peter Anastopulos**, **Carolyn Dove**, **David Gair**, **Amber Gajjar**, **Laura Grimball**, **Jennifer Gurevitch**, **Amber Haque**, **Chip Hider**, **Matt Hunsaker**, and **Lee Meyercord**.

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- In Houston: **Pat Bunch**, **Carol Cantrell**, **Pat Cantrell**, **Finis Cowan**, **Ed Hartline**, **Bill Lee**, **Derek Matta**, **Rob Morris**, **Charlie Wist**, and **Juan Vasquez**.

- In San Antonio: **Gerald Brantley**, **Barbara Lamar**, **Katherine Noll**, **Jamie Vasquez**, and **Dustin Whittenburg**.

And of course, no list of volunteers would be complete without **Elizabeth Copeland** and **Pete Lowy**, who coordinate the program in San Antonio and Houston respectively.

It's a great program and contributes to the Tax Court, the IRS, and the community. If you would like more information, or would like to participate, please contact me, Elizabeth, or Pete.

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January 25, 2013

VIA U.S. MAIL & FEDERAL eRULEMAKING PORTAL
HTTP://WWW.REGULATIONS.GOV

Office of Health Plan Standards and Compliance Assistance
Employee Benefits Security Administration
Room N-5653
U.S. Department of Labor
200 Constitution Avenue NW
Washington, DC 20210
Attention: Wellness Programs

Re: Comments on Proposed Regulations Relating to Incentives for Nondiscriminatory Wellness Programs in Group Health Plans

Dear Ladies and Gentlemen:

On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of Labor, Department of Health & Human Services and the Department of the Treasury for comments concerning the proposed regulations relating to incentives for nondiscriminatory wellness programs in group health plans under Treasury Regulations section 54.9802-1(f) prohibiting discrimination against participants and beneficiaries based on a health factor with respect to wellness programs.

THE REQUEST FOR ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE SECTION OF TAXATION OF THE STATE BAR OF TEXAS. THIS REQUEST AND THESE COMMENTS SHOULD NOT BE CONSTRUED AS REPRESENTING THE POSITION OF THE BOARD OF DIRECTORS, THE EXECUTIVE COMMITTEE OR THE GENERAL MEMBERSHIP OF THE STATE BAR OF TEXAS. THE SECTION

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

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OF TAXATION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW. THE REQUEST FOR THE ISSUANCE OF ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSION OF THE SECTION OF TAXATION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE SECTION OF TAXATION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED FOR THIS REQUEST FOR ADDITIONAL GUIDANCE AND ACCOMPANYING COMMENTS AND THIS REQUEST AND THESE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE SECTION OF TAXATION WHO PREPARED THEM.

We commend the (i) Employee Benefits Security Administration, Department of Labor, (ii) Internal Revenue Service, Department of the Treasury, and (iii) Centers for Medicare & Medicaid Services, Department of Health and Human Services, for permitting us to submit this request for additional guidance, and we appreciate being extended the opportunity to participate in this process.

Sincerely,

Tina R. Green

Tina R. Green
Chair, Section of Taxation
State Bar of Texas

cc: Ms. Amy Turner
Senior Advisor
Employee Benefits Security Administration
Department of Labor
turner.amy@dol.gov

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REQUEST FOR ADDITIONAL GUIDANCE WITH RESPECT TO PROPOSED REGULATIONS RELATING TO INCENTIVES FOR NONDISCRIMINATORY WELLNESS PROGRAMS IN GROUP HEALTH PLANS

This request for additional guidance with respect to the application of the proposed rules relating to incentives for nondiscriminatory wellness programs in group health plans under section 9802 of the Internal Revenue Code of 1986, as amended ("Code") and section 54.9802-1(f) of the Treasury Regulations (as published in 77 Federal Register 70620 (November 26, 2012) ("Proposed Treasury Regulations"), and supporting comments are presented on behalf of the Section of Taxation of the State Bar of Texas. The principal drafter of these comments was Henry Talavera, Vice-Chair of the Compensation and Employee Benefits Committee of the Section of Taxation of the State Bar of Texas. The Committee on Government Submissions (COGS) of the Section of Taxation of the State Bar of Texas has approved these comments. Stephanie Schroepfer is the Chair of COGS. Substantive comments were provided by Stephanie M. Schroepfer, Susan A. Wetzel, David D'Alessandro and Josephine Stewart Harvey. Mark Bodron reviewed this request for additional guidance on behalf of COGS.

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

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Date: January 25, 2013

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I. EXECUTIVE SUMMARY

The following submission contains a request for additional guidance with respect to the future application of the Proposed Treasury Regulations relating to incentives for nondiscriminatory wellness programs in group health plans under Code section 9802[1] which are intended to modify Treasury Regulations section 54.9802-1(f).[2]

The following is a summary of our request:

A. We respectfully request that the (i) Employee Benefits Security Administration, Department of Labor, (ii) Internal Revenue Service, Department of the Treasury and (iii) the Centers for Medicare & Medicaid Services, Department of Health and Human Services (collectively, the "Department") eliminate their proposed clarification of the additional reasonable alternatives which an employer must offer in order to avoid prohibited discrimination under a wellness program, except in the case when it would be:

   (i) "unreasonably difficult" for an individual to satisfy the otherwise applicable standard "due to a medical condition;" or

   (ii) "medically inadvisable" for an individual to attempt to satisfy the otherwise applicable standard.

   We respectfully suggest that requiring an employer to provide other different, reasonable alternatives in situations (other than in the medical situations as described immediately above) substantially limits an employer's ability to effect meaningful change in the overall health of its employees, to promote the health of its employees and to prevent disease. Without holding employees accountable for meaningful change in their behavior, employers will likely be unable to materially and substantially create a healthier workforce, thereby limiting the overall effectiveness of wellness programs. At a minimum, we request that the Department delay the effective date for this proposed clarification in order to give additional time for employers and third-party administrators to further comment on and address this new requirement.

B. Although we commend the Department for generally suggesting that the wellness program documents will generally control, we also respectfully request that the Department clarify whether there are any limits or restrictions regarding when any reward/award must be restored (or penalty abated) (collectively "Reward") to any participant who initially fails to meet an established goal pursuant to a wellness program, but later satisfies the established goal or a reasonable alternative standard for the Reward. We respectfully suggest that any Reward be provided during a wellness program year (generally a 12 month period) if the employee subsequently meets the conditions to qualify for the Reward prior to open enrollment for the next following year after the employee initially fails to meet the condition of any Reward.

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

[2] Section 54.9802-1(f) of the Treasury Regulations (as published in 77 Federal Register 70620 (November 26, 2012)).

We recommend that any Reward restored during such year should be paid out or credited to the wellness program participant no later than two and one-half months after the end of such year. If an employee later meets the conditions to have a Reward restored, we recommend, with some exceptions, that employers should only be required to provide any restored Reward on a prospective basis in accordance with the applicable wellness program once a goal has been met, as it would be administratively burdensome to track any Reward restored in a later calendar year. We also recommend that the terms of any restoration of any Reward should be explained by an employer during the open enrollment period of the preceding year (during which such Reward could have been earned initially) or, if later, by the date the wellness program is established.

II. BACKGROUND

A. Certain Key Facts Relating to Wellness Programs

Health care costs are expected to continue to grow at an average of 5.9% in 2012.[3] In 2009, 36% of all employers were offering Rewards for participating in a wellness program, with 61% in 2012, and over 80% projected for 2013.[4]

Furthermore:

(i) About 90% of all companies with achievement-based wellness programs include a weight/obesity threshold as a requirement under the wellness program (measured by either the body mass index ("BMI"), waist-to-hip or body fat measures);

(ii) About 75% of all companies with achievement-based wellness programs include blood pressure, cholesterol and tobacco use; and

(iii) About 59% of all companies with achievement-based wellness programs include glucose levels.[5]

Employers have historically used financial penalties such as premium surcharges or higher deductibles to incentivize their employees, with 9% of such employers using such penalties in 2009 and 20% in 2012.[6] There is also increasing interest among employers in pinpointing specific outcomes for weight control and cholesterol levels.[7] In one recent survey, almost 60% of employers indicated that their programs were designed mainly to improve the overall health of their employees.[8] In addition, employers generally believe that offering a wellness program is an effective way to reduce health care costs (68% of large employers [200 or more workers] vs. 51% of small firms).[9]

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[3] Towers, Watson, *Performance in an Era of Uncertainty, 2012, 17th Annual Towers Watson/National Business Group on Health Employer Survey on Purchasing Value in Health Care* ("Towers Study") at 3, http://www.towerswatson.com/assets/pdf/6556/Towers-Watson-NBGH-2012.pdf (last visited Jan. 22, 2013).

[4] Towers Study at 25.

[5] Towers Study at 26.

[6] Towers Study at 27.

[7] *Id.*

[8] Matt Dunning, *Few Employers Focus on Savings Participation Rate Key Success Measure,* 6 Business Insurance 47 (December 10, 2012).

[9] Kaiser Family Foundation and Health Research & Educational Trust, *Employer Health Benefits 2012 Annual Survey,*

B. New Alternative Set Forth in the Proposed Treasury Regulations

The PPACA[10] amended section 2705(j) of the PHSA[11], but did not actually amend the Code or ERISA[12].The PHSA generally applies to health insurance coverage and nonfederal governmental plans.[13] The PHSA does not apply to self-insured health plans of private employers, which plans are generally subject to ERISA and the Code.

PHSA section 2705(j) largely reflects the requirements set forth by the current, final Treasury Regulationssection54.9802-1(as adopted on December 13, 2006, with minor modifications since) ("Treasury Regulations") and extends nondiscrimination protections to the individual market.[14]Any Reward provided under a wellness program currently has to be, among other requirements, available to all similarly situated individuals, as follows:

> (iv) The reward under the program must be available to all similarly situated individuals.
>
> > (A) A reward is not available to all similarly situated individuals for a period unless the program allows—
> >
> > > (1) A reasonable alternative standard (or waiver of the otherwise applicable standard) for obtaining the reward for any individual for whom, for that period, it is unreasonably difficult due to a medical condition to satisfy the otherwise applicable standard; and
> > >
> > > (2) A reasonable alternative standard (or waiver of the otherwise applicable standard) for obtaining the reward for any individual for whom, for that period, it is medically inadvisable to attempt to satisfy the otherwise applicable standard.
> >
> > (B) A plan or issuer may seek verification, such as a statement from an individual's physician, that a health factor makes it unreasonably difficult or medically inadvisable for the individual to satisfy or attempt to satisfy the otherwise applicable standard.[15]

We find nothing in the Treasury Regulations or the legislative history to the PPACA to suggest that a different, reasonable alternative has to be provided in circumstances other than those

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at 179, http://ehbs.kff.org/pdf/2012/8345.pdf.

[10] Patient Protection and Affordable Care Act, as amended (the "PPACA"), Public Law 111-148 (2010).

[11] Public Health Services Act, as amended (the "PHSA").

[12] Employee Retirement Income Security Act of 1974, as amended ("ERISA").

[13] *See* Gary Cohen, Acting Director, Office of Oversight, Centers for Medicare & Medicaid Services, Department of Health and Human Services, *Application of Individual and Group Market Requirements under Title XXVII of the Public Health Services Act when Insurance Coverage Is Sold to, or through Associations,* September 1, 2011, http://cciio.cms.gov/resources/files/association_coverage_9_1_2011.pdf.pdf.

[14] Preamble to the Proposed Treasury Regulations, 77 Federal Register 70620 at 70621.

[15] Treasury Regulation section 54.9802-1(f)(2)(iv); see also PPACA section 1201(f)(3)(D), which is substantively identical to the above except for the italicized language which follows: ("The *full* reward under the *wellness* program *shall* be *made* available to all similarly situated individuals. *For such purpose, among other things,...*" [*Emphasis Added*]).

outlined in Treasury Regulations section 54.9802-1(f)(2)(iv) ("Current Alternative Regulation"). The only change by the PPACA potentially affecting the Current Alternative Regulation relates to a wellness program demonstration project.[16]Because of the PPACA changes, however, the Proposed Treasury Regulations will affect most wellness programs, as the Department intended that the Proposed Treasury Regulations will apply to both grandfathered and non-grandfathered health plans, along with those non-federal governmental wellness programs newly affected by the PPACA changes.[17]

The Proposed Treasury Regulations reiterate the requirements set forth above under the Current Alternative Regulation, with certain clarifications.[18]First, a plan or issuer may waive an otherwise applicable standard and provide a Reward. Second, the Proposed Treasury Regulations require that a "reasonable alternative standard" be provided upon a specific request by those individuals who either have a medical condition or for whom it is medically inadvisable to meet such standards as provided in Treasury Regulation section 54.9802-1(f)(2)(iv) set forth above (collectively "medical conditions"). In such circumstances, the Department provides that an individual with a medical condition could ask for an alternative standard, citing the Preamble to the Current Alternative Regulation relating to overcoming tobacco addiction, as follows:

> All the facts and circumstances would be taken into account in determining whether a plan or issuer has provided a reasonable alternative standard, including but not limited to the following proposed factors:
>
> - If the reasonable alternative standard is completion of an educational program, the plan or issuer must make the educational program available instead of requiring an individual to find such a program unassisted, and may not require an individual to pay for the cost of the program.
> - If the reasonable alternative standard is a diet program, the plan or issuer is not required to pay for the cost of food but must pay any membership or participation fee.
> - If the reasonable alternative standard is compliance with the recommendations of a medical professional who is an employee or agent of the plan or issuer, and an individual's personal physician states that the medical professional's recommendations are not medically appropriate for that individual, the plan or issuer must provide a reasonable alternative standard that accommodates the recommendations of the individual's physician with regard to medical appropriateness.[19]

Furthermore, and most significantly, the Proposed Treasury Regulations provide that a program cannot be designed as subterfuge for discrimination or underwriting, as follows:

> To ensure that programs are not a subterfuge for discrimination or underwriting based on health factors such as weight, blood pressure, glucose levels, cholesterol levels, or tobacco use with no or insufficient support to improve individuals' health, the Departments propose that, to the extent a plan's initial standard for

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[16] PPACA section 1201(l).

[17] *See* Preamble to Proposed Treasury Regulations, 77 Federal Register 70620 at 70622.

[18] *See* Preamble to Proposed Treasury Regulations, 77 Federal Register 70620 at 70624.

[19] Preamble to Proposed Treasury Regulation, 77 Federal Register 70620 at 70624.

> obtaining a reward (or a portion of a reward) is based on results of a measurement, test, or screening that is related to a health factor (such as a biometric examination or a health risk assessment), the plan is not reasonably designed unless it makes available to all individuals who do not meet the standard based on the measurement, test, or screening a different, reasonable means of qualifying for the reward.[20]

The Department added the rule discussed in the immediately preceding paragraph at the end of Proposed Treasury Regulation section 54.9802-1(f)(3)(iv) ("Proposed Alternative Regulation"),[21] as follows:

> To the extent a plan's initial standard for obtaining a reward (including a portion of a reward) is based on the results of a measurement, test, or screening relating to a health factor (such as a biometric examination or a health risk assessment), the plan must make available to any individual who does not meet the standard based on the measurement, test, or screening a different, reasonable means of qualifying for the reward.

The Department explained the reason for the changes discussed above, as follows:

> The Departments intend that these clarifications with respect to offering reasonable alternative standards will help prevent health-contingent wellness programs that provide little to no support to enrollees to improve individuals' health. In addition, as explained later in this Preamble to the Proposed Regulations, clarifications were proposed to ensure that a health-contingent wellness program is reasonably designed to improve health and is not a subterfuge for underwriting or reducing benefits based on health status."[22]

The Department invited comments on what facts and circumstances should be specifically addressed by the alternatives offered and specifically asked for comments on any additional rules or clarifications that might be appropriate, particularly as it relates to what the Department sees as a "one-size-fits-all" approach to designing different means of qualifying for a Reward. Specifically, the Department asked for comments "on whether any other consumer protections are needed to ensure that wellness programs are reasonably designed to promote health or prevent disease."[23]

C. Discussion of When a Reward Must Be Reinstated/Waiver of any Penalty

We did not find any significant discussion in the Proposed Treasury Regulations relating to how or when a Reward had to be provided under a wellness program, except that a Reward must be provided in accordance with the terms of the applicable wellness program documents and each employee must be provided an opportunity to qualify for the Reward "at least once per year."[24]

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[20] Preamble to Proposed Treasury Regulation, 77 Federal Register 70620 at 70625.

[21] Note that similar parallel proposed provisions are found under proposed 29C.F.R. section 2590.702(f)(3) and 45 C.F.R. section 146.121, but for ease of reference we only refer to the Proposed Treasury Regulations in this Comment.

[22] Preamble to Proposed Treasury Regulation, 77 Federal Register 70620 at 70624-25.

[23] Preamble to Proposed Treasury Regulation, 77 Federal Register 70620 at 70625.

[24] Proposed Treasury Regulation section 54.9802-1(f)(3)(i).

The Proposed Treasury Regulations do make it clear that the wellness program "rewards" that are at issue can be provided in a wide variety of forms.[25]

The Proposed Treasury Regulations also do not apparently address the practical interaction of Reward pay-outs in the case of participants satisfying a primary standard based on the results of a measurement, test, or screening relating to a health factor compared to/versus those participants satisfying the "different, reasonable means of qualifying" that must be legally established for that same Reward.

On the other hand, based on the "Examples" set forth in the Proposed Treasury Regulations, the Department suggested that it may take some additional time for an employee to meet any established alternative standard at least in some cases. The following are examples provided at the end of the Proposed Treasury Regulations which implicitly have time frames for completion and giving a Reward to an employee who does not initially qualify:

1. Exercise and diet regimen. Example 2.
2. Following the advice of doctor regarding medication and blood testing. Example 3.
3. Following doctor's recommendations under a wellness program. Example 4 (participant must complete walking program "within the plan's timeframe," and if not, the participant must follow a doctor's recommendation).
4. Completing a smoking cessation program. Example 5.

The four examples above are clearly contrasted with examples in the Proposed Treasury Regulations addressing whether an individual meets any primary/initial standard set forth in the wellness program based upon any initial test or screening.[26]

III. REQUEST FOR ADDITIONAL GUIDANCE

A. <u>We Respectfully Request that the Department Reconsider and Ideally Eliminate the Proposed Alternative Regulations</u>

Based upon the above statistics and anecdotal evidence, wellness programs have been embraced by employers and their popularity is expected to increase over time. We suggest that the increase in wellness programs among employers reflects a widespread understanding and acceptance of the Current Alternative Regulation and a desire by employers for those rules to continue essentially unchanged. We understand the Department's concern regarding consumer protection and providing assistance to employees, but nowhere in the preamble of the current Treasury Regulations (or otherwise in the current Treasury Regulations) does such guidance provide that consumer protection or employee assistance is to be considered as an objective in all circumstances. We believe that the current Treasury Regulations properly balance an employer's

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[25] *See* Proposed Treasury Regulation section 54.9802-1(f) ("Except where expressly provided otherwise, references in this section to an individual obtaining a reward include both **obtaining a reward** (such as a **premium discount or rebate, a waiver of all or part of a cost-sharing mechanism**, an **additional benefit**, or any **financial or other incentive**) and **avoiding a penalty** (such as the absence of a **premium surcharge**, or **other financial or nonfinancial disincentive**"). *Emphasis added.*

[26] *See* Examples 2 through 5 of section 54.9802-1(f)(4) of the Proposed Treasury Regulations where any initial determination of whether a participant meets a standard appears to be accomplished in a snapshot-type determination (particularly BMI, cholesterol level, non-smoker, etc.). *See also* Preamble to the Proposed Treasury Regulations, 77 Federal Register 70620 at 70621.

desire to hold employees accountable, while at the same time protecting employees in the case of certain medical conditions.

We agree that wellness programs should not be designed as a "subterfuge for discriminating based on a health factor," but we would respectfully suggest that the Department reconsider whether it is appropriate to require a different, reasonable alternative any time a Reward is based upon the results of measurement, test or screening relating to a health factor results. The Department provides, without exception, that an employer must offer a different, reasonable alternative when a Reward is based on the achievement of results on certain tests. In our view, it is difficult to conceive how the failure of a plan sponsor to offer a different, reasonable alternative in such circumstances would constitute a "subterfuge," using the common understanding of "subterfuge," as a "deception by artifice or stratagem in order to conceal, escape, or evade."[27]Tests are typically the basis for most well-designed wellness programs.

If a different alternative is generally required to be provided to an employee under a wellness program, there appears to be no standard that an employer can use to incentivize otherwise healthy employees to change their behavior if the program is based upon, among other things, biometric screenings and tests. We respectfully suggest that the Department balance any employee participant considerations against the employer's need for certainty in the application of the rules and personal accountability on behalf of employees. We anticipate that if it is not permissible to require employees to be personally accountable for their own behavior, wellness programs will be much less successful in the future than they are today.

We respectfully suggest that the Department reconsider the proposition that otherwise healthy employees should always be provided with additional support to become healthier employees simply because any wellness Rewards are based upon certain objective tests and standards. To avoid uncertainty, the only reasonable response by an employer to the Proposed Alternative Regulation would be to provide the employee with an alternative that has no real likelihood to change unhealthy behavior. We respectfully suggest that the Department consider whether it should be the employee's responsibility to change his or her own behavior, without the employer having to modify its program for each participant. We suggest that the Department reconsider how far employers should be required to move away from a "one-size-fits-all" approach. We respectfully suggest that the Department's current position would introduce unduly burdensome and costly requirements on employers to individually tailor a wellness program to the needs of each employee.

Further, we suggest that the Department consider whether the new rule in the Proposed Alternative Regulation introduces uncertainty when none existed previously. We respectfully request that the Department reconsider the introduction of the concept of "a different, reasonable means of qualifying for the reward." We are concerned that, if implemented, the Proposed Alternative Regulation will invite litigation relating to the proposed requirement that employers provide a "different, reasonable" alternative for all employees, regardless of whether such employees are healthy and could otherwise cooperate and participate in any wellness programs. If employees cannot be expected to achieve any meaningful health results, we believe that many employers will not implement wellness programs, and, since wellness programs are voluntary, many employers will decide to cancel any such programs rather than be subjected to litigation on what it means to provide a different, reasonable alternative to an otherwise healthy employee who fails to meet certain standard measurements.

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[27] Merriam-Webster Dictionary, http://www.merriam-webster.com/dictionary/subterfuge.

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The Proposed Alternative Regulation also arguably imposes an additional standard that mostly replaces existing guidelines, as Proposed Treasury Regulation section 54.9802-1(f)(3)(iii) already provides alternatives upon request for those with medical conditions (i.e., those who can demonstrate that it would be "unreasonably difficult due to a medical condition to satisfy the otherwise applicable standard" or "medically inadvisable to attempt to satisfy the otherwise applicable standard.") We respectfully recommend that the Department reconsider its apparent position that it is necessary to provide all other employees (i.e., including employees for whom it would not be medically inadvisable or unreasonably difficult to satisfy the primary Reward criteria) with similar, if not greater, protection through the implementation of the Proposed Alternative Regulation.

We respectfully suggest that the protections added by the new Proposed Alternative Regulation are already addressed if such plans are subject to the Americans with Disabilities Act of 1990 ("ADA"). The courts should be able to determine whether such wellness programs are subject to the ADA, and whether an employer has engaged in any conduct in violation of the ADA. In our experience, the ADA prevents most employers from imposing onerous conditions on employees. While the recent 11thCircuit Court of Appeals decision in *Seff v. Broward County, Florida*[28] which was published on August 20, 2012 ("*Seff*"), concludes that the ADA does not apply to a wellness program that is part of a group health plan, we believe that the Proposed Alternative Regulation essentially moots *Seff*, because there would almost never be a potential ADA issue if a different, reasonable alternative must be provided in most circumstances. We respectfully suggest that the ADA issues should be addressed by the courts and not by implementation of the Proposed Alternative Regulation.

For the reasons discussed above, we respectfully request that the Department eliminate the requirement of "a different, reasonable means of qualifying for the reward." The implementation of the new requirement does not appear to have any basis under the PPACA, the legislative history of the PPACA or the Current Alternative Regulation.

Alternatively, we respectfully request that, at a minimum, the Department postpone the implementation of the Proposed Alternative Regulation pending the issuance of certain standards regarding alternatives which must be provided. The Proposed Alternative Regulation (unlike the alternatives provided in cases of a medical condition) would completely change the rules that have been relied upon by employers in the past. The Proposed Alternative Regulation would require an employer to make an alternative available even when not requested by an employee and regardless of whether an employee can demonstrate any sort of medical justification for the provision of alternative. Employers have been given little time to respond and determine what rules should be implemented, given that such a drastic change from the current Treasury Regulations was not expected. We would respectfully suggest that additional time for comment on this very important issue might lead to the development of an appropriate safe harbor with respect to the Proposed Alternative Regulation after careful consideration and comment by the Department and other interested parties.

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[28] 691 F3d. 221(11th Cir. 2012).

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B. <u>Standards should be Implemented Clarifying When a Reward Must be Provided After Failing to Meet Any Initial Standard</u>

We recommend that the Department specify the period over which any "earn-back"/waiver of imposing a penalty (i.e., "a Reward") should be measured. Logically, it would seem that the plan year would be the proper measuring period for purposes of determining when the Reward should be reinstated if an employee meets the conditions for receipt of the Reward and the employer complies with the Treasury Regulations. Like other guidance under the PPACA, we respectfully recommend that employers be given some leeway in determining the period over which a Reward can be earned again. We believe it would be reasonable for the Department to defer to the terms of the wellness program, but additional guidance would be welcome.

We respectfully recommend that the Department consider implementing the following proposal. If an employee satisfies a standard at some point during a plan year that he or she previously failed to initially meet for such plan year, any resulting Reward should apply only prospectively. It would be administratively burdensome to retroactively credit a Reward to an employee late in the year in most cases, particularly with respect to a past plan year. Under the proposal, exceptions would be provided when an employee meets the conditions to earn a Reward during the plan year before open enrollment for the next following plan year. Under the proposal, if an employee would meet the conditions to receive the Reward prior to open enrollment for the next year, the employer would be required to provide the Reward during such year in which the conditions for the Reward are satisfied, but no later than two and one-half months after the end of such year, consistent with short-term deferral exception of Code section 409A and proposed guidance applicable to flexible spending accounts under the Code. Under the proposal, in any event, the employer would be granted some discretion to make employees whole with respect to the payment of any Reward which is earned during the year.

We also recommend that the Department consider requiring employers to explain to employees the period for determining a Reward during the immediately preceding open enrollment period prior to the beginning of the applicable program year (or if later, on or before the first day that the wellness program is implemented during such year). The following is an example, with three possible alternative outcomes that we would recommend the Department accept based upon the proposal set forth above.

> **<u>Proposed Facts</u>**: Under the company "X" wellness plan, if an employee has a BMI of less than or equal to 30 during testing provided by "X" during open enrollment in November 2012 for the 2013 plan year, an employee is notified that he or she will be eligible to receive a Reward for the 2013 plan year beginning on the first payroll period of "X" during the 2013 plan year, which is the calendar year. The Reward equals $5 per pay period if the employee's BMI is 30 or less. The employee is tested in November 2012 and has a BMI of 31. If the employee has a BMI higher than 30, the employee could sign up and complete a six week weight loss program during the 2013 plan year. The next open enrollment begins on November 1, 2013. Upon completion of the program, when would the employee receive his or her Reward for the alternative goal?

- **<u>Proposed Option 1</u>**: The employee would receive the full Reward for the entire plan year (a gift card or other cash payment in a lump sum) within a reasonable period after completion during such year before

November 1, 2013, but no later than two and one-half months after the end of such year.

- **Proposed Option 2**: The Reward would be provided retroactively back to the beginning of the plan year if the Reward is earned and reinstated timely. For example, the program could provide for reinstatement of a Reward if the employee completed the program by the end of the first quarter of 2013. The employee would then receive the Reward (a reduction of $5 per pay period of his or her employee contribution for health coverage) retroactive to the beginning of the plan year.

- **Proposed Option 3**: If the employee completed the program after November 1, 2013 and before 2014, the Reward would be a reduction of $5 per pay period beginning as soon as administratively practicable after completion of the program.

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SECTION OF TAXATION
State Bar of Texas

December 14, 2012

VIA U.S. MAIL

Mr. Steven T. Miller
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224, Internal Revenue Service

Re: Comments on Proposed Regulation relating to Circular 230 (REG-138367-06)

Dear Acting Commissioner Miller:

On behalf of the Section of Taxation of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury and the Internal Revenue Service for comments concerning the proposed regulations relating to Circular 230 governing practice before the Internal Revenue Service.

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

1414 Colorado Street, Austin, TX 78701
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We commend the Service for permitting us to submit this request for additional guidance, and we appreciate being extended the opportunity to participate in this process.

Sincerely,

Tina R. Green

Tina R. Green
Chair, Section of Taxation
State Bar of Texas

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RESPONSE TO REQUEST FOR COMMENTS REGARDING PROPOSED REGULATIONS RELATING TO CIRCULAR 230 GOVERNING PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

This response to the request for comments in the notice of proposed rulemaking, REG 138367-06, relating to regulations governing practice before the Internal Revenue Service is presented on behalf of the Section of Taxation of the State Bar of Texas. The principal drafters of these comments are David Gair, David Colmenero and Shawn O'Brien. The Committee on Government Submissions ("COGS") of the Section of Taxation of the State Bar of Texas has approved these comments. Stephanie M. Schroepfer is the Chair of COGS and David Colmenero is the Chair of the Controversy Committee of the Section of Taxation of the State Bar of Texas. Mary McNulty reviewed these comments on behalf of COGS.

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

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Date: December 14, 2012

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This comment letter is in response to the request of the Internal Revenue Service (the "IRS") and the Department of the Treasury ("Treasury") for comments concerning the notice of proposed rulemaking, REG 138367-06, relating to rules governing practice before the Internal Revenue Service (the "Proposed Regulations").

The Section of Taxation of the State Bar of Texas applauds Treasury and the IRS for their efforts to improve the regulations governing practice before the IRS. The Proposed Regulations eliminate the burdensome covered opinion rules that are not appropriate for most tax matters. We offer suggestions to improve the Proposed Rules that address competence, reliance on representations and advice from others, and the heightened standard for certain opinions.

1. Proposed Amendment to Section 10.35 - Competence.

We support the IRS's and Treasury's proposal to eliminate the covered opinion rules under current Section 10.35[1]. In our view, the current covered opinion rules are overly broad and unnecessarily increase the costs of tax compliance.

However, we have concerns with the reference to "thoroughness and preparation" in the competence standard of proposed Section 10.35, and therefore, submit the following recommendation and supporting comments.

Recommendation

We recommend that proposed Section 10.35(a) be amended either to delete the requirement of "thoroughness and preparation" or to conform it to ABA Model Rule 1.1.

Proposed Rule:

Section 10.35(a) of the Proposed Regulations provides as follows:

> (a) A practitioner must possess the necessary competence to engage in practice before the Internal Revenue. Competent practice requires the knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged.

Discussion:

It is essential that the United States tax system be supported by competent tax practitioners. The Proposed Regulation, however, creates a standard that could be interpreted in a manner that is detrimental to taxpayers in cases in which tax practitioners are engaged shortly before the matter's deadline. Specifically, the references to "thoroughness" and "preparation" could be interpreted to mean that a practitioner should not advise a client who has an imminent deadline unless the practitioner is able to thoroughly prepare for the representation. This may not be possible for some engagements. For example, many times practitioners are approached late in the process by taxpayers to represent them in specific proceedings before the IRS, such as administrative hearings. The tax practitioner may not have the opportunity to prepare thoroughly for the proceeding because he or she was engaged only shortly before the proceeding. In our view, such lack of preparation in no way reflects on the practitioner's competence.

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[1] All references to "Section(s)" made herein are to section(s) of the Treasury Department Circular No. 230.

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Practitioners should not be discouraged from accepting engagements with impending deadlines. To the contrary, public policy is better served by encouraging tax practitioners to assist taxpayers whose lack of knowledge in dealing with the IRS may have caused the short deadline for the tax practitioner. As drafted, subsection (a) of Section 10.35 could discourage tax practitioners from accepting certain engagements when they do not have an opportunity to prepare thoroughly because of the risk of violating Circular 230.

In addition, there is a cost/benefit analysis that practitioners and their clients must necessarily undertake when deciding how to approach any particular situation. Some tax matters may be immaterial and of little significance to the taxpayer and not require the same level of thoroughness and preparation as required for a more significant the tax issue. But the lack of thorough preparation in any given situation may not necessarily reflect lack of competence.

ABA Model Rule 1.1 ("ABA Rule 1.1"), which appears to be the basis for the proposed revision to Section 10.35, provides as follows:

> A lawyer shall provide competent representation to a client. Competent representation requires the legal knowledge, skill, thoroughness and preparation **reasonably** necessary for the representation. [emphasis added].

Comment 5 to ABA Rule 1.1 states, in part:

> [t]he required attention and preparation are determined in part by what is at stake; major litigation and complex transactions ordinarily require more extensive treatment than matters of lesser complexity and consequence.

Thus, use of the word "reasonably" in ABA Rule 1.1 helps to clarify that each representation is unique and requires different levels of knowledge, skill, thoroughness and preparation.

We suggest that the IRS and Treasury consider amending Section 10.35(a) of the Proposed Regulation to remove its reference to "thoroughness and preparation". In our view, the failure to thoroughly prepare should not be evidence of a lack of competence in all instances. Alternatively, if the IRS and Treasury deem it appropriate to retain the "thoroughness and preparation" requirement, we recommend that the IRS and Treasury then consider adding the word "reasonably" to rule 10.35, as follows:

> (a) A practitioner must possess the necessary competence to engage in practice before the Internal Revenue. Competent practice requires the knowledge, skill, thoroughness, and preparation **reasonably** necessary for the matter for which the practitioner is engaged. [emphasis added].

2. Proposed Amendments to Section 10.37--Requirements For Written Advice

Proposed Section 10.37 sets forth the general rules that govern the conduct of all practitioners who issue written advice. While we applaud the proposal to streamline the written opinion rules and to

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eliminate the covered opinion provisions, we are concerned about: (i) the effect that the proposed rules may have on a practitioner's ability to rely on factual representations made by others, including representations made by a client; and (ii) the ability of a practitioner to rely on the advice of others. Our concerns stem from use of the phrase "know or should know" in several portions of Section 10.37. We also have concerns with the lack of guidance in determining the heightened standard that will be applied to opinions described in subsection (c)(2) of Section 10.37. Therefore, we provide the following recommendations and related comments.

Reliance on Representations and Advice From Others

Recommendation

We suggest two changes in this section: (a) Modify the phrase "know or should know" as used in Proposed Section 10.37 (specifically - 10.37(a)(2)(ii), (a)(3), and (b)(1-3), with "know or **reasonably** should know" [emphasis added]; and (b) provide more specific guidance or examples on the facts a practitioner "should know."

Proposed Section 10.37

Proposed Sections 10.37(a)(2)(ii) and (iv) state that a "practitioner must . . . [r]easonably consider all relevant facts that the practitioner knows or should know . . . .[and] Not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or another person if reliance on them would be unreasonable . . . ." Proposed Section 10.37(a)(3) further provides: "Reliance on representations, statements, findings, or agreements is unreasonable if the practitioner knows or should know that one more representations or assumptions on which any representation is based are incorrect or incomplete."

Proposed Section 10.37(b) also states that reliance on the advice of others is not reasonable when "(1) The practitioner knows or should know that the opinion of the other practitioner should not be relied on; (2) The practitioner knows or should know that the other practitioner is not competent or lacks the necessary qualifications to provide the advice; or (3) The practitioner knows or should know that the other practitioner has a conflict of interest . . . ."

Discussion

Proposed Section 10.37 adds a new standard to the facts that a practitioner should consider when issuing written advice. Specifically, when a practitioner undertakes to provide a client written advice, Section 10.37 holds a practitioner accountable, not only for facts that the practitioner knows, but also for facts that the practitioner "should know." As drafted, the proposed amendment provides no guidance as to when a practitioner *should* be deemed to know certain facts, which potentially places the Commissioner in the position of second-guessing what a practitioner should have known in hindsight. We understand that the Commissioner may be concerned with avoiding situations in which a tax practitioner is willfully blind to facts that exist, and this concern may provide the basis for holding practitioners accountable for facts that they "should know" in certain circumstances. However, as drafted, proposed Section 10.37, does not distinguish between *reasonable* reliance on client representations, which should be permitted even when those representations later turn out to be incorrect or incomplete, and willful or reckless disregard of the facts by a practitioner, which should not. For

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instance, Section 10.37(a)(2)(ii) simply refers to facts that a practitioner knows or should know. Revising the phrase "know or should know" in Proposed Section 10.37 (specifically - 10.37(a)(2)(ii), (a)(3), and (b)(1-3), with "know or **reasonably** should know" [emphasis added]helps to clarify that a reasonableness standard will be the test.

We believe it would also be helpful to provide more specific guidance or examples on the facts a practitioner should be deemed to know in situations in which the practitioner may not have actual knowledge of those facts, particularly when a practitioner must rely on representations made by a client in providing advice.[2]

Heightened Standard for Certain Opinions

Recommendation

We recommend that subsection (b)(2) be revised (i) by clarifying what is meant by a "heightened standard" and (ii) by removing the parenthetical "(or a person who is a member of, associated with, or employed by the practitioner's firm)."

Regulatory Language

Subsection (b)(2) under the proposed revision provides as follows:

> In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing, or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, the determination of whether a practitioner has failed to comply with this section will be made on the basis of a heightened standard of review because of the greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.

Discussion

It would be helpful for practitioners to know the "heightened standard" that will be applied to opinions referenced in this section. These types of opinions do not appear to be precluded by Circular 230 under the proposed revisions. In the absence of an explanation concerning the heightened standard

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[2] Because practitioners cannot be expected to know everything or to be experts in all matters, they must necessarily rely, on some level, on information and factual representations provided by their clients in providing advice. Indeed, particularly where representations made by clients relate to facts and matters outside the practitioner's knowledge or expertise, the only way that a practitioner can provide reliable and affordable advice to a client is to rely on representations made by the client. As long as a client is made aware of the importance of the accuracy of those factual representations to the overall reliability of the written advice provided, a practitioner should be permitted to rely on representations made by the client.

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that will be applied, practitioners who issue these types of opinions will not know whether they are in compliance with Circular 230.

In addition, we recommend, in any event, that the IRS and Treasury consider deleting the parenthetical in subsection (b)(2) which provides "(or a person who is a member of, associated with, or employed by the practitioner's firm)." The parenthetical appears to be superfluous because the sentence already references "a person other than the practitioner." The inclusion of the parenthetical may pose the risk of creating ambiguity for practitioners as to its intended meaning.

CONCLUSION

We appreciate the opportunity to provide these comments to the proposed revisions to Circular 230. We also welcome the opportunity to be a further resource on this matter if either the IRS or Treasury desires additional input.

INTERNATIONAL TAX UPDATE

State Bar of Texas
International Tax Symposium

by

David L. Forst

Fenwick & West LLP

November 2012

1299274.1

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INTERNATIONAL TAX UPDATE

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I. SPLITTERS.

A. Foreign Tax Credit Splitters Under § 909.

1. Enacted in 2010 as part of the Education Jobs and Medicaid Assistance Act ("EJMAA), P.L. 111-226, § 909 addresses situations in which foreign income taxes become separated from their related income.

2. Under § 909(a), if there is a foreign tax credit splitting event with respect to a direct foreign income tax paid or accrued by the taxpayer, the tax will not be taken into account before the taxable year in which the taxpayer takes the related income into account.

3. Under § 909(b), if there is a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by a section 902 corporation, the tax will not be taken into account (including for E&P purposes) before the taxable year in which the related income is taken into account by the section 902 corporation or its 10% U.S. corporate shareholder.

4. A foreign tax credit splitting event occurs with respect to a foreign income tax if the related income is (or will be) taken into account by a covered person. § 909(d)(1). Section 909 does not suspend foreign income taxes if the same person pays the tax but takes into account the related income in a different taxable period (*e.g.*, timing differences between U.S. and foreign tax accounting rules).

5. A covered person is defined, with respect to any person who pays or accrues a foreign income tax (a payor), as any of the following:

   (a) any entity in which the payor holds, directly or indirectly, at least a 10 percent ownership interest (by vote or value),

   (b) any person that holds, directly or indirectly, at least a 10 percent ownership interest in the payor,

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(c) any person that bears a relationship to the payor described in § 267(b) or 707(b), and

(d) any other person specified by the Secretary. § 909(d)(4).

i. The Joint Committee on Taxation's Technical Explanation (the "JCT Report") states that Treasury and the IRS may issue regulations that treat an unrelated counterparty as a covered person in certain sale-repurchase transactions and certain other transactions deemed abusive. JCX-46-10 (Aug. 10, 2010).

6. Related income is defined, with respect to any portion of foreign income tax, as the income (or earnings and profits) to which such portion of foreign income tax relates. § 909(d)(3).

7. Partnerships. Section 909(c)(1) provides that in the case of a partnership, § 909(a) and (b) will be applied at the partner level. A similar rule applies in the case of an S corporation or trust under the new § 909 Temporary Regulations, discussed below.

8. Effective Date. Section 211(c)(1) of the EJMAA provides that § 909 applies to foreign income taxes paid or accrued in post-2010 taxable years. Section 211(c)(2) of the EJMAA provides that § 909 also applies to pre-2011 taxes, but only for purposes of applying §§ 902 and 960 after December 31, 2010.

B. Notice 2010-92.

1. Notice 2010-92 addresses the application of § 909 to foreign income taxes paid or accrued by a § 902 corporation in taxable years beginning on or before December 31, 2010.

2. The Notice sets forth an exclusive list of four types of arrangements that are treated as giving rise to a FTC splitting event in pre-2011 tax years. These splitting events are generally the same as in the new temporary regulations and are discussed below in the context of the temporary regulations.

3. Notice 2010-92 states that any pre-2011 taxes that were not paid or accrued in connection with one of the splitting events will not

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be suspended under § 909. In addition, the Notice also provides that the following pre-2011 taxes will not be suspended.

(a) Any pre-2011 taxes that were paid or accrued in connection with one of the identified pre-2011 splitter arrangements but that were deemed paid or accrued under § 902 or § 960 on or before the last day of the section 902 corporation's last pre-2011 taxable year.

(b) Any pre-2011 split taxes if the payor section 902 corporation or a section 902 shareholder took the related income into account before the effective date; and

(c) Any pre-2011 split taxes paid or accrued by a section 902 corporation in its taxable years beginning before 1997.

4. The determination of related income, other income, pre-2011 split taxes, and other taxes, and the portion of these amounts that were distributed, deemed paid, or otherwise transferred or eliminated must be made on an annual basis beginning with the § 902 corporation's first taxable year beginning after December 31, 1996 in which the § 902 corporation paid or accrued a pre-2011 tax. Annual amounts of related income and pre-2011 split taxes are aggregated for each separate pre-2011 splitter arrangement.

5. The determination of annual and aggregate amounts of related income and pre-2011 split taxes with respect to each pre-2011 splitter arrangement must be made for each separate § 904(d) category of the § 902 corporation, each covered person, and any other person thatsucceeds to the related income and pre-2011 split taxes.

6. Notice 2010-92 provides that if the earnings and profits of a covered person include amounts attributable to both related income and other income, then distributions, deemed distributions, and inclusions out of earnings and profits of the covered person are considered made out of related income and other income on a pro rata basis.

(a) However, in lieu of this rule, a § 902 shareholder may choose to treat all distributions, deemed distributions, and inclusions out of earnings and profits of a covered person as attributable first to related income.

(b) This alternative election in effect becomes the primary rule since all taxpayers likely would elect such treatment.

(c) Note, the new temporary § 909 regulations (discussed below) eliminate the ability to elect the alternative method for identifying related income distributions for taxable years beginning on or after January 1, 2011.

7. Related income will be considered taken into account by a § 902 shareholder to the extent that the related income is recognized as gross income by the § 902 shareholder, or by an affiliated corporation that is a member of the same consolidated group, upon a distribution, deemed distribution, or inclusion (such as under § 951(a)) out of the earnings and profits of the covered person attributable to such related income.

8. For each pre-2011 splitter arrangement, as related income is taken into account by the payor section 902 corporation or a section 902 shareholder, a ratable portion of the associated pre-2011 split taxes will no longer be treated as pre-2011 split taxes.

9. New temporary regulations issued in February 2012 adopt the rules described in Notice 2010-92 with respect to FTC splitting events and the application of § 909 to foreign income taxes paid or accrued by a § 902 corporation in pre-2011 taxable years. Temp. Treas. Reg. § 1.909-6T.

C. New Temporary § 909 Regulations.

1. The temporary regulations provide an exclusive list of arrangements that will be treated as giving rise to foreign tax credit splitting events. The preamble to the new temporary regulations states that future guidance may identify additional transactions or arrangements to which § 909 applies. However, any such guidance will apply only to foreign taxes paid or accrued in taxable years beginning on or after the date such guidance is issued.

(a) Temp. Treas. Reg. § 1.909-1T(a) provides definitions. Temp. Treas. Reg. § 1.909-1T(b) and (c)

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provide rules substantially similar to those set forth in Notice 2010-92 concerning the application of § 909 to partnerships and trusts, except that the temporary regulations expand the scope of these rules to include S corporations and taxes paid or accrued by persons other than § 902 corporations.

(b) Temp. Treas. Reg. § 1.909-1T(b) provides that under § 909(c)(1), § 909 applies at the partner level, and similar rules apply in the case of an S corporation or trust. Accordingly, in the case of foreign income taxes paid or accrued by a partnership, S corporation or trust, taxes allocated to one or more partners, shareholders or beneficiaries (as the case may be) will be treated as split taxes to the extent that the taxes would be split taxes if the partner, shareholder or beneficiary had paid or accrued the taxes directly on the date the taxes are taken into account by the partner under § 702 and 706, by the shareholder under § 1373(a), or the beneficiary under § 901(b)(5). Any split taxes will be suspended in the hands of the partner, shareholder or beneficiary.

(c) Notice 2010-92 provided that for purposes of applying § 909 in post-2010 taxable years, there will not be a foreign tax credit splitting event with respect to a foreign income tax paid or accrued by a partner to the extent the related income is taken into account by the partner. A commenter recommended that the regulations adopt an aggregate approach to partnerships in determining whether related income is taken into account by a covered person. Treasury and the IRS agreed with this comment. Accordingly, Temp. Treas. Reg. § 1.909-1T(c) provides that for purposes of determining whether related income is taken into account by a covered person, related income of a partnership, S corporation or trust is considered to be taken into account by the partner, shareholder or beneficiary to whom the related income is allocated.

(d) Temp. Treas. Reg. § 1.909-1T(d) addresses the application of § 909 to annual layers of pre-1987 accumulated profits and pre-1987 foreign income taxes of a § 902 corporation. Section 909 and the regulations under that section will apply to pre-1987 accumulated profits and pre-1987 foreign income taxes of a § 902 corporation attributable to taxable years beginning on or after January 1, 2012. Pursuant to § 902(c)(6) and regulations under that section, earnings and profits and associated foreign taxes paid or accrued by a foreign corporation in taxable years before it was a § 902 corporation are treated as pre-1987 accumulated profits and pre-1987 foreign income taxes.

(e) Temp. Treas. Reg. § 1.909-1T(d) also provides that foreign corporations that become § 902 corporations must account for split taxes paid or accrued and related income in pre-acquisition taxable years beginning on or after January 1, 2012. Suspension of split taxes paid or accrued with respect to pre-1987 accumulated profits attributable to earlier taxable years is not required.

(f) Temp. Treas. Reg. § 1.909-1T applies to taxable years beginning on or after January 1, 2011.

2. Splitter Arrangements – In General.

(a) Section 909(d)(1) provides that there is a foreign tax credit splitting event with respect to a foreign income tax if the related income is (or will be) taken into account by a covered person. Treasury and the IRS believe that a transaction or arrangement in which the related income was taken into account by a covered person before the associated foreign income tax is paid or accrued (for example, due to a timing difference) presents the same concerns about the inappropriate separation of foreign income taxes and related income that § 909 was intended to address.

(b) Accordingly, Temp. Treas. Reg. § 1.909-2T(a)(1) provides that there is a foreign tax credit splitting event with respect to foreign income taxes paid or accrued if and only if, in connection with an arrangement described in Temp. Treas. Reg. § 1.909-2T(b) (a splitter arrangement) the related income was, is or will be taken into account for U.S. federal income tax purposes by a person that is a covered person with respect to the payor of the tax.

(c) Foreign income taxes that are paid or accrued in connection with a splitter arrangement are split taxes to the extent provided in Temp. Treas. Reg. § 1.909-2T(b). Income (or, as the case may be, earnings and profits) that was, is or will be taken into account by a covered person in connection with a splitter arrangement is related income to the extent provided in Temp. Treas. Reg. § 1.909-2T(b). Split taxes will not be taken into account for U.S. federal income tax purposes before the taxable year in which the related income is taken into account by the payor or, in the case of split taxes paid or accrued by a § 902 corporation, by a § 902 shareholder of the § 902 corporation.

(d) In the case of split taxes paid or accrued by a § 902 corporation, split taxes will not be taken into account for purposes of § 902 or 960, or for purposes of determining earnings and profits under § 964, before the taxable year in which the related income is taken into account by the payor § 902 corporation, a § 902 shareholder of the § 902 corporation, or a member of the § 902 shareholder's consolidated group.

(e) Section 901(m), enacted at the same time § 909 was enacted, applies to foreign taxes paid or accrued in connection with certain transactions that are covered asset acquisitions. Taxpayers hoped for favorable coordination rules in situations in which both sections can apply. Treasury and the IRS stated that they considered several approaches to address the interaction of §§ 901(m) and 909, including providing taxpayers with an election to apply § 909 in lieu of § 901(m). However, they concluded that applying § 909 to covered asset acquisitions between related persons would substantially increase the complexity and administrative burdens associated with these transactions.

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(f) Accordingly, a covered asset acquisition is not a foreign tax credit splitting event for purposes of § 909. However, § 901(m) may apply to foreign taxes paid or accrued in connection with a foreign tax credit splitting event, for example, if an election under § 338 is made with respect to the acquisition of an interest in a reverse hybrid. In such a case, Treasury and the IRS are considering the extent to which § 909 should apply to suspend foreign income taxes with respect to which § 901(m) disallows a credit.

(g) The preamble states that Treasury and the IRS are considering whether to treat as a foreign tax credit splitting event other arrangements or transactions that can result in a separation of foreign income taxes and the related income. One such arrangement could involve a distribution that is a dividend for foreign tax purposes but for U.S. tax purposes is either not included in the shareholder's gross income pursuant to § 305 or is disregarded. *See, for example,* Rev. Rul. 80-154 (involving a series of arrangements that were treated as a stock distribution from a foreign corporation to which § 305 applies); *see also* Rev. Rul. 83-142 (involving a cash payment by a corporation to its shareholder which was returned to the corporation and disregarded for U.S. tax purposes even though treated as a dividend subject to withholding under foreign law).

(h) Treasury and the IRS are considering whether and to what extent these types of asset transfers and distributions should be treated as foreign tax credit splitting events and request comments on the circumstances in which splitter treatment should apply.

3. <u>Reverse Hybrid Splitter Arrangements</u>.

(a) The definition of a reverse hybrid splitter arrangement in Temp. Treas. Reg. § 1.909-2T(b)(1) is substantially similar to that set forth in Notice 2010-92, except that the scope is extended to cover taxes paid or accrued by persons other than § 902 corporations. A reverse hybrid is an entity that is a corporation for U.S. federal tax purposes but it is a fiscally transparent entity (under the principles of Treas. Reg. § 1.894-1(d)(3)) or a branch under the laws of a foreign country imposing tax on the income of the entity.

(b) A reverse hybrid is a splitter arrangement when a payor pays or accrues foreign income taxes with respect to income of a reverse hybrid. A reverse hybrid splitter arrangement exists even if the reverse hybrid has a loss or a deficit in earnings and profit for a particular year for U.S. tax purposes (for example, due to a timing difference). The foreign taxes paid or accrued with respect to income of the reverse hybrid are split taxes. The related income with respect to the split taxes from a reverse hybrid splitter arrangement would be the earnings and profits, or part of the earnings and profits, of the reverse hybrid. Specifically, it would be the E&P attributable to the activities of the reverse hybrid that gave rise to the income included in the payor's foreign tax base with respect to which the split taxes were paid or accrued. Accordingly, related income of the reverse hybrid only includes items of income or expense attributable to a disregarded entity owned by the reverse hybrid to the extent that the income attributable to the activities of the disregarded entity is included in the payor's foreign tax base.

(c) An example of a reverse hybrid splitter arrangement is provided in the diagram below:

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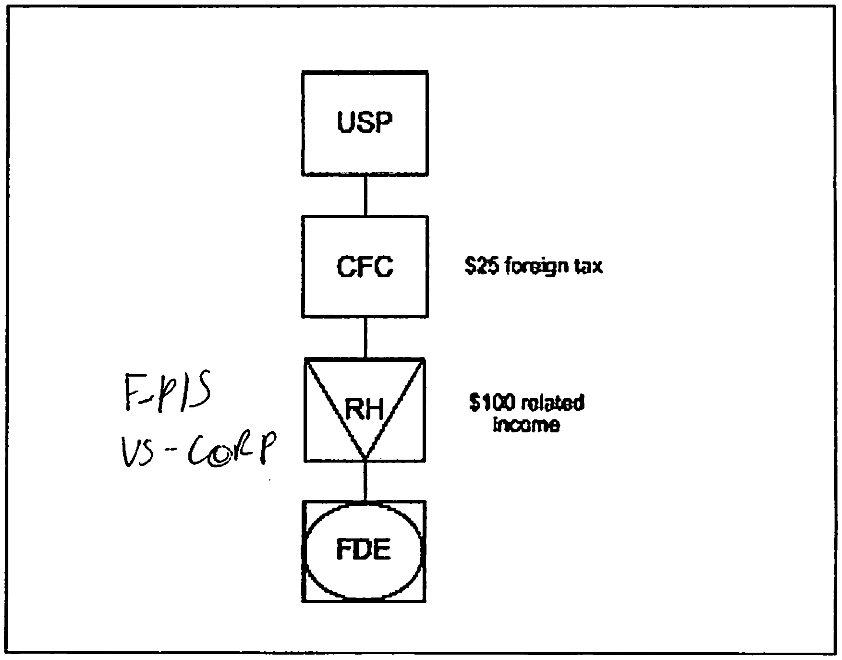

4. Loss-Splitter Arrangements.

(a) Temp. Treas. Reg. § 1.902-2T(b)(2) expands the types of loss-sharing arrangements in Notice 2010-92 that are treated as splitter arrangements. A foreign group or loss-sharing regime is a regime in which one entity may surrender its loss to offset the income of one or more other entities. The loss of one entity that, in connection with a foreign group relief or other loss-sharing regime, that is taken into account by one or more other entities for foreign tax purposes is called a "shared loss." Shared losses can be used to shift foreign tax liability from one entity to another without a concomitant shift in U.S. earnings and profits.

(b) Notice 2010-92 applied only to shared losses attributable to a debt that is disregarded for U.S. federal income tax purposes. A commenter suggested that it would be appropriate to treat other loss-sharing arrangements as foreign tax credit splitter arrangements as well, in particular, when the payor of a tax could have used a shared loss to offset foreign tax on income that is treated as the payor's own income under U.S. federal income tax principles.

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(c) Treasury and the IRS accordingly expanded the scope of the loss-sharing arrangement rules to cover these cases. Temp. Treas. Reg. § 1.909-2T(b)(2)(i) defines a "loss-sharing splitter arrangement" as arising under a foreign group relief or other loss-sharing regime to the extent the shared loss of a U.S. combined group could have been used to offset income of that group (a "usable shared loss") but is used instead to offset income of another U.S. combined income group.

(d) Under Temp. Treas. Reg. § 1.909-2T(b)(2)(ii), a U.S. combined income group consists of a single individual or corporation and all other entities (including entities that are fiscally transparent for U.S. tax purposes under the principles of Treas. Reg. § 1.894-1(d)(3)) that for U.S. federal income tax purposes combine any of their respective items of income, deduction, gain or loss with the income, deduction, gain or loss of that individual or corporation.

(e) A U.S. combined income group may arise, for example, as the result of an entity being disregarded for U.S. federal income tax purposes or, in the case of a partnership or hybrid partnership and a partner, as a result of the allocation of income or any other item of the partnership to the partner. For this purpose, a branch is treated as an entity, all members of a U.S. consolidated group are treated as a single corporation, and individuals filing a joint return are treated as a single individual.

(f) A U.S. combined income group may consist of a single individual or corporation and no other entities, but cannot include more than one individual or corporation. In addition, an entity that combines items of income, deduction, gain or loss with the income, deduction, gain or loss of two or more entities can belong to more than one U.S. combined group. For example, a hybrid partnership that has two corporate partners that do not combine items of income, deduction, gain or loss with each other belongs to each partner's separate U.S. combined income group, because each partner receives an allocable share of hybrid partnership items.

(g) Under Temp. Treas. Reg. § 1.909-2T(b)(2)(iii)(A), the income of a U.S. combined group consists of the aggregate amount of taxable income of the members of the group that have positive taxable income, as computed under foreign law. Under Temp. Treas. Reg. § 1.909-2T(b)(2)(iii)(B), the amount of shared loss of a U.S. combined group is the sum of the shared losses of all members of the group. Temp. Treas. Reg. §§ 1.909-2T(b)(2)(iii)(A) and (B) provide that in the case of an entity that is fiscally transparent (under the principles of Treas. Reg. § 1.894-1(d)(3)) for foreign tax purposes and that is a member of more than one U.S. combined group, the foreign taxable income or shared loss of the entity is allocated between or among the groups under foreign tax law.

(h) In the case of an entity that is not fiscally transparent for foreign tax purposes and is a member of more than one U.S. combined income group, the entity's foreign taxable income or shared loss is allocated between the separate U.S. combined income groups based on U.S. federal income tax principles. Although the allocations are based on U.S. federal income tax principles, the amount of the foreign taxable income or shared loss to be allocated is determined under foreign law.

(i) In the case of a hybrid partnership with two partners that are in different U.S. combined groups, income or a shared loss incurred by the hybrid partnership, as determined under foreign law, is allocated between or among the U.S. combined groups based on how the hybrid partnership allocated the income or loss under § 704(b).

(j) To the extent the income or shared loss would be income or loss under U.S. tax principles in another year, the income or shared loss is allocated to the U.S. combined group based on how the hybrid partnership would allocate the income or shared loss if it were recognized for U.S. tax purposes in the year it is recognized for foreign tax purposes. To the extent the income or shared loss would not constitute income or loss under U.S. tax principles in any year, the income or shared loss is

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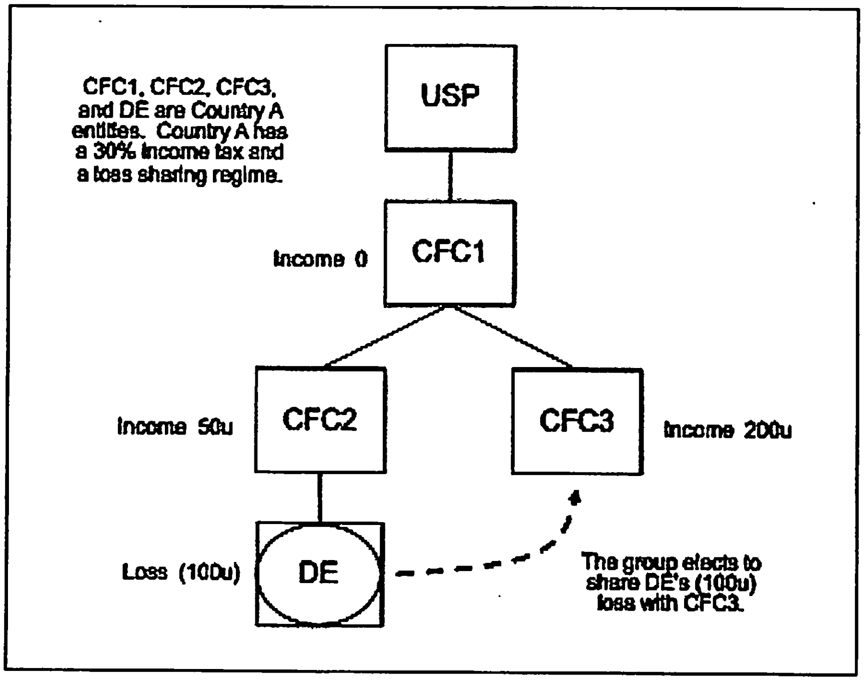
allocated to the U.S. combined income groups in the same manner as the partnership items attributable to the activity giving rise to the income or shared loss.

(k) Temp. Treas. Reg. § 1.909-2T(b)(2)(iv) provides that split taxes from a loss-sharing splitter arrangement are foreign income taxes paid or accrued by a member of a U.S. combined income group with respect to income equal to the amount of the usable shared loss of that U.S. combined group that offsets income of a different U.S. combined income group. Under Temp. Treas. Reg. § 1.909-2T(b)(2)(v), the related income is an amount of income of the individual or corporate member of a U.S. combined income group equal to the amount of income of that U.S. combined income group that is offset by the usable shared loss of another U.S. combined income group.

(l) Temp. Treas. Reg. § 1.909-2T(b)(2)(vii), Example 1.



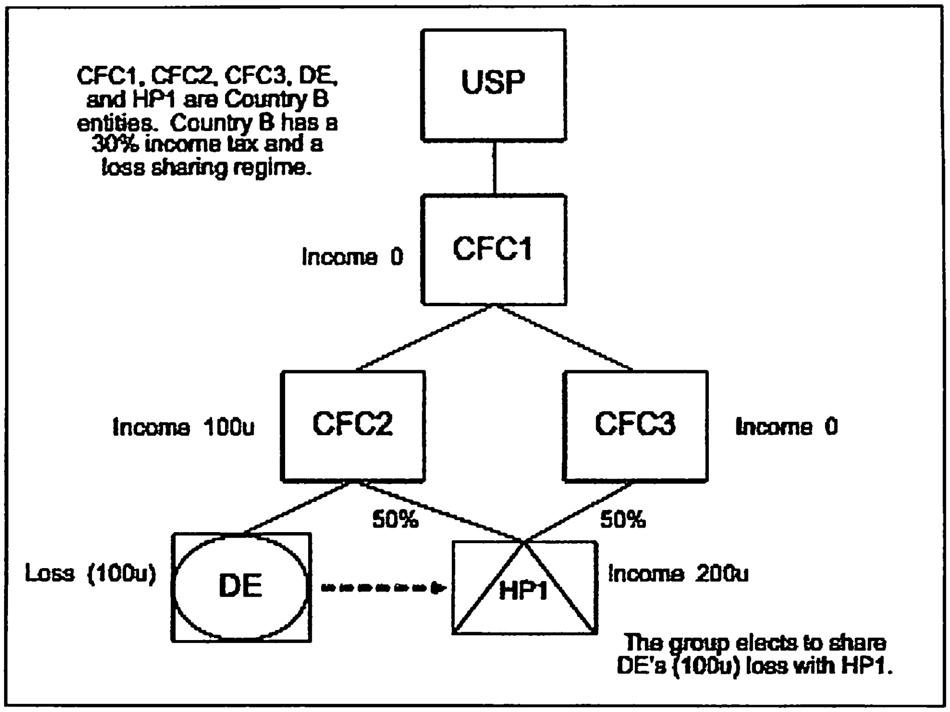
i. Facts. USP, a domestic corporation, wholly owns CFC1, a corporation organized in country A. CFC1 wholly owns CFC2 and CFC3, both corporations organized in country A. CFC2 wholly owns DE, an entity organized in country

A. DE is a corporation for country A tax purposes and a disregarded entity for U.S. federal income tax purposes. Country A has a loss-sharing regime under which a loss of CFC1, CFC2, CFC3 or DE may be used to offset the income of one or more of the others. Country A imposes an income tax at the rate of 30% on the taxable income of corporations organized in country A. In year 1, before any loss sharing, CFC1 has no income, CFC2 has income of 50u, CFC3 has income of 200u, and DE has a loss of 100u. Under the provisions of country A's loss-sharing regime, the group elects to use DE's 100u loss to offset 100u of CFC3's income. After the loss is shared, for country A's tax purposes, CFC2 still has 50u of income on which it pays 15u of country A tax. CFC3 has income of 100u (200u less the 100u shared loss) on which it pays 30u of country A tax. For U.S. tax purposes, the loss sharing with CFC3 is not taken into account. Because DE is a disregarded entity, its 100u loss is taken into account by CFC2 and reduces its earnings and profits for U.S. federal income tax purposes. Accordingly, before application of § 909, CFC2 has a loss for earnings and profits purposes of 65u (50u income less 15u taxes paid to country A less 100u loss of DE). CFC2 also has the U.S. dollar equivalent of 15u of foreign taxes to add to its post-1986 foreign income taxes pool. CFC3 has earnings and profits of 170u (200u income less 30u of taxes) and the dollar equivalent of 30u of foreign taxes to add to its post-1986 foreign income taxes pool.

ii. Result. CFC2 and DE constitute one U.S. combined income group, while CFC1 and CFC3 each constitute separate U.S. combined income groups. The income of the CFC2 combined income group is 50u (CFC2's country A taxable income of 50u). The income of the CFC3 U.S. combined income group is 200u (CFC3's country

A taxable income of 200u). The shared loss of the CFC2 U.S. combined income group includes the 100u of shared loss incurred by DE. The usable shared loss of the CFC2 U.S. combined income group is 50u, the amount of the group's shared loss that could have otherwise offset CFC2's 50u of country A taxable income that is included in the income of the CFC2 U.S. combined income group. There is a splitter arrangement because the 50u usable shared loss of the CFC2 U.S. combined income group was used instead to offset income of CFC3, which is included in the CFC3 U.S. combined income group. The split taxes are the 15u of country A income taxes paid by CFC2 on 50u of income, an amount of income of the CFC2 U.S. combined income group equal to the amount of usable shared loss of that group that was used to offset income of the CFC3 U.S. combined income group. The related income is the 50u of CFC3's income that equals the amount of income of the CFC3 U.S. combined income group that was offset by the usable shared loss of the CFC2 U.S. combined income group.

(m) Temp. Treas. Reg. § 1.909-2T(b)(2)(vii), Example 2.



i. Facts. USP, a domestic corporation, wholly owns CFC1, a corporation organized in country B. CFC1 wholly owns CFC2 and CFC3, both corporations organized in country B. CFC2 wholly owns DE, an entity organized in country B. DE is a corporation for country B tax purposes and a disregarded entity for U.S. federal income tax purposes. CFC2 and CFC3 each own 50% of HP1, an entity organized in country B. HP1 is a corporation for country B tax purposes and a partnership for U.S. federal income tax purposes. All of HP1's items of income and loss are allocated for U.S. federal income tax purposes equally between CFC2 and CFC3. Country B has a loss-sharing regime under which a loss of any of CFC1, CFC2, CFC3, DE, and HP1 may be used to offset the income of one or more of the others. Country B imposes an income tax at the rate of 30%. In year 1, before any loss sharing, CFC2 has income of 100u, CFC1 and CFC3 have no income, DE has a loss of 100u, and HP1 has income of 200u. Under the provisions of country B's loss-sharing regime, the group elects to use DE's 100u loss to offset 100u of HP1's income. After the loss is shared, for country B tax purposes, CFC2 has 100u of income on which it pays 30u of country B income tax, and HP1 has 100u of income (200u less the 100u shared loss) on which it pays 30u of country B income tax. For U.S. federal income tax purposes, the loss sharing with HP1 is not taken into account, and, because DE is a disregarded entity, its 100u loss is taken into account by CFC2 and reduces CFC2's earnings and profits for U.S. Federal income tax purposes. The 200u income of HP1 is allocated 50/50 to CFC2 and CFC3, as is the 30u of country B income tax paid by HP1. Accordingly, before application of § 909, for U.S. federal income tax purposes, CFC2 has earnings and profits of 55u (100u income + 100u share of HP1's income - 100u loss of DE - 30u country B income tax paid by CFC2 - 15u share of HP1's country B income tax) and the dollar equivalent of 45u of country B income tax to add to its post-1986 foreign income taxes pool. CFC3 has earnings and profits of 85u (100u share of HP1's income less 15u share of HP1's country B income taxes) and the dollar equivalent of 15u of country B income tax to add to its post-1986 foreign income taxes pool.

ii. Result. HP1 is a member of both of the separate CFC2 and CFC3 U.S. combined income groups. DE is a member of the CFC2 U.S. combined income group. The income of the CFC2 U.S. combined income group is the 200u country B taxable income of the members of the group with positive taxable incomes (CFC2's country B taxable income of 100u + 50% of HP1's country B taxable income of 200u, or 100u). The income of the CFC3 U.S. combined income group is 100u (50% of HP1's country B taxable income of 200u, or 100u). The shared loss of the CFC2 U.S. combined income group is the 100u loss incurred by DE that is used to offset 100u of HP1's income. The usable shared loss of the CFC2 U.S. combined income group is 100u, the full amount of the group's 100u shared loss that could have been used to offset income of the CFC2 U.S. combined income group. The shared loss of the CFC2 combined income group is used to offset 100u country B taxable income of HP1. Because the taxable income of HP1 is allocated 50/50 between the CFC2 and CFC3 U.S. combined income groups, the shared loss is treated as offsetting 50u of the CFC2 U.S. combined income group's income and 50u of the CFC3 U.S. combined income group's income. There is a splitter arrangement because 50u of the 100u usable shared loss of the CFC2 U.S. combined income group was used to offset income of the CFC3 U.S. combined income group. The split taxes are the 15u of country B income tax paid by CFC2 on 50u of its income, which is equal to the amount of the CFC2 U.S. combined income group's usable shared loss that was used to offset income of another U.S. combined income group. The related income is the 50u of CFC3's income that was offset by the usable shared loss of the CFC2 U.S. combined income group.

5. <u>Hybrid Instrument Splitter Arrangements</u>.

(a) Temp. Treas. Reg. § 1.909-2T(b)(3) addresses hybrid splitter arrangements. The definition of hybrid instrument splitter arrangements is substantially the same as that set forth in Notice 2010-92, except that the scope is extended to cover taxes paid or accrued by persons other than § 902 corporations.

(b) Temp. Treas. Reg. § 1.909-2T(b)(3)(i)(D) defines a *U.S. equity hybrid instrument* as an instrument that is treated as equity for U.S. federal income tax purposes but is treated as indebtedness for foreign tax purposes, or with respect to which the issuer is otherwise entitled to a deduction for foreign tax purposes for amounts paid or accrued with respect to the instrument. For example, an instrument that is treated as equity for U.S. federal income tax purposes but with respect to which amounts paid or accrued by the issuer are treated for foreign tax purposes as a deductible notional interest payment (even though the instrument is otherwise treated as equity for foreign purposes) is a U.S. equity hybrid instrument.

(c) Under Temp. Treas. Reg. § 1.909-2T(b)(3)(i)(A), a U.S. equity hybrid instrument is a splitter arrangement if foreign income taxes are paid or accrued by the owner of a U.S. equity hybrid instrument with respect to payments or accruals on or with respect to the instrument that are deductible by the issuer under the laws of a foreign jurisdiction in which the issuer is subject to tax but that do not give rise to income for U.S. federal income tax purposes.

(d) Under Temp. Treas. Reg. § 1.909-2T(b)(3)(i)(B), split taxes from a U.S. equity hybrid instrument splitter arrangement are equal to the total amount of foreign income taxes, including withholding taxes, paid or accrued by the owner of the hybrid instrument less the amount of foreign income taxes that would have paid or accrued had the owner of the U.S. equity hybrid instrument not been subject to foreign tax on income from the instrument. Under Temp. Treas. Reg. § 1.909-2T(b)(3)(i)(C), the related income with respect to split taxes from a U.S. equity hybrid instrument splitter arrangement is income of the issuer of the U.S. equity hybrid instrument in an amount equal to the payments or accruals giving rise to the split taxes that are deductible by the issuer for foreign tax purposes, determined without regard to the actual amount of issuer's income or earnings and profits for U.S. federal income tax purposes.

(e) Temp. Treas. Reg. § 1.909-2T(b)(3)(ii)(D) defines a *U.S. debt hybrid instrument* as an instrument that is treated as equity for foreign purposes but as indebtedness for U.S. federal income tax purposes. Under Temp. Treas. Reg. § 1.909-2T(b)(3)(ii)(A), a U.S. debt hybrid instrument is a splitter arrangement if foreign income taxes that are paid or accrued by the issuer of a U.S. debt hybrid instrument with respect to income in an amount equal to the interest (including original issue discount) paid or accrued on the instrument that is deductible for U.S. federal income tax purposes but that does not give rise to a deduction under the laws of a foreign jurisdiction in which the issuer is subject to tax.

(f) Under Temp. Treas. Reg. § 1.909-2T(b)(3)(ii)(B), split taxes from a U.S. debt hybrid instrument splitter arrangement are the foreign income taxes paid or accrued by the issuer on the income that would have been offset by the interest paid are accrued on the U.S. debt hybrid instrument had such interest been deductible for foreign tax purposes.

(g) Under Temp. Treas. Reg. § 1.909-2T(b)(3)(ii)(C), the related income from a U.S. debt hybrid instrument splitter arrangement is the gross amount of interest income recognized for U.S. federal income tax purposes by the owner of the U.S. debt hybrid instrument, determined without regard to the actual amount of the owner's income or earnings and profits for U.S. federal income tax purposes.

6. Partnership Inter-Branch Splitter Arrangements. Discussed in the partnership section below.

7. 2011 and Certain 2012 Splitter Arrangements.

(a) Section 909 applies to foreign income taxes paid or accrued in taxable years beginning after December 31, 2010. Temp. Treas. Reg. § 1.909-2T(b), which sets forth the exclusive list of splitter arrangements, is effective for foreign income taxes paid or accrued in taxable years beginning on or after January 1, 2012.

(b) Notice 2010-92 stated that pre-2011 splitter arrangements will give rise to foreign tax credit splitting events in post-2010 taxable years. Accordingly, Temp. Treas. Reg. § 1.909-5T(a)(1) provides that foreign income taxes paid or accrued by any person in a taxable year beginning on or after January 1, 2011, and before January 1, 2012, in connection with a pre-2011 splitter arrangement (as defined in Temp. Treas. Reg. § 1.909-6T(b)), are split taxes to the same extent that the taxes would have been treated as pre-2011 split taxes if the taxes were paid or accrued by a § 902 corporation in a pre-2011 taxable year. The related income with respect to split taxes from such an arrangement is the related income described in Temp. Treas. Reg. § 1.909-6T(b), determined as if the payor were a § 902 corporation.

(c) In addition, Notice 2010-92 stated that allocations described in Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3) will result in a foreign tax credit splitting event in post-2011 taxable years to the extent the allocations result in foreign income taxes being allocated to a partner different from the partner to whom the related income is allocated. Accordingly, Temp. Treas. Reg. § 1.909-5T(a)(2) provides that foreign income taxes paid or accrued by any person in a taxable year beginning on or after January 1, 2011, and before January 1, 2012, in connection with a partnership inter-branch splitter arrangement described in Temp. Treas. Reg. § 1.909-2T(b)(4) are split taxes to the extent those taxes are identified as split taxes in Temp. Treas. Reg. § 1.909-2T(b)(4)(ii). The related income with respect to split taxes is the related income described in Temp. Treas. Reg. § 1.909-2T(b)(4)(iii).

(d) The temporary regulations also provide that foreign income taxes paid or accrued by any person in a taxable year beginning on or after January 1, 2012 and on or before February 14, 2012 in connection with the foreign consolidated group splitter arrangement described in Temp. Treas. Reg. § 1.909-6T(b)(2) are split taxes to the same extent that the taxes would have been treated as pre-2011 split taxes if the taxes were paid or accrued by a § 902 corporation in a pre-2011 taxable year.

(e) This rule ensures that § 909 applies to suspend foreign tax on income of foreign consolidated groups paid or accrued in post-2010 taxable years to the extent the tax is not apportioned among the members of the group in accordance with the principles of Treas. Reg. § 1.901-2(f)(3). As discussed above, new final regulations explicitly treat the ratable allocation rules of Treas. Reg. § 1.902-2(f)(3) to tax paid on combined income of foreign consolidated groups, without regard to whether the group members are jointly or severally liable for the tax under foreign law.

8. Rules Regarding Related Income Split Taxes and Coordination Rules.

    (a) Notice 2010-92 provided guidance in determining the amount of related income and pre-2011 split taxes paid or accrued with respect to pre-2011 splitter arrangements. A commenter requested guidance on the amount of related income and split taxes in the case of certain dispositions that were not described in the notice (specifically, dispositions of § 902 corporations in transactions other than those that qualify under § 381).

    (b) Treasury and the IRS expect to issue regulations that will provide additional guidance on determining the amount of related income and split taxes attributable to a foreign tax credit splitting event, and intend to address the comment when regulations covering those matters are issued.

    (c) Until guidance is issued, Temp. Treas. Reg. § 1.909-3T(a) provides that the principles of Temp. Treas. Reg. § 1.909-6T(d) through 1.909-6T(f) will apply to related income and split taxes in taxable years beginning on or after January 1, 2011, *except that* the alternative "related income first" method described in Temp. Treas. Reg. § 1.909-6T(d)(4) (which follows that provision in Notice 2010-92) for identifying distributions of related income applies only to identify the amount of pre-2011 split taxes of a § 902 corporation that are suspended as of the first day of the § 902 corporation's first taxable year beginning on or after January 1, 2011.

    (d) Temp. Treas. Reg. § 1.909-3T(b) contains a new rule that was not in Notice 2010-92 that split taxes include taxes paid or accrued in taxable years beginning on or after January 1, 2011, with respect to the amount of a disregarded payment that is deductible by the payor of the disregarded payment under the laws of a foreign jurisdiction in which the payor of the disregarded payment is subject to tax on related income from a splitter arrangement. The amount of the deductible disregarded payment to which this rule applies is limited to the amount of related income from the splitter arrangement.

(e) In addition to future guidance on determining the amount of related income and split taxes, the preamble states that Treasury and the IRS expect to issue regulations that provide additional guidance on the interaction between § 909 and other Code provisions such as §§ 904(c), 905(a), and 905(c). Until that guidance is issued, Temp. Treas. Reg. § 1.909-4T(a) provides that the principles of Temp. Treas. Reg. § 1.909-6T(g), which adopts the rules described in Notice 2010-92, will apply to taxable years beginning on or after January 1, 2011.

9. Pre-2011 Foreign Tax Credit Splitting Events. Temp. Treas. Reg. § 1.909-6T adopts the rules described in Notice 2010-92 regarding pre-2011 foreign tax credit splitting events and the application of § 909 to foreign income taxes paid or accrued by a § 902 corporation in pre-2011 taxable years.

D. New Final Technical Taxpayer Regulations

1. Concurrently with the § 909 temporary regulation discussed below, Treasury and the IRS finalized the portion of the 2006 proposed foreign tax credit "technical taxpayer" regulations that address foreign consolidated groups in Treas. Reg. § 1.901-2(f). T.D. 9576. This was prompted in part by the enactment of § 909 and also by comments submitted in response to Notice 2010-92. In the notice, the Service had requested comments on whether this portion of the proposed regulations should be finalized. The portion of the proposed regulations dealing with certain partnership and disregarded entity issues were also finalized. The other portions of the 2006 proposed regulations were withdrawn.

2. Foreign Consolidated Return Regimes.

(a) Prop. Treas. Reg. § 1.901-2(f)(2) (2006) addressed the application of the foreign tax credit legal liability rules to foreign consolidated groups and other combined income regimes, including those in which the combined-income regime imposes joint and several liability in the U.S. sense, those in which the regime treats subsidiaries as branches of the parent corporation (or otherwise attributes income of subsidiaries to the parent corporation), and those in which some of the group members have limited obligations, or even no obligation, to pay the consolidated tax.

(b) The proposed regulations provided that the foreign tax must be apportioned among the persons whose income is included in the combined base pro rata based on each person's portion of the combined income, as computed under foreign law. Some commenters recommended that this portion of the proposed regulations be finalized in lieu of treating these arrangements as foreign tax credit splitting events under § 909, which would require suspension of the split tax until the related income is taken into account.

(c) Treas. Reg. § 1.901-2(f)(3)(i) of the final regulations adopts with minor modifications Prop. Treas. Reg. § 1.901-2(f)(2)(i). Under Treas. Reg. § 1.901-2(f)(3)(i), if foreign tax is imposed on the combined income of two or more persons (e.g., a corporation and its subsidiaries), foreign law is considered to impose legal liability for tax on each such person for the amount of the tax that is attributable to such person's portion of the base of the tax. Accordingly, the foreign tax is allocated among, and considered paid by, such persons on a pro rata basis in proportion to each person's portion of the combined income, as determined under foreign law and Treas. Reg. § 1.901-2(f)(3)(iii).

(d) The requirement under the prior regulation that each member of combined filing group must have joint and several liability in order for the foreign tax to be allocated has been eliminated. The rules of Treas. Reg. § 1.901-2(f)(3) apply regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid.

(e) One taxpayer's comment recommended that combined income subject to preferential tax rates should be allocated only to group members with that type of income, in order to more closely match the tax with the related income. Treasury and the IRS agreed with this comment, and the final regulations provide that combined income with respect to each foreign tax that is imposed on a combined basis, and combined income subject to tax exemption or preferential tax rates, is combined separately, and the tax on that combined income is allocated separately.

(f) Under Treas. Reg. § 1.901-2(f)(3)(ii), foreign tax is considered to be imposed on the combined income of two or more persons if such persons compute their taxable income on a combined basis under foreign law and foreign tax would otherwise be imposed on each such person on its separate taxable income. Foreign tax is considered to be imposed on the combined income of two or more persons even if the combined income is computed under foreign law by attributing the income of other group members to one person (for example, the foreign parent of a foreign consolidated group) or by treating persons that would otherwise be subject to tax as separate entities as unincorporated branches.

(g) Foreign tax is not considered to be imposed on the combined income of two or more persons if, because one or more persons is a fiscally transparent entity under foreign law, only one of such persons is subject to tax under foreign law. Additionally, the regulations specify that the combined income rule does not apply solely because foreign law:

  i. Permits one person to surrender a loss to another person pursuant to a group relief or other loss-sharing regime described in Treas. Reg. § 1.909-2T(b)(2)(vi);

  ii. Requires a shareholder of a corporation to include in income amounts attributable to taxes imposed on the corporation with respect to distributed earnings, pursuant to an integrated tax system that allows the shareholder a credit for such taxes;

iii. Requires a shareholder to include income attributable to the shareholder's interest in a corporation pursuant to an anti-deferral regime;

iv. Reallocates income from one person to a related person under foreign transfer pricing rules;

v. Requires a person to take into account a distributive share of income of an entity that is a partnership or other fiscally transparent entity for foreign tax law purposes; or

vi. Requires a person to take all or part of the income of an entity that is a corporation for U.S. federal income tax purposes into account because foreign law treats the entity as a branch or fiscally transparent entity (a reverse hybrid).

(h) A commenter requested clarification that the exclusions from the definition of a combined income base (for example, foreign integration and anti-deferral systems) apply solely for purposes of determining whether foreign income tax is imposed on combined income, and do not apply for purposes of determining each person's ratable share of the combined income base. Treasury and the IRS agreed that these exclusions from the definition of combined income base do not exclude any amount of income otherwise subject to tax on a combined basis from the operation of the combined income rule. However, states the preamble to the final regulation, since nothing in the list of exclusions affects the amount of income in the combined income base, which is computed under foreign law, Treasury and the IRS believe that a further change to the regulations is unnecessary.

(i) Prop. Treas. Reg. § 1.901-2(f)(2)(iii) provided that a reverse hybrid is considered to have legal liability under foreign law for foreign taxes imposed on the owners of the reverse hybrid in respect of each owner's share of the reverse hybrid's income. As stated in Notice 2010-92, Treasury and the IRS did not finalize this portion of the 2006 proposed regulations. Instead, Notice 2010-92 identified reverse hybrids as pre-2011 splitter arrangements, and the temporary regulations under § 909 (discussed below) also identify reverse hybrids as splitter arrangements.

(j) Prop. Treas. Reg. § 1.901-2(f)(2)(iv) provided rules for determining each person's share of the combined income tax base, generally relying on foreign tax reporting of separate taxable income or books maintained for that purpose. The proposed regulations provided that payments between group members that result in a deduction under both U.S. and foreign tax law will be given effect in determining each person's share of the combined income. The proposed regulations, however, explicitly reserved with respect to the effect of hybrid instruments and disregarded payments between related parties, which the preamble to the proposed regulations described as a matter to be addressed in subsequent published guidance.

(k) Final Treas. Reg. § 1.901-2(f)(3)(iii) adopts these rules with modifications reflecting that certain hybrid instruments and certain disregarded payments are treated as splitter arrangements subject to § 909. In particular, the final regulations provide that in determining separate taxable income of members of a combined income group, effect will be given to intercompany payments that are deductible under foreign law, even if those payments are not deductible (or are disregarded) for purposes of U.S. tax law. Thus, for example, interest accrued by one group member with respect to an instrument held by another member that is treated as debt for foreign purposes but as equity for U.S. tax purposes would be considered income of the holder and would reduce the taxable income of the issuer. The final regulations, however, include a cross reference to Temp. Treas. Reg. § 1.909-2T(b)(3)(i) for rules requiring suspension of foreign income taxes paid or accrued by the owner of a U.S. equity hybrid instrument.

(l) Prop. Treas. Reg. § 1.901-2(f)(2)(v) provided that U.S. tax principles apply to determine the tax consequences if one person remits a tax that is the legal liability of another person. For example, payment of tax for which a

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corporation has legal liability by a shareholder of that corporation (including an owner of a reverse hybrid) will ordinarily result in a deemed capital contribution and a deemed payment of tax by the corporation. The proposed regulation also provided that if the corporation reimburses the shareholder for the tax payment, the reimbursement will ordinarily be treated as a distribution for U.S. tax purposes. Commenters stated that a shareholder's payment of a corporation's tax and a corporation's reimbursement of a shareholder for paying its tax liability will not result in deemed capital contribution and deemed dividend treatment if arrangements are in place to treat the shareholder's payment of the tax as pursuant to a lending or agency agreement. In response to these comments, the second and third sentences of the proposed § 1.901-2(f)(2)(v) (above) were not included in the final regulations. The final regulations simply provide that U.S. tax principles apply to determine the tax consequences if one person remits a tax that is the legal liability of another person.

3. Partnership Issues. Discussed separately in Partnership discussion below.

4. Effective Date.

    (a) The final regulations are generally effective for foreign taxes paid or accrued during taxable years beginning after February 14, 2012, the date the final regulations were published in the Federal Register. A foreign tax credit splitting event will not occur with respect to foreign taxes paid or accrued on combined income after the effective date of the new regulation. However, with respect to foreign income taxes paid or accrued on combined income during taxable years beginning after December 31, 2010 and on or before February 14, 2012, new temporary regulations under § 909 (discussed below) provide that a foreign tax credit splitting event will occur in the context of a foreign combined-income regime to the extent that the taxpayer does not allocate the foreign consolidated tax liability among the members of the foreign consolidated group based on each member's share of the consolidated taxable income included in the foreign base under the principles of Treas. Reg. § 1.901-2(f)(3) prior to its amendment by the new final regulation.

(b) A commenter raised several transition-related questions arising in situations where applying the final regulations changes the person who is considered the taxpayer with respect to a particular foreign income tax. First, the commenter stated is unclear what happens to the carryover under § 904(c) of foreign taxes paid or accrued in a taxable year beginning before the effective date of the final regulations to a taxable year beginning on or after the effective date of the final regulations. The commenter recommended that the regulations clarify the treatment of foreign tax credit carryovers from pre-effective date years and foreign tax credit carrybacks from post-effective date years, and that the regulations provide that taxes paid or accrued in a pre-effective date year that are carried forward to a post-effective date year be assigned to the taxpayer that paid or accrued the foreign taxes in the pre-effective date tax year. Similarly, the commenter recommended that taxes paid or accrued in a post-effective date year that are carried back to the last pre-effective date year should be treated in the carryback year as paid or accrued by the taxpayer that paid or accrued the taxes in the post-effective date tax year.

(c) Treasury and the IRS believe it is clear under current law that the person who paid or accrued foreign income taxes in a pre-effective date year is the person who is eligible under § 904(c) to carry forward those taxes to a post-effective date year, notwithstanding that person may not be considered the taxpayer under these final regulations had the taxes been paid or accrued in the post-effective date carryover year. Similarly, Treasury and the IRS believe it is clear that the person who paid or accrued foreign taxes in a post-effective date year is the person who is eligible under § 904(c) to carry back the taxes to the last pre-effective date year. Therefore, the final regulations were not changed to reflect that comment is unnecessary.

(d) The commenter also recommended that taxpayers be permitted to apply the final regulations retroactively, but that taxpayers should not be permitted to take inconsistent positions with respect to the incidence of the foreign tax. The commenter recommended that a duty of consistency be imposed on related parties, or parties that were related at the time the foreign tax was imposed. The parties that were related but are now unrelated do not agree on an election to apply the regulations retroactively, the comment stated that no election should be permitted.

(e) In response to the comment, the final regulations permit taxpayers to apply the combined income rules of Treas. Reg. § 1.901-2(f)(3) of the final regulations to taxable years beginning after December 31, 2010 and on or before February 14, 2012. This will permit taxpayers to avoid uncertainty regarding the application of § 909 to foreign taxes paid or accrued by foreign consolidated groups in pre-effective date taxable years beginning in 2011 and 2012. No inference was intended as to the determination of the person who paid the foreign tax under the rules in effect prior to the amendment of the regulations. To the extent that a taxpayer did not allocate foreign consolidated tax liability among the members of a foreign consolidated group based on each member's share of the consolidated taxable income included in the foreign base under the principles of Treas. Reg. § 1.901-2(f)(3), the existence of a foreign consolidated group is a foreign tax credit splitting event under § 909.

(f) Treasury and the IRS, however, have concerns about the administrative complexity and burden on taxpayers that could result if Treas. Reg. § 1.901-2(f)(4) were applied retroactively. Rules would be necessary to prevent potential whipsaws from two unrelated persons claiming a foreign tax credit for the single payment of foreign income tax, in cases where different persons are considered to pay the tax under the final regulations and under prior law. Although taxpayers may not elect to apply Treas. Reg. § 1.901-2(f)(4) retroactively, certain portions of these rules, specifically with respect to the person that has legal liability for a foreign tax paid by a disregarded entity or a partnership in the absence of a change in ownership, are consistent with the rules in effect under the regulations in effect prior to amendment by the new final regulations. Thus, to prevent treating more than one person as paying a single amount of tax, Treas. Reg. § 1.901-2(f)(4) will not apply to any amount of tax paid or accrued in a post-effective date year of any person, if the tax would be treated as paid or accrued by a different person in a pre-effective date year under the prior regulations.

E. Splitter Rules Related to Partnerships

1. *Final Regulations*. The final regulations generally adopt the 2006 proposed regulations regarding the treatment of entities treated as partnerships (or are disregarded) for U.S. tax purposes, but that are taxable at the entity level for foreign purposes. *See* Treas. Reg. §§ 1.706-1(c)(6) and 1.901-2(f)(4). The effective date is generally foreign tax paid or accrued in taxable years beginning after February 14, 2012.

(a) If foreign law imposes tax at the entity level on the income of a partnership, the partnership is considered to be legally liable for such tax under foreign law and therefore is considered to pay the tax for U.S. Federal income tax purposes. This rule applies regardless of which person is obligated to remit the tax, which person actually remits the tax, or which person the foreign country could proceed against to collect the tax in the event all or a portion of the tax is not paid.

(b) If the U.S. taxable year of a partnership closes for all partners due to a termination of the partnership under § 708(b)(1)(A) a and the foreign taxable year of the partnership does not close, then foreign tax paid or accrued with respect to the foreign taxable year in which the termination occurs is allocated between the terminating partnership and its successors or assigns. For example, if, as a result of a change in ownership during a partnership's foreign taxable year, the partnership becomes a disregarded entity and the entity's foreign taxable year does not close, foreign tax paid or accrued by the owner of the disregarded entity with respect to the foreign taxable year is allocated between the partnership and the owner of the disregarded entity. If the U.S. taxable year of a partnership closes for all partners due to a termination of the partnership under § 708(b)(1)(B) and the foreign taxable year of the partnership does not close, then foreign tax paid or accrued by the new partnership with respect to the foreign taxable year in which the termination occurs is allocated between the terminating partnership and the new partnership. If multiple terminations under § 708(b)(1)(B) occur within the foreign taxable year, foreign tax paid or accrued with respect to that foreign taxable year by a new partnership is allocated among all terminating and new partnerships.

(c) Allocations of tax are made under the principles of Treas. Reg. § 1.1502-76(b) based on the respective portions of the taxable income of the hybrid entity (as determined under foreign law) for the foreign taxable year that are attributable to the period ending on the date of the ownership change (or the last day of the terminating partnership's U.S. taxable year) and the period ending after such date. The preamble states that this approach is consistent with the rule provided in Treas. Reg. § 1.338-9(d) for apportioning foreign tax paid by a target corporation that is acquired in a transaction for which a § 338 election is made if the foreign taxable year of the target does not close at the end of the acquisition date.

(d) The final regulations apply the same foreign tax allocation rules to § 708 terminations that arise under § 708(b)(1)(A) in the case of a partnership that has ceased its operations, including a change in ownership in which a partnership becomes a disregarded entity. The final regulations also apply the same allocation rules if there are multiple ownership changes within a single foreign taxable year.

(e) If there is a change in the ownership of a disregarded entity during the entity's foreign taxable year and such change does not result in a closing of the disregarded entity's foreign taxable year, foreign tax paid or accrued with respect to such foreign taxable year is allocated between the transferor and the transferee. If there is more than one change in the ownership of a disregarded entity during the entity's foreign taxable year, foreign tax paid or accrued with respect to that foreign taxable year is allocated among all transferors and transferees. The allocation is made based on the respective portions of the taxable income of the disregarded entity (as determined under foreign law) for the foreign taxable year that are attributable under the principles of Treas. Reg. §1.1502-76(b) to the period of ownership of each transferor and transferee during the foreign taxable year. If, as a result of a change in ownership, the disregarded entity becomes a partnership and the entity's foreign taxable year does not close, foreign tax paid or accrued by the partnership with respect to the foreign taxable year is allocated between the owner of the disregarded entity and the partnership under the principles discussed above.

(f) Due to administrative complexity and compliance burdens, Treasury and the IRS did not adopt a comment that if a termination under § 708(b)(1)(B) or change in a partner's interest requires a closing of the books under U.S. tax principles, but the foreign taxable year does not close, foreign tax for the year of change should similarly be allocated under the principles of §§ 706 and 708 and the regulations under those sections rather than under the principles of § 1.1502-76(b), which permits ratable allocation of the foreign tax with an exception for extraordinary items. The comment noted that apportioning the foreign tax using the same methodology as is used to apportion U.S. taxable income between the terminating partnership and the new partnership, or between the partner whose interest changes and the other partners, would lead to better matching of foreign tax and the associated income.

(g) Treas. Reg. § 1.901-2(f)(5), Example 3 illustrates the operation of the above rules:

1. *Facts*. A, B, and C are U.S. persons that each use the calendar year as their taxable year. A and B each own 50 percent of the capital and profits of

D, a country M entity that is treated as a partnership for U.S. tax purposes. D uses the calendar year as its taxable year for both U.S. tax purposes and country M tax purposes. Country M imposes a 30% income tax at the entity level on the taxable income of D. On September 30 of Year 1, A sells its 50 percent interest in D to C. A's sale of its partnership interest results in a termination of the partnership under § 708(b)(1)(B) for U.S. tax purposes. As a result of the termination, "old" D's taxable year closes on September 30 of Year 1 for U.S. tax purposes. New D also has a short U.S. taxable year, beginning on October 1 and ending on December 31 of Year 1. The sale of A's interest does not close D's taxable year for country M tax purposes. D has 400u of taxable income for its foreign taxable year ending December 31, Year 1 with respect to which country M imposes 120u of income tax, equal to $120 as translated in accordance with section 986(a).

2. *Result.* D is legally liable for the $120 of country M income tax imposed on its foreign taxable income. Because D's taxable year closes on September 30, Year 1, for U.S. tax purposes, but does not close for country M tax purposes, under paragraph (f)(4)(i) of this section the $120 of country M tax must be allocated under the principles of § 1.1502-76(b) between terminating D and new D. *See* §1.704-1(b)(4)(viii) for rules relating to the allocation of terminating D's country M taxes between A and B and the allocation of new D's country M taxes between B and C.

2. *Temporary Regulations.* The temporary regulations address a number of other issues related to partnerships and splitters.

(a) Section 909(c)(1) provides that § 909 applies at the partner level. Accordingly, Treas. Reg. § 1.909-1T(b) provides that in the case of foreign income taxes paid or accrued by a partnership, taxes allocated to one or more partners will be treated as split taxes to the extent such taxes would be split taxes if the partner had paid or accrued the taxes directly on the date such taxes are taken into account by the partner under §§ 702 and 706(a). Any such split taxes will be suspended in the hands of the partner.

(b) Treas. Reg. § 1.909-1T(c) provides that for purposes of determining whether related income is taken into account by a covered person, related income of a partnership is considered to be taken into account by the partner to whom the related income is allocated.

(c) Treas. Reg. § 1.909-2T(b)(4) describes a *partnership inter-branch payment splitter arrangement.*

i. Under § 1.909-2T(b)(4)(i), an allocation of foreign income tax paid or accrued by a partnership with respect to an inter-branch payment as described in § 1.704-1(b)(4)(viii)(d)(3) (revised as of April 1, 2011) (the inter-branch payment tax), is a splitter arrangement to the extent the inter-branch payment tax is not allocated to the partners in the same proportion as the distributive shares of income in the CFTE category to which the inter-branch payment tax is or would be assigned under Treas. Reg. § 1.704-1(b)(4)(viii)(d) without regard to Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3).

ii. Under Treas. Reg. § 1.909-2T(b)(4)(ii), split taxes from a partnership inter-branch payment splitter arrangement equal the excess of the amount of the inter-branch payment tax allocated to a partner under the partnership agreement over the amount of the inter-branch payment tax that would have been allocated to the partner if the tax had been allocated in the same proportion as the distributive shares of income in that CFTE category.

iii. Under Treas. Reg. § 1.909-2T(b)(4)(iii), related income from a partnership inter-branch payment splitter arrangement equals the amount of income

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allocated to a partner that exceeds the amount of income that would have been allocated to the partner if income in that CFTE category in the amount of the inter- branch payment had been allocated to the partners in the same proportion as the inter- branch payment tax was allocated under the partnership agreement.

iv. The Treasury Department and the IRS stated in § 5.03 of Notice 2010-92 that future guidance would provide that allocations described in Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3) will result in a foreign tax credit splitting event in post-2010 taxable years to the extent such allocations result in foreign income taxes being allocated to a different partner than the related income. The above rules reflect such future guidance.

v. The Preamble explains that Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3) provides that if a branch of a partnership (including a disregarded entity owned by the partnership) is required to include in income under foreign law a payment (an inter-branch payment) it receives from the partnership or another branch of the partnership, any CFTE imposed with respect to the payment relates to the income in the CFTE category that includes the items attributable to the recipient (the recipient CFTE category). However, because the inter-branch payment is disregarded for U.S. Federal income tax purposes, the income related to the CFTEs imposed with respect to the payment may remain in the CFTE category that includes the items attributable to the payor of the inter-branch payment (the payor CFTE category). This is an exception to the general application of the principles of § 1.904-6 that would allocate the CFTEs to the payor CFTE category that includes the related income. *See* § 1.704-1(b)(4)(viii)(d)(1). Because this exception allows the CFTEs and related income to be allocated to different CFTE categories, they may potentially be allocated to the partners in a manner that separates the CFTEs from the related income.

vi. The temporary regulations revise Example 24 of § 1.704-1(b)(5) to reflect these changes, as follows:

1. *Facts.* A (foreign) and B (US) own interests in an entity treated as partnership (AB). The partnership conducts businesses M and N through two entities (DE1 and DE2, respectively) that are corporations for country X and Y tax purposes and disregarded entities for U.S. tax purposes. B has a 25% economic interest in DE1 and a 50% interest in DE2. A owns the balance of the economic interests in DE1 and DE2. DE1 makes payments of $75,000 during 2012 to DE2 that are deductible by DE1 for country X tax purposes and includible in income of DE2 for country Y tax purposes. As a result of such payments, DE1 has taxable income of $25,000 for country X purposes on which $10,000 of taxes are imposed and DE2 has taxable income of $125,000 for country Y purposes on which $25,000 of taxes are imposed. For U.S. tax purposes, $100,000 of AB's income is attributable to the activities of DE1 and $50,000 of AB's income is attributable to the activities of DE2. Pursuant to the partnership agreement, all partnership items from business M, excluding CFTEs paid or accrued by business M, are allocated 75 percent to A and 25 percent to B, and all partnership items from business N, excluding CFTEs paid or accrued by business N, are split evenly between A and B (50 percent each). Accordingly, A is allocated 75 percent of the income from business M ($75,000), and 50 percent of

the income from business N ($25,000). B is allocated 25 percent of the income from business M ($25,000), and 50 percent of the income from business N ($25,000).

2. *Result.* Because the partnership agreement provides for different allocations of the net income attributable to businesses M and N, the net income attributable to each of business M and business N is income in separate CFTE categories. The $100,000 of net income attributable to business M is in the business M CFTE category and the $50,000 of net income attributable to business N is in the business N CFTE category. The $10,000 of country X taxes is allocated to the business M CFTE category and $10,000 of the country Y taxes is allocated to the business N CFTE category. The additional $15,000 of country Y tax imposed with respect to the inter-branch payment is assigned to the business M CFTE category because for U.S. tax purposes, the related $75,000 of income that country Y is taxing is in the business M CFTE category. Therefore, $25,000 of taxes ($10,000 of country X taxes and $15,000 of the country Y taxes) is related to the $100,000 of net income in the business M CFTE category and the other $10,000 of country Y taxes is related to the $50,000 of net income in the business N CFTE category. The allocations of country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 75 percent to A and 25 percent to B. The allocations of country Y taxes will be in proportion to the distributive shares of income to which

they relate and will be deemed to be in accordance with the partners' interests in the partnership if $15,000 of such taxes is allocated 75 percent to A and 25 percent to B and the other $10,000 of such taxes is allocated 50 percent to A and 50 percent to B. No inference is intended with respect to the application of other provisions to arrangements that involve disregarded payments.

3. *Alternate case*. Assume that the facts are the same, except that in order to reflect the $75,000 payment from DE1 to DE2, the partnership agreement allocates $75,000 of the income attributable to business M equally between A and B (50 percent each). In order to prevent separating the CFTEs from the related foreign income, the $75,000 payment is treated as a divisible part of the business M activity and, therefore, a separate activity. Because items from the disregarded payment and business N are both shared equally between A and B, the disregarded payment activity and the business N activity are treated as a single CFTE category. Accordingly, $25,000 of net income attributable to business M is in the business M CFTE category and $75,000 of income of business M attributable to the disregarded payment and the $50,000 of net income attributable to business N are in the business N CFTE category. The $10,000 of country X taxes is allocated to the business M CFTE category and all $25,000 of the country Y taxes is allocated to the business N CFTE category. The allocations of country X taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in

accordance with the partners' interests in the partnership if such taxes are allocated 75 percent to A and 25 percent to B. The allocations of country Y taxes will be in proportion to the distributive shares of income to which they relate and will be deemed to be in accordance with the partners' interests in the partnership if such taxes are allocated 50 percent to A and 50 percent to B.

vii. The rules described above are generally effective for taxable years beginning on or after January 1, 2012. Allocations made in accordance with Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3) in taxable years beginning on or after January 1, 2011, and before January 1, 2012, will result in a foreign tax credit splitting event and suspension of foreign income taxes that are allocated to a different partner than the covered person that is allocated the related income. *See* § 1.909-5T(a)(2). The temporary regulations also provide a transition rule for partnerships whose agreements were entered into prior to February 14, 2012. If there has been no material modification to the partnership agreement on or after February 14, 2012, then the partnership may apply the provisions of Treas. Reg. § 1.704-1(b)(4)(viii)(c)(3)(ii) and §1.704-1(b)(4)(viii)(d)(3) as in effect prior to February 14, 2012. *See* § 1.704-1T(b)(1)(ii)(b)(3). For purposes of this transition rule, any change in ownership constitutes a material modification to the partnership agreement. This transition rule does not apply to any taxable year in which persons bearing a relationship to each other specified in section 267(b) or 707(b)collectively have the power to amend the partnership agreement without the consent of any unrelated party (and all subsequent taxable years).

viii. In the case of any partnership that applies, under the transition rule, the provisions of § 1.704-1(b)(4)(viii)(c)(3)(ii) and § 1.704-1(b)(4)(viii)(d)(3) as in effect prior to February 14, 2012, an allocation of foreign income taxes paid or accrued by the partnership with respect to an inter-branch payment will result in a foreign tax credit splitting event to the extent that the tax on the inter-branch payment is not allocated to the partners in proportion to the distributive shares of income to which the inter-branch payment tax relates. *See* Treas. Reg. §1.909-2T(b)(4).

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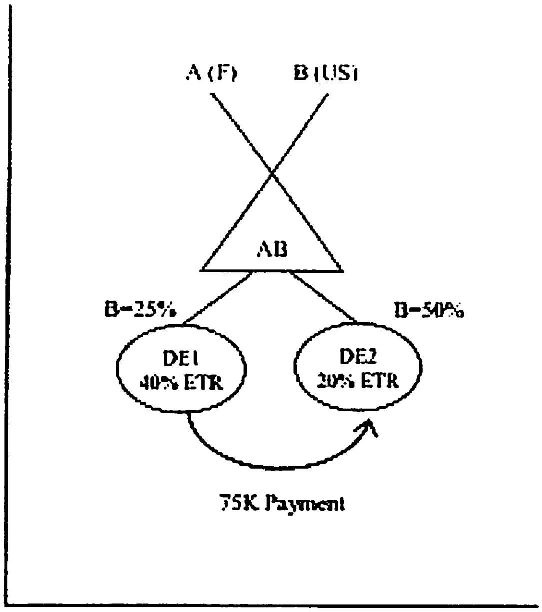
Treas. Reg. § 1.704-1(b)(5) Example 24



US TREATMENT

DE1	DE2
100K Income	50K Income

FOREIGN TREATMENT

DE1	DE2
25K Income	125K Income
10K Tax	25K Tax (includes 15K of Tax on disregarded payment)

RESULT TO B w/o SPLITTER REGS

DE1	DE2	TOTAL
25K Income	25K Income	50K Income
2.5K Tax	12.5K Tax	15K Tax
		30% ETR

RESULT TO B IF TAX REALLOCATION

TAX REALLOCATION

DE1	DE2
10K Actual Tax	25K Actual Tax
15K Reallocated Tax	(15K Reallocated Tax)
25K Total Tax	10K Total Tax

RESULT TO B

DE1	DE2	TOTAL
25K Income	25K Income	50K Income
6.25K Tax	5K Tax	11.25K Tax

B Loses 3.75K of Tax
22.5% ETR

RESULT TO B IF INCOME REALLOCATION

INCOME REALLOCATION

DE1	DE2
100K US Income	50K US Income
(75K Disregarded Payment)	75K Disregarded Payment
25K Total Income	125K Total Income

RESULT TO B

DE1	DE2	TOTAL
6.25K Income	62.5K Income	68.75K Income
2.5K Tax	12.5K Tax	15K Tax

B Gains 37.5K of Income
21.8% ETR

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II. COVERED ASSET ACQUISITIONS.

A. General Rules.

1. New § 901(m) is entitled, "Denial of Foreign Tax Credit with Respect to Foreign Income Not Subject to United States Taxation by Reason of Covered Asset Acquisitions." The statutory definition of a CAA includes four categories of transactions:
   - (a) A qualified stock purchase for which a § 338 election has been made;
   - (b) Any transaction treated as an asset acquisition for U.S. income tax purposes and as a stock acquisition (or disregarded) for foreign income tax purposes;
   - (c) Any acquisition of a partnership interest if the partnership has a § 754 election in place; and
   - (d) Any other similar transaction as identified in regulations.
2. Under § 901(m), the disqualified portion of any foreign income tax determined regarding the income or gain attributable to the relevant foreign assets is not be taken into account in determining the § 901 foreign tax credit, and for a foreign income tax paid by a § 902 corporation, is not be taken into account for purposes of §§ 902 and 960.
3. The JCT Technical Explanation illustrates this new rule with the following example. Assume US, a domestic corporation, acquires 100% of the stock of FT, a foreign target organized in country F with a "u" functional currency, in a qualified stock purchase for which a § 338 election is made. The tax rate in country F is 25%. The aggregate basis difference in connection with the qualified stock purchase is 200u, including: (1) 150u that is attributable to asset A, with a 15 year recovery period for U.S. tax purposes (10u of annual amortization); and (2) 50u that is attributable to asset B, with a five year recovery period (10u of annual depreciation).
4. In each of years 1 and 2, FT's taxable income is 100u for local purposes and FT pays foreign income tax of 25u (equal to $25 when translated at the average exchange rate for the year). As a result, the disqualified portion of foreign income tax in each of years 1 and 2 is $5 (10u + 10u of allocable basis difference over 100u of foreign taxable income times $25 foreign tax paid).

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5. In year 3, FT's taxable income is 140u, 40u of which is attributable to gain on the sale of asset B. FT's country F tax is 35u (equal to $35 translated at the average exchange rate for the year). Accordingly, the disqualified portion of its foreign income taxes paid is $10 ((40u (10u of annual amortization on asset A plus 30u attributable to disposition of asset B) of allocable basis difference over 140u of foreign taxable income) times $35 foreign tax paid)).

6. The disqualified portion of the foreign tax can be claimed as a deduction to the extent otherwise deductible.

7. Section 901(m) is effective for covered asset acquisitions after December 31, 2010, unless covered by an agreement binding on January 1, 2011, or described in a ruling request filed with the IRS before July 29, 2010 or a public announcement before January 1, 2011.

B. Observations with Respect to CCAs.

1. Category 2 above is very broad.

   (a) It would appear to include every transaction involving a check-the-box election. To take the simplest of examples, suppose USP owns CFC1, which owns CFC2. CFC1 and CFC2 have operated as CFCs for a number of years. CFC2 makes a check-the-box election to be treated as a disregarded entity. The deemed liquidation of CFC2 is a Category 2 CAA: It is treated as an asset acquisition for U.S. tax purposes (CFC1 acquired CFC2's assets) and is disregarded under foreign law.

   (b) In this example the transaction's status as a CAA might not be too great a concern for USP. It probably will not result in a denial of foreign tax credits, as it would not result in any "basis difference." On the other hand, the existence of a 1% minority shareholder, for example, could create such a basis difference to the extent of that shareholder's interest in the underlying CFC2 assets.

   (c) Other examples of Category 2 CAAs resulting from check-the-box elections include:

      ☐ Any "unchecking" of a previously disregarded foreign entity.

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☐ Any check-and-sell transaction (*e.g.*, CFC1 owns CFC2; CFC2 checks the box to become a disregarded entity, and CFC1 sells the CFC2 stock (assets for U.S. tax purposes)).[1]

☐ The transfer within the corporate group of a previously checked foreign disregarded entity (FDE).

☐ Any "drop and check" D reorganization (*e.g.*, USP contributes CFC1 to CFC2, and CFC1 checks the box to become a disregarded entity).

☐ Any "cash D" reorganization in which the liquidation of the target is effected through a check-the-box election.

2. Overlap with Section 909 "Splitter" Rules.

(a) Category 2 CAAs include any cross-chain sale, contribution, or distribution of a foreign disregarded entity, as noted above. Suppose USP owns CFC1 in Country X and CFC2 in Country Y. CFC1 owns FDE, a Country Z entity that is disregarded for U.S. tax purposes. CFC1 sells FDE to CFC2 for cash. The sale is an acquisition of assets for U.S. tax purposes (because FDE is disregarded) and an acquisition of stock for foreign tax purposes. Thus, the sale is a CAA. Additionally, CFC2 obtains a stepped-up basis in all of the FDE assets.

(b) Again, it does not seem appropriate in this circumstance for USP to suffer a permanent denial of foreign tax credits as a result of the cross-chain sale. Even if the sale is not taxable in Country X or Country Z, gain on the assets is recognized for U.S. tax purposes and taken into account in CFC1's E&P. Denying CFC2 a basis step-up, or the foreign tax credit equivalent, would result in double taxation.

(c) Commentators and government officials have suggested that it might be more appropriate in this circumstance to apply the § 909 "splitter" rules in lieu of the § 901(m) CAA rules. If no foreign taxes are imposed on CFC1's sale of FDE, the sale has an effect similar to a

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splitter. CFC1 earns E&P with no associated foreign income tax, while CFC2, over time, earns a reduced amount of E&P subject to full foreign income tax. The E&P has, in some sense at least, been separated from the tax.

3. Reconstructing the Foreign Target's U.S. Asset Basis.

   (a) Before the enactment of § 901(m), U.S. acquirers of foreign target companies generally made a § 338 election with respect to their acquisitions. This was done in part to obtain a stepped-up asset basis, but also to clear out the target's historic E&P. That way, the acquirer could go forward with a "fresh start," unencumbered by the target's foreign assets and earnings history (and the required U.S. GAAP and tax adjustments) in its future tax planning, return filing, and IRS audits. For this reason, many U.S. acquirers will continue to make § 338 elections, despite § 901(m), that is, to be freed from having to spend weeks or months reconstructing E&P, § 904 baskets, foreign tax pools, and asset bases.

   (b) On the other hand, Congress has now defeated that goal of tax simplification. Section 901(m) will essentially force these U.S. acquirers to undertake a major new diligence project in connection with the foreign acquisition: the reconstruction of the foreign target company's pre-closing U.S. asset bases. Consider a U.S. company (USP) that acquires a foreign target company (FT) for $1 billion and makes a § 338 election. Assume that (as is often the case) FT was wholly foreign-owned before the acquisition.

   (c) USP will have a strong incentive to investigate fully FT's transactional history, possibly for many years prior to the acquisition's closing, to determine the pre-close U.S. tax bases of FT's assets. How could a multinational corporation's V.P. tax justify not undertaking this project? It could result in substantial benefits. How will IRS examiners cope with the sheer magnitude of such an undertaking?

   (d) As a wholly foreign-owned entity, FT in our example will not have kept any records of the U.S. tax bases of its assets. FT's transactions over the years will not have been done with U.S. tax rules in mind. Thus, as part of its pre-acquisition due diligence and post-closing integration project, USP will have to engage its attorneys and accountants to reconstruct FT's U.S. asset bases from the ground up, starting with the first year of FT's operations.[2] A Treasury official acknowledged that Congress "will be creating more jobs for accountants" by enacting § 901(m). Indeed.

(e) As part of its § 901(m) basis study, USP will want to consider whether any previous transactions, undertaken while FT was foreign-owned, might have resulted in a stepped-up U.S. asset basis. If, for example, FT engaged in a merger, demerger, or other asset transfer a couple of years before the acquisition, that previous transaction, even if tax-free under foreign law, might have been taxable from a U.S. perspective, thereby giving FT a stepped-up asset basis for U.S. tax purposes even before the CAA. Of course, if the previous transaction was itself a CAA that occurred after § 901(m)'s effective date, that could substantially complicate the analysis.

(f) Pre-close diligence and post-close integration project checklists undoubtedly will need to be developed. Corporate transactions may be one thing. If the acquired entity was a partnership for U.S. tax purposes at any time, or its historic transferors were partnerships, the disguised sale rules, § 731, § 751(b) transactions, and transactions implicating §§ 752, 732, 734, 743, etc., all will need to be considered to see whether there were pre-close basis step-ups for U.S. tax purposes. Finding any such transactions could produce substantial U.S. tax benefits in the form of preserved foreign tax credits.

(g) The target's tax accounting treatment and conventions may also provide opportunities to find asset basis. How were asset replacements and depreciation treated? Allowable U.S. depreciation for foreign assets well could be less than the relevant foreign asset depreciation rules permit. Were costs deducted that under U.S. rules should have been capitalized? UNICAP

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could become a taxpayer-favorable provision. Finding valid basis will be limited only by the advisor's creativity.

(h) Pre-close R&D, for example might have created a large asset. Even R&D predating the foreign target's incorporation could be relevant in determining the size of this asset. The IRS position is that capitalized R&D has a life going forward in perpetuity.[3] Thus, if it cannot be deducted for U.S. tax purposes, it never could have been abandoned, either. This could mean going back many years. A massive asset would have been created, presumably translated into dollars at the exchange rates in effect when funds were expended.

(i) Government officials reportedly are considering whether coming guidance should allow U.S. acquirers to use foreign tax rules to determine their historical basis in assets for purposes of § 901(m). We believe such an election is consistent with the purpose of § 901(m), and should be allowed. It would provide needed simplification for smaller acquisitions. However, as the New York State Bar Association comments stated, such a rule should be at the taxpayer's option. The statutory rule turns on U.S. tax basis pre-closing; the legislative history suggests that regulations allow the use of foreign tax basis in appropriate cases.[4]

(j) Curiously, even this simplification might not prevent the need for a major foreign asset-basis research project. The taxpayer would need to determine which course of action was better. That is, with large amounts of foreign tax credits potentially at stake, U.S. acquirers probably would want to perform the U.S. tax basis study described above, despite its potential size and cost, and then decide whether making an election to use foreign basis would provide a better result.

4. Determining the Income Attributable to the Acquired Assets.

(a) Once the U.S. acquirer has determined the pre-close U.S. tax bases of the acquired assets, it will have overcome the first substantial administrative burden arising from § 901(m). But there is another looming task, possibly equally daunting. The U.S. acquirer (or the IRS) will have to determine what portion of the target's foreign income tax is "attributable" to the "relevant foreign assets" acquired in the CAA. Here, too, regulations could provide shortcuts, or simplified approaches. Congress certainly has not given us tax simplification here, but rather, has dropped the matter into the hands of Treasury and the IRS (or failing that, taxpayers, IRS examiners, and possibly the courts) to figure out.

(b) Section 901(m) denies foreign tax credits for the "disqualified portion" of the foreign income tax determined with respect to the income or gain attributable to the relevant foreign assets. The term "disqualified portion" means the ratio (expressed as a percentage) of the aggregate basis differences for the year with respect to the relevant foreign assets, divided by the income for the year that is attributable to those assets and included in the foreign tax base.

(c) Basing the amount of disallowed foreign tax credits on the amount of foreign income tax determined with respect to the income attributable to the acquired assets appears to raise difficult issues of income allocation, at least in the ordinary case where the foreign target continues to develop or acquire additional assets or replace existing assets in the ordinary course of business following the CAA.

(d) Suppose USP acquires FT, a Country X technology company, and makes a § 338 election. FT's principal asset is its developed IP. Immediately before the acquisition, the IP is worth $1,050. For simplicity, assume it has a pre-acquisition U.S. tax basis of zero in FT's hands. (A zero basis in IP might not be very realistic as discussed above.) After the acquisition, as a result of the § 338 deemed sale, FT holds the assets with a stepped-up basis of $1,050. The acquisition is a CAA, and the basis difference with respect to the FT IP is $1,050, or $70 per year over 15 years. For simplicity, assume FT has no other assets with a basis difference. The income tax rate in Country X is 30%.

(e) Following the acquisition, FT continues to develop IP. FT earns income in Country X by exploiting its IP, which integrates the IP acquired in the CAA with the later-developed IP. Suppose that in Year 3, FT earns $200 of income, as determined for Country X tax purposes, and pays Country X income tax of $60. How much of the $200 of income is "attributable" to the acquired assets (the IP in existence as of the closing)? How is the "disqualified portion" of the $60 of Country X tax calculated? Every year, every day, new assets (IP) are added.

(f) Is this not a common example? Goodwill, marketing intangibles, and changes in going concern value could produce similar issues. Is goodwill the same asset in the year 2015 that was acquired in 2011? Are new marketing strategies and personnel in place? Perhaps important new customers have been found. See, for example, the marketing intangibles discussion in *Veritas*.

(g) The mathematics of § 901(m) probably would cause these issues to work themselves out in a simple, laboratory test case. If the entire $200 of income is treated as being attributable to the acquired assets, then the disqualified portion is 35% ($70 basis difference divided by $200 income) and is applied with respect to the Country X tax imposed on $200, or $60. This would result in $21 of disallowed credits (35% of $60). But this is not real life.

(h) Suppose, for example, the acquired business included a manufacturing plant. Are not portions of the plant's equipment withdrawn from service each year and replacement parts installed in their place in the ordinary course of business? How will these assets be treated? Must they be traced? How will the plant's income be attributed to old and new parts?

(i) The complications would multiply quickly if FT had operations in two countries with different tax rates, and the acquired assets were used to generate income in both countries. What if FT recognized significant capital gains, in addition to its regular business income? Would the result depend on whether the gains arose from the sale of acquired assets? How should the rules adjust the disqualified portion if FT is entitled to Country X R&D credits, or other Country X tax credits? Would the result depend on whether those credits arose from the acquired assets?

(j) Needless to say, Treasury and the IRS face a difficult challenge in developing workable rules for making these determinations in the myriad factual situations that might arise.

III. ANTI-HOPSCOTCH RULES--§960(c).

A. Section 960(c) limits foreign tax credits in the situation in which a lower-tier, high-tax CFC which is owned by a higher-tier, lower-tax CFC makes a § 956 loan to the U.S. parent company. The U.S. parent's foreign tax credit is limited to the amount of the foreign tax credit that would have resulted had the amount been distributed through the tiers of corporations between the high-tax CFC and the U.S. parent company.

B. The statute states:

> § 960(c)(1). "If there is included under section 951(a)(1)(B) in the gross income of a domestic corporation any amount attributable to the earnings and profits of a foreign corporation which is a member of a qualified group...with respect to a domestic corporation, the amount of any foreign income taxes deemed to have been paid...by the domestic corporation...***shall not exceed the amount of the foreign income taxes which would have deemed to have been paid...if a cash distribution equal to the amount of such inclusion in gross income were distributed as a series of distributions***... through the chain of ownership which begins with such foreign corporation and ends with such domestic corporation."
>
> § 960(c)(2): "AUTHORITY TO PREVENT ABUSE – The Secretary shall issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of this subsection, including regulations or other guidance which prevent the inappropriate use of the foreign corporation's foreign income taxes not deemed paid by reason of paragraph (1)."

> Legislative History: "It is anticipated that guidance will prohibit the inappropriate use of excess taxes, and will address attempted avoidance of the provision through a series of transactions."

C. The provision is effective with respect to § 956 inclusions attributable to U.S. property acquired by a CFC after December 31, 2010. Since § 956 property often consists of loans to the U.S. parent company, *i.e.*, debt instruments, issues could arise under the § 1001 regulations as to whether a debt instrument constitutes a new debt instrument should there be some change in the terms of the instrument.

D. The JCT Technical Explanation states that no special rules apply in determining the hypothetical credit. The only exception is that, to the extent an actual distribution would be subject to any income or withholding taxes, those taxes that are not taken into account in determining the hypothetical credit.

E. Assume, for example, that USP, a U.S. parent company, owns all the vote and value of CFC-1, a CFC organized in country A with post-1986 undistributed earnings of 200u and post-1986 foreign income taxes in the amount of $10. CFC-1 owns all of the vote and value of CFC-2, a CFC organized in country B with post-1986 undistributed earnings of 100u, and post-1986 foreign income taxes in the amount of $50. If CFC-2 makes a loan to USP that results in a § 956 inclusion in the amount of 100u, the tentative credit is $50 (100u over 100u times $50).

F. The hypothetical distribution of 100u from CFC-2 to CFC-1 would increase CFC-1's current E&P by 100u, from 200u to 300u, and increase CFC-1's foreign income taxes from $10 to $60. The 100u hypothetical distribution results in a dividend of 100u that is not-Subpart F income of CFC-1 under the Subpart F look-through rules of § 954(c)(6). Although country B would impose a 10% withholding tax on an actual distribution of 100u to CFC-1, for a total withholding tax of 10u, this amount is not taken into account in determining the hypothetical credit.

G. Next, the 100u of hypothetical distribution from CFC-1 to US would result in a dividend of 100u, with respect to which US would be deemed to have paid $20 in taxes (100u over 300u times $60). Because the hypothetical credit of $20 is less than the tentative credit of $50, US's foreign taxes deemed paid with respect to its § 956 inclusion are limited to $20. US's § 78 gross up with respect to the § 956 inclusion is also $20.

H. The Technical Explanation further states that if in the same taxable year CFC-1 were also to make an actual distribution of all of its accumulated E&P of 200u, the 100u hypothetical distribution from CFC-1 to US would have no impact on the calculation of US's actual deemed paid credit from CFC-1's actual dividend. The deemed paid credit on the 200u dividend would be $10 (200u over 200u times $10). In addition, the calculation of the hypothetical credit with respect to the hypothetical distribution of 100u from CFC-2 would be the same (100u over 300u times $60 equals $20) whether or not CFC-1 paid an actual dividend.

I. The Technical Explanation states that the treatment of any foreign taxes over the limit imposed under the new rule (the "excess taxes") is the same as the treatment of any other foreign taxes paid or accrued, but not yet deemed paid for purposes of the foreign tax credit rules. Thus, if a foreign corporation's excess taxes are in its general category post-1986 foreign income taxes pool, the foreign corporation's excess taxes are still considered general category post-1986 foreign income taxes. Accordingly, these taxes are included in the computation of foreign taxes deemed paid with respect to a subsequent distribution from, or income inclusion with respect to, that foreign corporation, subject to applicable limitations including the limitation of the new provision. In the example above, the excess taxes that remain at CFC-2 equal $30. The excess taxes equal the deemed paid foreign tax credit (determined without regard to the new provision) of $50 minus a hypothetical credit of $20.

J. Alternatively, states the JCT Technical Explanation, if CFC-2's E&P also included 125u of previously taxed income, then the excess taxes remaining at CFC-2 would be $50, because the applicable ordering rules would prioritize the hypothetical distribution as coming first from the 125u in previously taxed income over the 100u in untaxed earnings. Thus, the new rule can have interesting applications in the context of previously taxed income.

IV. FOREIGN TAX CREDITS – OTHER DEVELOPMENTS.

A. *Pritired 1 LLC*

1. In *Pritired 1 LLC v. United States*, 816 F. Supp. 2d 693 (S.D. Iowa 2011), the IRS successfully argued that a structured transaction should not generate FTCs for the taxpayer because it lacked economic substance. The taxpayer unsuccessfully argued that it had several non-tax business reasons for entering

into the transactions: obtaining higher yields on foreign bonds; obtaining the enhanced yield on the transaction itself; duration-matching with respect to five-year liabilities; and greater portfolio diversification. The Taxpayer also stated that it had a real expectation of making a profit.

2. The court held that the taxpayer's transaction was designed to be a loan and not an equity investment. It found that the parties acted with the intent to structure a transaction that appeared to be equity but was in substance debt. Thus, a partnership that was key to the structure was found not to be a partnership.

3. The court also held that the transaction failed each prong of the economic substance test set forth in *IES Industries v. United States*, 253 F.3d 350 (8th Cir. 2001). The court stated that the transaction was designed to appear as a partnership equity investment, but was primarily structured to generate foreign tax credits.

4. The court also held that in applying the partnership anti-abuse regulation, the partnership may be disregarded which also results in disallowing the foreign tax credits claimed by the U.S. taxpayer for the French taxes paid by the partnership.

5. Finally, because the court had alternatively found in favor of the IRS on all of the government's other proposed findings, the court declined to reach the question of whether the transaction had substantial economic effect under the partnership rules.

B. Bank of New York Mellon Corporation. *The Bank of New York Mellon Corporation v. Commissioner*, T.C. Dkt. No. 26683-09 involves what the IRS argues is an abusive use of foreign tax credits. The case would seem to be a follow on to the *Pritired 1 LLC* case above. Several other banks also participated in STARS transactions, and the case has been widely followed. The pre-trial memoranda filed by the parties are lengthy, totaling in the aggregate 130 pages.

C. *Hewlett-Packard*. Discussed below in debt vs. equity section. In brief, the court denied HP deemed paid foreign tax credits holding that the instrument owned by HP constituted debt rather than equity, and therefore "dividends" paid in respect of the instrument did not bring up § 902 credits.

D. PPL-Creditability I.

1. *PPL Corp. v. Commissioner*, 665 F.3d 60 (3d Cir. 2011), reversed the Tax Court's holding in favor of the taxpayer with respect to the creditability of a U.K. tax. The Third Circuit said the windfall tax at issue emerged in the U.K. from a backlash against the privatization of U.K. utilities and transit operators. In concept, stated the court, the windfall tax was a one-time 23% tax on the difference between each company's "profit making value" and its "flotation value," the price for which the U.K. government had sold it. The court stated that the U.K. public believed that the government had sold the companies too cheaply; hence, the term "windfall."

2. The U.K. statute defined each company's "profit-making value" as its average annual profit multiplied by its price-to-earnings ratio. It defined average annual profit as the company's average profit per day over a statutorily defined "initial period" (which for the company in issue and most others was the first four years after privatization) multiplied by 365. Rather than using the companies' actual price earnings ratio, the statute imputed a ratio of 9 for all companies. This "ratio," a U.K. government document explained, "approximates the lowest averagesectoral price-to-earnings ratio of the companies liable to the tax."

3. The Third Circuit then stated that the tax may be expressed algebraically as follows: tax = 23% x [(365 x (P/D) x 9) – flotation value]. The tax rate is 23%, P is the company's total profit over the initial period, and D is the length of the initial period in days. We suppose one could shorten the court's formula since exactly four years was involved: tax = 23% x (average 4 years profit x 9) – flotation value. Reducing a tax issue to algebra would seem to be a first. Read on in this regard.

4. The court seems to have addressed the Tax Court's holding only briefly. The court discussed the regulation's three requirements

to have a creditable foreign income tax: the realization requirement, the gross receipts requirement, and the net income requirement. The court stated that the three requirements concern the timing and the base of the foreign tax. The realization requirement ensures that the taxpayer has received income before being obligated to pay taxes on it. The gross income and net income requirements, stated the court, present questions about the tax base, the amount on which the tax is levied. The amount that a particular corporation owes is the product of its tax base multiplied by its tax rate.

5. The tax base, felt the court, is what the U.K. statute says: the difference between two imputed values of each affected company. The first value is the profit making value, defined as its average annual profit during its initial period times nine. The second value is the company's flotation value. In the taxpayer's view, stated the court, looking through the form of the tax to its substance reveals that the tax is in substance a tax on profits, specifically on excess profits.

6. The court held that the taxpayer's formulation of the substance of the U.K. windfall tax is "a bridge too far." No matter how many of PPL's proposed simplifications the court accepts, the court stated that it must return to a fundamental problem: the tax base cannot be initial-period profit alone unless the court rewrites the tax rate.

7. Returning to its algebraic formula, the court stated that if this were a tax on initial-period profit, as the taxpayer contended, the tax base would be simply P, so that we could express the tax as follows: tax = 23% x P. The court stated, however, that no amount of emphasis on substance over form can take us from this equation to the court's equation stated above. The court worked this through with more algebra to show that the one formula cannot be modified to become the equivalent of the other formula.

8. The court then stated that the taxpayer attempted to skirt the court's concerns by changing the tax rate. However, stated the court, changing the tax rate in this way to avoid a problem with the tax base would read the gross receipts requirement out of the regulation.

9. In conclusion, the court held that the tax was not a creditable foreign income tax.

10. One interesting question left unaddressed: in the Tax Court, the taxpayer also briefed a separate issue that involves the rescission of a dividend. It said the Tax Court did not need to address that issue if the court found in favor of the taxpayer on the creditability issue. We wonder whether the rescission issue will now be addressed? It was not a subject of the appeal because the Tax Court had not resolved the issue.

E. PPL-Creditability II.

1. *Entergy Corporation v. Commissioner*, 683 F.3d 233 (5th Cir. 2012), *aff'g* T.C. Memo 2010-197, involved an appeal by the government from the Tax Court's decision. In rendering its holding in *Entergy*, the Tax Court had relied on its parallel decision in *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010), *rev'd*, 665 F.3d 60 (3d Cir. 2011). The Tax Court concluded that Entergy was entitled to claim a foreign tax credit for its U.K. subsidiary's payment of a U.K. windfall tax. The Fifth Circuit affirmed the Tax Court's decision notwithstanding the Third Circuit's reversal in *PPL Corp.*

2. The Tax Court determined with windfall tax was based on excess profits and that it therefore necessarily satisfied Treas. Reg. § 1.901-2(a)'s three-part "predominant character" test: namely, that the windfall tax (1) reached only realized income, (2) was imposed on the basis of gross receipts and (3) targeted only net income. The Tax Court found that these requirements were satisfied.

3. The Fifth Circuit agreed stating that the realization requirement tracks the American income tax principle that income is typically taxed only following a "realization event," usually when property is sold or exchanged. The Court stated that the gross income requirement mandates that "generally the starting point for calculating income subject to a creditable foreign income tax must be actual gross receipts. The net income requirement only allows foreign tax credit for taxes which "provide for recovery of the significant cost and expenses (including significant capital expenditures) attributable, under reasonable principles, to the gross receipts included in the tax base."

4. The Tax Court, stated the Fifth Circuit, considered the windfall tax's reliance on "profit-making value." The Service argued for "text-bound approach" to determining creditability, relying primarily on the fact that the windfall tax by its own terms was levied on the difference between two statutory values. PPL and Entergy, by contrast, successfully argued that both parliamentary history surrounding the windfall tax as well as the algebraic reformulations demonstrated that the windfall tax was both intended as and actually acted as an excess profits tax.

5. Viewed in practical terms, stated the Fifth Circuit, the windfall tax clearly satisfies the realization and net income requirements. The tax is based on revenues from ordinary operation of the utilities that accrued long before the design and implementation of the tax. Revenues from earlier ordinary operations are clearly realized. Furthermore, the tax only reached--and only could reach--utilities that realized a profit in the relevant period.

6. The Service's formalistic argument applied with somewhat greater force to the gross receipts requirement, stated the Fifth Circuit. A tax actually directed at corporate value would not, in the ordinary sense, be imposed on the basis of gross receipts. The Court, however, was persuaded by the Tax Court's observation as to the windfall tax's predominant character: the tax's history and practical operation were to "claw back" a substantial portion of privatized utilities' "excess profits" in light of their sale value. These initial profits were the difference between the utilities income from all sources less their business expenses, in other words, gross receipts less expenses from those receipts, or net income.

7. The Third Circuit held that the windfall tax failed at least the gross receipts requirement. The Fifth Circuit, however, stated that this reasoning exemplifies the form-over-substance methodology that the governing regulation and caselaw eschew. The gross receipts requirement ensures a creditable income tax is usually computed "beginning from actual gross receipts, rather than notional amounts." This distinction between "actual receipts" and "notional amounts" reflects a core requirement in the regulation that creditable foreign taxes must be based on either actual income or an

imputed value not intended to reach more than actual gross receipts.

8. The court stated that this policy arises from a common foreign response to the attempt to avoid double taxation. Foreign countries would use imputed, rather than actual, income formulas for income tax purposes "structured to tax artificial or fictitious income" in order to increase domestic tax receipts. Nevertheless, not all methods of imputing income fail to satisfy the gross receipts requirement. The Court stated that a close reading of all of the examples in that subsection of the regulations indicates they do not illustrate the meaning of the "actual gross receipts," but instead differentiate between permissible imputed actual gross receipts and impermissible notional amounts.

9. The windfall tax begins by taking 23% of the daily average of profit based on actual gross receipts, multiplied by a statutory constant of 9 (deemed a "price-to-earnings ratio"), less each company's flotation value. There was no need to calculate imputed gross receipts; gross receipts were actually known. Thus, an example detailing an impermissible method for calculating imputed gross receipts (based on historical practices by OPEC countries) is facially irrelevant.

10. Moreover, stated the Fifth Circuit, the Third Circuit seems to overlook the fact that a tax based on actual financial profits in the U.K. necessarily begins with gross receipts, as the record indicates. "We are always chary to create a circuit split," stated the Fifth Circuit, "but we cannot engage in this sort of formalism in light of the predominant character standard." The Court closed its opinion by stating "We therefore disagree with the Third Circuit's conclusion and hold that the windfall tax is a creditable foreign income tax under IRC § 901."

F. *R.H. Donnelley Corp.*—FTC Carrybacks

1. *R.H. Donnelley Corp. v. United States*, 641 F.3d. 70 (4th Cir. 2011), affirmed a district court's denial of a company's refund claims for 1991 and 1992 stemming from research and foreign tax credit carrybacks from 1994.

2. The taxpayer filed its refund claims for 1991 and 1992, the court noted, just two days before the 1994 year's statute of limitations ran, barring the IRS from assessing additional taxes for that

year. After an IRS investigation revealed that the taxpayer had so underreported its 1994 income that there was sufficient tax liability to use up all of the credits in that year, the IRS denied the refund claim.

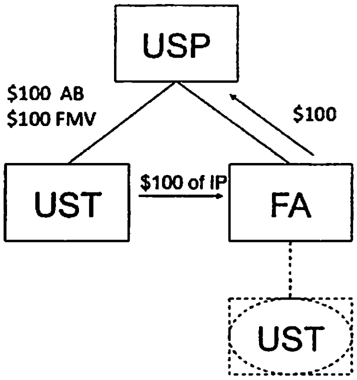
3. The general rule, of course, is that the IRS can raise offsets to determine if there was an overpayment of tax in the context of a taxpayer's refund claim. The taxpayer argued that *Lewis v. Reynolds*, 284 U.S. 281 (1932), the landmark case so holding, was distinguishable because it only permits the IRS to raise issues arising in that same tax year as an offset to the refund claim. Under its argument, the IRS could not reexamine whether there were excess credits in 1994 to be carried back to 1991 and 1992. The court disagreed.

4. The taxpayer also argued that even if *Lewis v. Reynolds* supported the IRS's ability to recalculate taxes to defeat refund claims in general, the Internal Revenue Code restricts the IRS when it comes to calculating foreign tax and business credit limitations for 1994 that determine whether there are excess credits to carryback to 1991 and 1992. The taxpayer relied primarily on § 904(a), and argued that section prevents the IRS from recalculating the foreign tax credit limitation in response to a refund suit. Specifically, the taxpayer contended that in§ 904(a)'s phrase for U.S. tax liability "the tax against which such credit is taken," the word "tax" refers solely to the tax that the IRS could actually collect before the statute of limitations expired, because a "credit can only be 'taken against' a real tax that exists." The court disagreed with this argument, as well.

V. Notice 2012-39

A. Notice 2012-39 is the latest in a series of examples where the IRS uses § 367 as a device to tax repatriations of offshore earnings. Over the past several years, the IRS has repeatedly invoked § 367 to issue notices and regulations addressing various transactions that it believes lead to inappropriate repatriation results. Notice 2012-39 addresses reorganizations involving outbound transfers of intangible property subject to § 367(d) in exchange for money or other property. Notice 2012-39 would treat such money or other property as a prepayment of § 367(d) royalties that are contingent on future use of IP. In other transactions involving use of offshore cash to acquire a US target company, the Notice treats an outbound IP transfer as immediately taxable at its fair market value.

B. Section 4.02 of the Notice involves the payment of money or other property (as defined under § 356) (i.e., boot) in the outbound asset reorganization as illustrated below.



1. Under the general subchapter C rules (§ 361(b)(1)(A)), UST would not be taxed on the receipt and distribution of boot as part of the reorganization. Further, USP would not be taxed at the shareholder level because of § 356(a)(2)'s limitation of boot to the amount of gain recognized by the shareholder

2. However, Section 4.02 of Notice 2012-39 prevents the tax-free receipt by USP of the $100 cash by viewing UST as receiving a $100 "prepayment" of the § 367(d) royalty amount. The Notice's real effect is to wipe away the shareholder-level protection offered by § 356(a)(2), even though § 367(d) is not concerned with the shareholder's exchange of stock in the reorganization.

3. Further, § 367(d) explicitly states that the U.S. transferor of the IP is taxed annually in accordance with the commensurate with income standard. By treating the boot as a prepayment of the annual royalty, the Notice abandons the commensurate with income standard. In this regard, the Notice states,

> As a prepayment of such income, the amount is included in income by the U.S. transferor in the year of the outbound section 367(d) transfer,

> regardless of the productivity of the transferred section 367(d) property in the year of the transfer or in subsequent years.

4. After presumably adjusting USP's basis in UST's stock upward by $80 under Reg. § 1.1502-32 (assuming UST is consolidated), USP would receive the boot without additional shareholder level tax. Under § 358, UST would take a basis of $100 in FA's stock, determined as $100 original basis, plus the $80 investment adjustment under § 1.1502-32, minus $80 for boot received without recognition of gain under § 358(a)(1). Thus, the Notice addresses the IRS's perceived "policy concern" that USP would be able to use the normal subchapter C rules to repatriate $80 in a tax-free reorganization without recognizing a deemed dividend. However, this result merely is a direct consequence of the boot-within-gain limitation of current § 356(a)(2) and not a result of the outbound IP transfer which was Congress' purpose in enacting § 367(d).

5. Section 4.04 of the Notice then treats any "qualified successor" of UST as continuing to include the contingent-on-use royalties in income under § 367(d), subject to a credit for any amounts previously taxed as a prepayment under § 4.02 of the Notice. Qualified successors" are defined as any shareholders of UST that are domestic C corporations.

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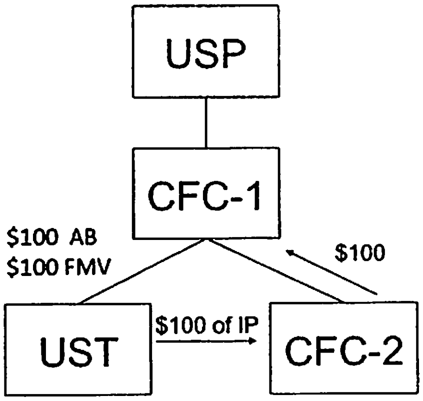
C. Section 4.03 of the Notice targets a second type of repatriation transaction that the IRS believes result in inappropriate tax-free repatriation of foreign earnings. An example of the transaction covered by Section 4.03 is illustrated below:



1. An assumption of the IRS's guidance is that, in between § 956 quarterly measuring dates, CFC-1 has acquired the stock of UST and then merges UST outbound into CFC-2.

2. Section 4.03 of the Notice provides that to the extent that the owner of UST is not a "qualified successor," UST will be taxed on the amount realized on a deemed sale of its intangibles. The Notice cites § 367(d)(2)(A)(ii)(II) as authority for this treatment. "Qualified successors" are defined as any shareholders of UST that are domestic C corporations. Since CFC-1 is a foreign corporation and, therefore, is not a "qualified successor," § 4.03 of the Notice converts the outbound IP transfer into a fully taxable sale.

3. As in the case of a subsequent disposition of the IP to an unrelated transferee, there apparently can be no commensurate with income adjustments. The IRS requests comments on whether it may be more appropriate to deem the ultimate U.S. parent of CFC-1 in this Example to be a qualified successor who continues to include § 367(d) royalties in income.

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4. While the stated purpose of the transactions covered in § 4.03 of the Notice is to prevent the use of a CFC's earnings to acquire U.S. property without § 956 consequences, it also apparently can apply to a foreign corporation which is not a CFC. Assume a publicly traded foreign company acquires a U.S. company and then the U.S. target merges into a foreign subsidiary of the U.S. parent. Since the acquiring foreign corporation is not a CFC, there can be no policy concern with tax-free repatriation of foreign earnings, but the Notice nonetheless appears on its face to cover such an outbound reorganization.

5. Further, the statutory basis for the inclusion seems erroneous. The statutory subsection invoked by the Notice is not concerned with the actual transfer of IP by a U.S. transferor to a foreign transferee (the transfer for which this provision is cited in the Notice), but rather a subsequent disposition of the IP (whether directly or indirectly). Indeed, the transaction in § 4.03 of the Notice seems to be a better (but still not exact) fit for § 367(e), which is concerned with distributions by a U.S. corporation to a foreign corporation in §§ 355 and 332 transactions. In the case of an acquisition of a U.S. target by a foreign parent corporation, the foreign parent could elect to liquidate the target under § 332, and not suffer the tax imposed by the Notice as long as the U.S. assets continue to be used in an active U.S. trade or business. See Treas. Reg. § 1.367(e)-2(b)(2)(i).

D. <u>Other Issues in Notice 2012-39</u>

1. Definition of Money or Other Property

(a) In defining the prepayment amount in the first category of transactions, § 4.02 of the Notice carefully hews to the definition of boot under subchapter C.

(d) This statutory definition is on its face limited to "money or other property" as defined under the relevant subchapter C provisions (i.e., §§ 356 and 361). For example, at the shareholder level, § 354(a)(1) provides that no gain or loss is recognized on the shareholder's receipt of "securities"[1] in a party to the reorganization. While exchanges of UST stock for FA "securities" are generally taxable as boot under the anti-bail out provisions of § 354(b)(1)(B), the exchange of

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UST securities for FA securities of no greater principal amount would still appear to be tax-free under § 354.

(e) Similarly, at the corporate level, the Notice deems there to be a prepayment on certain transactions in which FA assumes or supplies cash or other property to satisfy a "non-qualifying" liability of UST. Absent this provision, Notice 2012-39 could be easily circumvented through a pre-reorganization leveraged distribution by UST that was excluded in consolidation. To prevent such end-runs around the prepayment rule, the definition of "non-qualified" liabilities is very broad. Again, however, to maintain consistency with the subchapter C definition of boot, the Notice only deems there to be a prepayment with respect to a non-qualified liability to the extent that FA "assumes" the liability or satisfies the liability with "money or other property (as defined in section 361)." Under § 361, "securities" in a party to the plan of reorganization are not considered "other property." Of course, use of securities in this context would carry its own issues that would need to be considered.

2. Acceleration of Income/Effect on Transferee's E&P

(a) Another interesting implication of the Notice is in cases in which UST owns foreign IP rights. In this circumstance, affirmative application of Notice 2012-39 may have favorable sourcing and E&P effects as compared to an outright sale of the IP to FA for cash or entry into a qualified cost-sharing arrangement with a fixed price buy-in.

(b) Following § 367(d)(2)(C), § 4.06 of the Notice confirms that the prepaid royalties are sourced and characterized in the same manner as royalties. Thus, UST's income inclusion on a transfer of foreign IP rights would typically be foreign source, general basket income that creates additional FTC limitation. A simple fixed-price sale of the IP, by contrast, would generally give rise to U.S. source income under § 865(a).

(c) Likewise, treatment as a prepaid royalty would appear to be favorable vis-à-vis a fixed price sale of IP at the FA corporate level. Section 367(d)(2)(B) states that the FC's earnings and profits shall be reduced by the amount of income required to be included by UST under § 367(d)(2)(A)(II). While normal tax accounting principles generally defer the deductions of prepaid royalty expense, the statute arguably overrides these general principles by mandating a reduction to the transferee's E&P to the extent income is reallocated to the US transferor.[15] If the prepayment causes a larger amount of income to be re-allocated, FA should also secure an immediate E&P reduction for the same amount.

(d) In this context, a related question is whether the Notice 2012-39 prepayment amount would be treated as recognized built-in-gain (RBIG) for purposes of calculating UST's § 382 limitation on the use of its pre-change NOLs and other tax attributes. For example, assume that USP acquired UST with NOLs, but valuable intangible property and a net unrealized built-in gain (NUBIG) in its assets. If UST actually sold or exchanged its IP to FA for cash, the gain recognized on the sale would potentially increase UST's § 382 limitation under § 382(h). By contrast, if UST merged outbound in a cash D reorganization under Notice 2012-39, would the prepaid royalty included in the year of the reorganization be RBIG that allowed UST to absorb its NOLs on its final pre-migration return? Or, would the prepaid royalty simply be treated as post-ownership change income from licensing the intangibles?

3. Basis Recovery

(a) Section 4.02 of the Notice states that the prepayment is fully includible in the U.S. Transferor's gross income in the year of the transfer. One unresolved issue left open by the Notice, and in applying § 367(d) in general, is the US Transferor's method of basis recovery in the transferred IP. The IRS solicits comments on this issue.

(b) The difficulty arises from the hybrid nature of the § 367(d) event: While the statute treats the transferor as "having sold such property in exchange for payments which are contingent," the actual timing and character of income more closely resembles a licensing transaction than a contingent price sale. Further compounding the problem, certain provisions in the existing § 367(d) regulations suggest that the US Transferor's basis recovery is held in abeyance until certain subsequent dispositions occur.

(c) According to recent informal commentary by the IRS, the taxpayer should be permitted to recover its basis under § 367(d) through the general amortization provisions of § 167 or under a ratable basis over the IP's useful life. In Notice 2012-39 transactions, the Service should permit taxpayers to fully recover basis in the year of sale, proportionate to the prepayment ratio under § 4.02 of the Notice, or in full in transactions described in § 4.03 of the Notice. The Notice, by requiring the taxpayer to include the full FMV of the intangibles in income in the year of sale, regardless of productivity or use, effectively "closes" the contingent payment sale envisioned by the statute. Similarly, in cases where a taxpayer elects out of the installment method, the § 1001 regulations generally compute gain in the year of sale by allowing full basis recovery. The Notice, by essentially forcing the taxpayer to report the IP transfer as a closed transaction, should permit the taxpayer to claim full basis recovery, at least in the same proportion as the portion of the § 367(d) intangibles that are exchanged for money or other property.

4. Commensurate with Income Standard

(a) Section 4.02 requires the full prepayment to be included in income in the year of transfer regardless of the use or productivity of the IP. Could the taxpayer then claim a loss or deduction if subsequent events call for a negative adjustment to the purchase price?

(b) Section 367(d) requires that the royalties included in gross income be "commensurate with income" produced by the intangible. If the amount of income produced is less than the upfront inclusion, there should be some adjustment in the total royalties received by the taxpayer to account for the actual results. The IRS has generally opposed this argument in the context of fixed-price sales under § 482. See AM 2007-007 in which the IRS argued that the taxpayer is bound by its form of a fixed price sale, even though the IRS is permitted to make "commensurate-with-income" adjustments." However, in the transactions covered by Notice 2012-39 the taxpayer has not chosen the form of a taxable sale. Rather, the Notice re-characterizes the § 361 transfer as a taxable sale for a large upfront amount. This contrasts with the treatment mandated by the statute, which is an annual inclusion (which would be zero if the transferred intangibles did not produce income in a particular year). It would be a whipsaw, and a departure from the CWI standard, if the upfront amount could not be adjusted downward especially if due to a form not freely chosen by the taxpayer, but rather mandated by the IRS.

(c) AM 2007-007 also recognizes that genuine contingencies in parties' intercompany contracts should be respected.- In the context of Notice 2012-39, perhaps it would be possible for taxpayers to engage in self-help by providing for a contractual obligation on the part of UST (or its qualified successor) to repay the upfront cash payment to reflect the true commensurate with income royalties. Of course, this would involve heaping of tax fiction on top of tax fiction, but absent a faithful application of the CWI standard by the Service, this may be the taxpayer's best option to remain faithful to the CWI standard.

VI. NOTICE 2012-15

A. One area of longstanding difficulty in the U.S. international tax rules was the treatment of cross-border § 304 transactions and the interaction with §§ 367(a) and (b). Notice 2012-15 marks the third different set of IRS guidance on this issue, and appears to resolve the § 304 / § 367(a) issue once and for all. In addition, Notice 2012-15 confirms that the IRS intends to finalize regulations treating § 301(c)(3) gain with respect to a CFC's stock as causing §1248 to apply.

B. In a US shareholder's outbound transfer of CFC-T to CFC-A in exchange for cash, section 304(a)(1) creates the following fictional steps: (1) a § 351 transfer of CFC-T to CFC-A in exchange for newly issued CFC-A shares; and (2) a § 302, dividend-equivalent redemption

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of these newly issued CFC-A shares for the money or other property paid by CFC-A. The question that has plagued taxpayers and the Service is whether the initial step is subject to § 367(a), and if so, how the gain-recognition agreement ("***GRA***") rules apply to this transfer.

C. The history of IRS guidance on this issue is as follows:

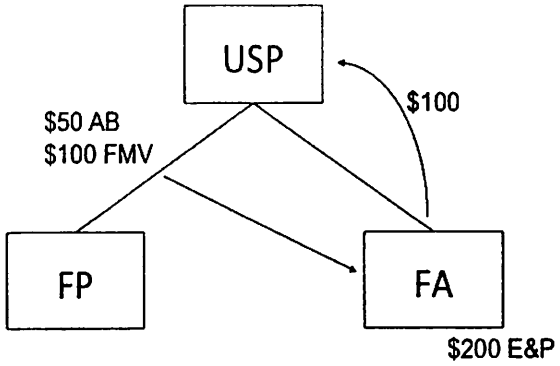
   1. Prior to 1997 ☐ Section 367(a) Applicable; GRA Filing Required to Avoid Gain
   2. 1997 through 2006☐ No definitive rules
   3. 2006 through 2009☐ Section 367(a) <u>Not</u> Applicable; No GRA Filing Required
   4. 2009 through Notice 2015-15☐ Section 367(a) Generally <u>Not</u> Applicable. However, If Taxpayer's Basis Recovery Method Under § 301(c)(2) Avoids Recognition of § 301(c)(3) Gain, Then Section 367(a) Is Applicable Without Possibility of Filing a GRA
   5. After Notice 2012-15 ☐ Section 367(a) Applicable; GRA Filing Required to Avoid Gain

D. Notice 2012-15 brings the administrative merry-go-round full circle with a return to the original IRS position. As a result of Notice 2012-15, unlike the previously prevailing rule under 2009 Temporary Regulations, Taxpayers generally can protect themselves from recognizing gain on the initial outbound transfer by filing a GRA. Notice 2012-15 no longer ties avoidance of gain under § 367(a) to the taxpayer's method of basis recovery under § 301(c)(2). In this respect Notice 2012-15 marks a welcome change from the previous regulations.

E. On the other hand, in cases where CFC-T is disposed of out of the group or taxpayers inadvertently fail to file a GRA or comply with the GRA requirements, Notice 2012-15 creates the potential for double taxation of the consideration received from CFC-T—once as a § 304 deemed dividend and again as a taxable § 367(a) outbound transfer. Also, if § 367(a) is triggered in the outbound transfer of CFC-T, Notice 2012-15's approach can give rise to a complex and uncertain set of interactions under §§ 959 and 1248.

F. Operation of New Rules

1. Example 1



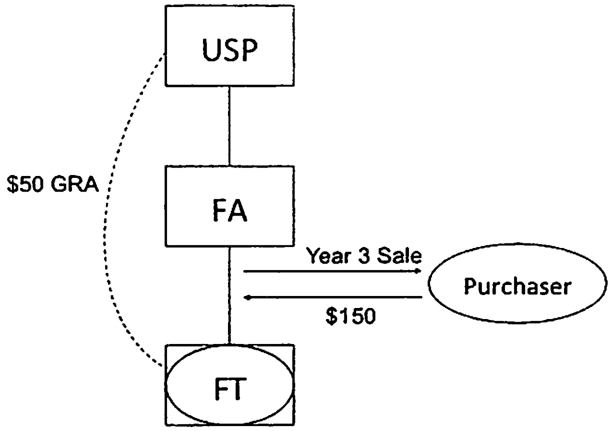
(a) US parent owns all of the stock of FT and FA. FT's stock has a tax basis of $50x and a fair market value of $100x. FA has accumulated E&P of $200. FA purchases FT for $100x.

(b) In this example, the Notice provides that USP's transfer of FT to FA is subject to § 367(a) and will be taxable unless USP files a GRA. Assuming the GRA is filed, it attaches to the $100 of new FA shares deemed issued under § 304(a)(1). Then, when those shares are redeemed in a dividend-equivalent redemption, the GRA is amended to attach to USP's remaining shares in FA.

(c) Thus, USP will need to monitor the GRA to ensure that it is not triggered by a disposition of FT's stock or substantially all of FT's assets. Assuming the GRA requirements are fulfilled, the Notice would have no adverse effects on USP here.

(d) While the Notice does not specifically provide any other examples, its principles can be applied to other fact patterns. First, consider the tax consequences if FA were to trigger the GRA.

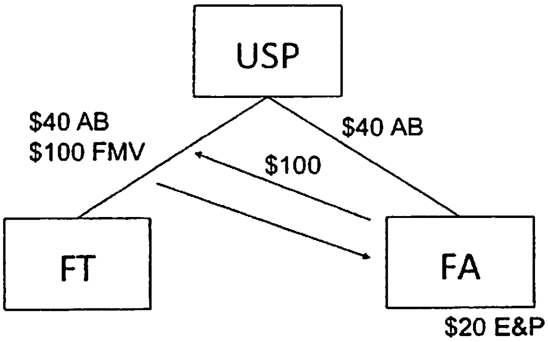
2. Example 2



(a) Same as #1 above, except that in year 3, FT's stock is sold for $150, triggering the $50 of gain covered by the GRA. Assume also that, on the date of the original § 304 transaction, FT had $30 of § 1248 E&P and related foreign tax credits of $10.

(b) Here, the triggering event would cause USP to recognize $50 of gain under the GRA. As illustrated by Reg. § 1.367(a)-8(q), Example 2, the § 1248 consequences of this § 367(a) depend upon whether the taxpayer elects to include the gain in the year of the original transfer or in the subsequent year. Under the default rule (i.e., amending the original return), USP would amend its year 1 return to report the outbound transfer as taxable and include $30 of this gain as a § 1248 deemed dividend. Under the election to include the results in the year of the triggering event, USP's § 1248 amount would be calculated based on FT's § 1248 E&P in Year 3.

3. Example 3



(a) USP owns all of the stock of FT with a basis of $40 and fair market value of $100, and all of the stock of FA with a basis of $40. FA has $20 of earnings and profits, and FT has zero earnings and profits. FT is sold to FA for its fair market value of $100.

(b) In the example, the § 304 deemed distribution ($100) exceeds FA and FT's combined E&P ($20). Therefore, under § 301(c)(2), $80 of the distribution is treated as a recovery of basis in FA shares. The issue is how will be basis be recovered, and which shares' basis will be available? At least in theory, there are 3 basis recovery approaches: (1) limiting basis recovery to the redeemed FA shares (which have a § 358 carryover basis from FT); (2) pro rata basis recovery from all of FA's shares of the class in which the redemption distribution was made; or (3) recovery of the aggregate basis first in all of FA's shares.

(c) In the above Example, the first approach (redeemed shares only) would result in a $40 gain under § 301(c)(3). Under the second approach, however, if the FA and FT shares were of equal value, then USP would recover $80 of stock basis under § 301(c)(2), and no gain would be recognized under § 301(c)(3) (i.e., all $100 of the distribution would be covered by E&P and stock basis). The built-in gain of $80 in FT's stock would be transferred outbound tax-free and, under § 367(a) / § 304 coordination rules, would fall outside the GRA regime.

(d) This issue was compounded in January 2009 when the IRS and Treasury issued Proposed Regulations that would, if finalized, have required the taxpayer to adopt the first approach to basis recovery in the deemed redemption resulting from a § 304 transaction. While these Proposed Subchapter C Regulations were only to be prospective, they effectively condoned the use of the first method.

(e) To prevent avoidance of tax under § 367(a) in a § 304 transaction that is covered by E&P and stock basis recovery, the 2009 Temporary Regulations required USP to recognize gain under § 367(a) to the extent that it recovered basis in FA's shares under § 301(c)(2). This gain was automatically imposed, and was not eligible for a GRA.

(f) Notice 2012-15 de-links the treatment of the outbound § 304 transaction from the shareholder's method of basis recovery under § 301(c)(2). The reason is that the GRA protects the Service from any permanent avoidance of U.S. tax with respect to the gain built into FT's stock. Indeed, as illustrated above, the GRA arguably "over-protects" the Service's interests. But, in any event, the new approach of Notice 2012-15 would allow the taxpayer to use any permissible method of basis recovery under § 301(c)(2). This is something the taxpayer should carefully consider in any § 304 transaction.

G. Guidance on § 1248 and § 301(c)(3)

1. The Notice also announces the IRS's intent to finalize § 1248 temporary regulations which provide that § 301(c)(3) gain is treated as a sale or exchange of stock for § 1248 purposes. In a case of a CFC Holding company which makes a distribution in excess of its E&P, this rule can helpfully permit § 301(c)(3) gain to be re-characterized as a deemed dividend from lower-tier

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CFCs' E&P that carries deemed-paid foreign tax credits. Finalization of this temporary regulation, therefore, is generally favorable for corporate taxpayers.

2. The lower-tier CFC's E&P deemed distributed under § 1248 is re-classified as PTI by virtue of § 959(e). The creation of PTI with proper planning could enable the same $100 to be repatriated again tax-free. While distributions of PTI are tax-free, however, § 961(b) requires negative basis adjustments with respect to the stock of the CFC making the PTI distribution. This is necessary to prevent the inclusion of PTI from conferring a double benefit in permitting a tax-free distribution and a loss (or offset to gain) on the sale of the stock. Further, § 961(b) requires immediate gain recognition to the extent that the negative basis adjustments under § 961(b) exceed the shareholder's basis in its CFC stock. Since the conversion of a lower-tier CFC's E&P from § 959(c)(3) live E&P to PTI does not in itself increase the HoldCo's basis in lower-tier CFC's stock, USP may experience a basis limitation in CFC HoldCo's shares in accessing the lower-tier CFC's newly created PTI.

3. Under the current regulations, the distribution of PTI by lower-tier CFC to CFC HoldCo would not appear to result in any basis adjustments, since a US person is neither including an amount in income under § 951(a), nor excluding the amount of a distribution from gross income under § 959(a). Similarly, under the 2006 Proposed § 959 Regulations, the movement of PTI up to CFC HoldCo generally would not change USP's basis in its CFC HoldCo stock.

4. Therefore, for USP to repatriate this § 959(e) PTI tax-free, it would generally have to contribute property to CFC HoldCo to increase its outside stock basis and cover the distribution. For example, USP could transfer stock of another subsidiary to CFC Holdco in a § 351 transfer, and then distribute the PTI received from the lower-tier CFC up to USP. Provided that USP had a sufficient stock basis to absorb the negative § 961(b) adjustments, the application of Notice 2012-15 would permit repatriation of $200 as an effective cost of a $100 § 1248 dividend paid out of the E&P of lower-tier CFC.

VII. NEW § 7874 REGULATIONS

A. New regulations under § 7874 raise even further the already high wall erected by Congress to prevent U.S. corporations from inverting.

B. General Operation of § 7874 and Regulatory History

1. Section 7874 can produce one of two results depending on the level of ownership of shareholders of the old U.S. parent in the new foreign parent. If the level of ownership (by vote or value) is at least 60 percent but less than 80 percent, then the U.S. corporation (now a subsidiary of the new foreign parent) and related U.S. corporations lose certain tax benefits. If the level of ownership (by vote or value) by former shareholders of old U.S. parent in the new foreign parent is at least 80 percent, then the new foreign parent is treated as a U.S. corporation for U.S. federal tax purposes. Both consequences can be nullified if the new foreign parent and affiliated corporations (the "expanded affiliated group") have "substantial business activities" in the foreign country in which the new parent is organized.

2. Temporary regulations issued in 2006 (which where superseded in 2009) provided that the determination of whether the expanded affiliated group has substantial business activities in the relevant foreign country is based on all the facts and circumstances. The 2006 temporary regulations also provided a safe harbor, which generally was satisfied if at least ten percent of the employees, assets, and sales of the expanded affiliated group were in the relevant foreign country.

3. Temporary regulations issued in 2009 (which were superseded by the most recent regulations) retained the facts and circumstances test, but removed the 10 percent safe harbor.

C. New Substantial Business Activities Test

1. New temporary regulations replace the facts and circumstances test with a bright line rule. Under the bright line rule an expanded affiliated group will have substantial business activities in the relevant foreign country only if at least **25 percent** of group employees, group assets, and group income are located or derived in the relevant foreign country. The 25 percent threshold is an effective ban on inversion transactions in all but the rarest of cases. It would be surprising if there were more than a handful (if that) of U.S. parent companies with 25%

of their employees, assets and sales located in a **single** foreign country. Therefore, Treasury has made what Congress intended to be difficult a near-impossibility.

2. The test for employees has two parts, each of which must be satisfied. The first test is calculated as the number of group employees based in the relevant foreign country divided by the total number of group employees. The second test is calculated as employee compensation with respect to group employees based in the relevant foreign country divided by the total employee compensation with respect to all group employees over a one-year testing period ending on the acquisition date (or the last day of the month preceding the acquisition date). Because both headcount and compensation must be measured, the regulations make inversions into a country with a relatively low wage scale or with lower skilled employees even more difficult.

3. The group asset test is calculated as the value of the group assets located in the relevant foreign country divided by the total value of all group assets as of the acquisition date (or the last day of the month preceding the acquisition date). The term group assets generally means tangible personal property or real property used or held for use in the active conduct of a trade or business by members of the expanded affiliated group. For this purpose, group assets include certain property rented by members of the expanded affiliated group and used in an active business, with the value of such rented property being deemed to be eight times the net annual rent paid or accrued with respect to such property. Intellectual property does not count for purposes of this test.

4. The income test is calculated as the group income derived in the relevant foreign country divided by the total group income determined during the one-year testing period ending on the acquisition date (or the last day of the month preceding the acquisition date). The term group income means gross income of members of the expanded affiliated group from transactions occurring in the ordinary course of business with customers that are not related persons. Group income is considered to be derived in a foreign country only if the customer is located in such country. Therefore, it is not sufficient that income be earned in the inverted country, but there must also be a very

substantial customer base in the inverted country. This requirement, in and of itself, effectively eliminates companies with robust worldwide sales networks from eligibility.

5. The 2009 temporary regulations provided a look-through rule for partnerships in which a member of an expanded affiliated group holds at least a 10 percent capital and profits interest. The new regulations increase the ownership threshold for look-through treatment to 50 percent. The rationale offered in the Preamble is that the IRS and Treasury believe that the policies of § 7874 are better advanced if the treatment of partnerships is made consistent with that of corporations for purposes of applying the substantial business activities test on a group basis.

6. The substantial business activities rules apply to acquisitions completed on or after June 12, 2012. A grandfather rule applies for transactions either described in an SEC filing or subject to a binding written agreement on this date.

D. Additional Rules

1. The 2009 temporary regulations provided that an option or similar interest is treated as stock of the corporation with a value equal to the holder's claim on the equity of the corporation less the exercise price of the option. The IRS did not agree with a comment that options should be ignored as they are under other Code sections. Instead, the final regulations retain the claim-on-equity treatment of options in applying the § 7874 value test. The IRS rejected a comment that if options are treated as having a claim on equity, then the the ownership percentages of actual shareholders should be correspondingly reduced, stating that the value of stock inherently reflects the existence of options that have a claim on equity. Options, however, are not counted in applying the § 7874 vote test unless a principal purpose of the issuance or acquisition of the option is to avoid treating the foreign corporation as a surrogate foreign corporation. Options are also not counted in any event if their probability of being exercised is remote.

2. The final regulations retain the rule in the 2009 temporary regulations that, with respect to a foreign corporation, the general option rule does not apply if a principal purpose of the issuance or acquisition of the option is to avoid the foreign corporation being treated as a surrogate foreign corporation.

The final regulations extend this anti-abuse rule to options in domestic corporations and partnerships.

3. The final regulations clarify that the rules addressing options also apply for purposes of determining the membership of an expanded affiliated group.

4. The final regulations retain the rule in the 2009 temporary regulations that creditors' claims against a domestic corporation is insolvent or in a title 11 or similar case are treated as stock. A similar rule continues to apply with respect to a domestic partnership, or a foreign partnership that owns stock of a domestic corporation.

5. The final regulations clarify that an acquisition by a corporation of its stock from another corporation or a partnership is an acquisition of the transferor's properties for purposes of § 7874(a)(2)(B)(i). This rule applies even though, for Federal tax purposes, the acquired stock no longer exists after the transaction. Thus, for example, if a domestic corporation that holds stock in a foreign corporation merges into the foreign corporation, the foreign corporation is, for purposes of § 7874(a)(2)(B)(i), treated as acquiring properties of the domestic corporation in the form of the foreign corporation's stock.

6. The Preamble to the final regulations asks for commments on current rules that treat the acquisition by a foreign corporation of two or more domestic entities as a single acquisition

7. The final regulations apply to acquisitions completed on or after June 7, 2012.

VIII. SECTION 482 AND OTHER TRANSFER PRICING ISSUES

A. "Soft Intangibles"

1. Treasury and the IRS plan to issue guidance under § 367(d) to clarify questions regarding goodwill, going concern value and workforce in place ("soft intangibles"). The IRS has stated that questions have been raised about soft intangibles in the context of Notice 2012-39. According to the IRS these intangibles have to be dealt with under § 367(a) or § 367(d).

2. Of course, the regulations exempt the transfer of foreign goodwill and going concern from § 367(d). Treas. Reg.

§ 1.367(d)-1T(b). However, the IRS has pushed hard for a narrow definition of these items, including an exclusion of workforce-in-place from going concern value, in contravention of its prior position.

B. Action on Decision in *Veritas*

1. The Service announced in an Action On Decision that it will not acquiesce in the result or reasoning in the Tax Court's opinion in Veritas Software Corp. v. Commissioner, 133 T.C. No. 14 (2009). The AOD states that the court's factual findings and legal assertions are erroneous.

2. The factual findings disputed by the AOD are that technological advances in the industry made existing products continually obsolete, that pre-existing technology had no ongoing R&D value, and that the Irish subsidiary was responsible for its marketing success largely independent of U.S. assistance. Similarly the court found that the marketing contributions that Veritas U.S. made to Veritas Ireland did not contribute value, but that Veritas Ireland's marketing success was attributable to its newly-hired sales manager, aggressive salesmanship, and savvy marketing. The AOD states that these facts would remove the underpinning of the Service's valuation.

3. The AOD states the Service also sees no legal basis for the court's inference that a "change in the law" is signified by the revenue estimate associated with the Administration's 2010 Budget proposal regarding the intangible status of workforce-in-place, goodwill, and going concern value.

4. The AOD states that the Service will continue to apply an aggregate valuation to interrelated transactions related to a cost sharing agreement where, under the facts and circumstances, such a valuation provides a most reliable measure of an arm's length result.

C. Buy-In payments

1. In ECC 201111013 the IRS addressed the following question: If one party (call it D for donor) gives a related party (call it R for recipient) something valuable, which R must further develop at its own expense before any exploitation (or at least before full exploitation is possible), how can one determine the compensation that R owes to D?

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2. In the IRS's view, this issue presents difficult problems, because "The [Treas. Reg. § 1.482]-4 regulations generally address a license of rights to exploit an intangible 'as is.'"

3. Instead the IRS stated that the residual profit split method in Treas. Reg. § 1.482-6 addresses the question "to some extent." The IRS reasoned that, "[u]nder that method, routine activities are given a return determined by comparables, and any residual profit is split according to each party's relative intangible contributions." However, according to the IRS, the approach of splitting capitalized costs "tends to be unreliable when one party's investment period entirely precedes another party's investment period."

4. Therefore, the IRS concluded, that none of the traditional specified methods tend to work well in the instant situation, and one needs to resort to unspecified methods. Further, according to the IRS, "one needs a new approach to valuation, relying less on comparables and more on fundamental financial principles." The IRS attached three economic papers for further consideration.

5. It concluded by stating that, "the IRS position is that the economic result should control: there is in general no legal loophole to avoid full economic compensation, and methods that deny full compensation should be rejected."

D. APA Report

1. The IRS released its most recent annual APA report on April 2, 2012. It reports on the APA program for 2011. The report shows a decrease of 38% in the number of completed APAs from the prior year. New APA applications filed during 2011 reflect a decrease of 33% from the prior year, and a decrease of 27% from the prior three- year average.

2. The APA program recently merged with the Office of the U.S. Competent Authority ("USCA") that resolves transfer pricing cases under the mutual agreement procedures of the U.S.'s bilateral income tax treaties. As successor to the APA program the new Advance Pricing and Mutual Agreement ("APMA") office prepared the new APA report. The report states that during the fall of 2011, the USCA hired additional managers and staff for the APMA office, representing a 50% increase in total headcount.

3. The report states that in part because of these transitional issues, during 2011, the APA office completed 43 APAs and 47 recommended negotiating positions, down from totals of 69 APAs and 58 recommended negotiating positions in 2010. The average time to complete an APA increased from 37 months in 2010 to 40.7 months in 2011.

4. The inventory of pending APA requests totals 445, with 258 of those requests consisting of requests for new APAs. The remainder consists of requests for APA renewals. The majority of the requests are for bilateral APAs, although 20% are for unilateral APAs.

IX. SUBPART F ISSUES

A. Factoring Income

1. In LTR 201131023 the Service ruled that income from the factoring of receivables is not subpart F income since the receivables themselves would not have produced subpart F income.

2. Taxpayer is a domestic corporation that has a Country B affiliate, Supplier. Supplier's business receipts are derived from the sales of Products and associated services.

3. Supplier's contracts provide for payment at contractually based "milestones." For example, a contract may require the customer to pay E% when the contract is signed; F% when Supplier has completed G Amount of the work; H% when Supplier has completed J Amount of the work; and the final K% when title passes to the customer. Upon reaching a milestone, Supplier sends an invoice to the customer, creating a Type L receivable, which is paid by the customer at a later date.

4. Supplier recognizes revenue on the accrual method for financial accounting, in accordance with GAAP. Supplier also uses accrual accounting for tax purposes, and has further elected to defer advance payments under Revenue Procedure 2004-34, 2004-1 C.B. 991. As a result, Supplier's revenue recognition for U.S. tax purposes is largely independent of its contractually based milestones or when its Type L receivables arise.

5. Whenever Supplier's Type L receivables arise before revenue is recognized for U.S. tax purposes, Supplier's Type L receivables will have zero basis for U.S. tax purposes.

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6. In order to accelerate the receipt of cash, Supplier often factors its receivables, including its Type L receivables. This factoring is generally done with a related party, as described below, and may result in an acceleration of income to Supplier.

7. Supplier owns Factor, which is treated as a disregarded entity for U.S. tax purposes. Factor factors Supplier's Type L receivables. Currently, this factoring program has no U.S. tax consequences because of Factor's U.S. tax status as a disregarded entity wholly owned by Supplier.

8. Taxpayer is considering transferring either the Factor business (by way of asset transfer or business migration) or the Factor stock into a separate ownership chain. Whichever form of transfer takes place, the Factor-Supplier factoring activity would cease to be disregarded for U.S. tax purposes as occurring entirely within one entity. Taxpayer nonetheless would like Supplier to continue the factoring program with Factor or its successor.

9. The contracts from which the Type L receivables arise would neither produce foreign base company sales income under § 954(d) nor foreign base company services income under § 954(e). The Type L receivables do not bear interest by their terms, and interest would not be imputed under sections 483 or 1274. The factoring transaction is properly treated for U.S. income tax purposes as a sale of the Type L receivables and not a borrowing.

10. The issue is whether the sale of the Type L receivables to Factor would give rise to foreign personal holding company income under § 954(c). Section 954(c)(1)(B)(iii) provides that FPHCI includes the excess of gains over losses from the sale or exchange of property that does not give rise to any income. "Sale or exchange" is not defined for purposes of section 954(c)(1)(B). Under Reg. §1.954-2(e)(3), the term "property that does not give rise to income" includes all rights and interests in property (whether or not a capital asset) including, for example, forwards, futures and options.

11. The Service framed the issue as whether the factoring of the receivables converts into foreign personal holding company income otherwise non-subpart F income earned by Supplier. It stated that it did not believe that such factoring converts Supplier's income into FPHCI.

12. Rather, according to the Service, any accelerated income received by Supplier as a result of factoring Type L receivables is a substitute for

the income it would have collected under the relevant contracts, and should retain the same (non-subpart F) character. See, e.g., Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 265, 78 S.Ct. 691, 694 (1958); and Prebola v. Commissioner, 482 F.3d 610, 611 (2d. Cir. 2007), citing Watkins v. Commissioner, 447 F.3d 1269, 1272 (10th Cir. 2006)(the "basic lesson" of the substitute-for-ordinary-income line of cases following P.G. Lake is that "when a party exchanges for a lump sum the right to receive in the future ordinary income already earned or obtained, the amount received serves as a substitute for the ordinary income the party had the right to receive over time" and the lump sum is ordinary income).

B. Section 956

1. In CCA 201106007 the IRS stated that the sale of software by a CFC to U.S. end-user customers does not cause the CFC to hold an investment in U.S. property for purposes of § 956(c)(1)(D). The CFC, pursuant to a cost sharing arrangement with its U.S. parent, held the right to exploit copyrights in the U.S. The U.S. parent developed the software product and transferred the final version, in the form of a "gold master" disc, to the CFC. The CFC reproduced and sold copies of the software to end-user customers in the U.S.

2. "U.S. property" for purposes of § 956(c)(1)(D) includes the right to use intangible property in the U.S. that is acquired and developed by a CFC for use in the U.S. The CCA interprets this provision as defining U.S. property in relation to whether a CFC develops intangible property intended for use in the U.S. or acquires a right to use intangible property in the U.S. It does not interpret this provision as defining U.S. property in relation to whether that right is actually exercised. Accordingly, an investment in U.S. property arises upon the actual acquisition or development of rights to use intangible property in the U.S., not upon the actual use of that intangible in the U.S.

3. The CCA states that the CFC is treated as making an investment in U.S. property under § 956 when it acquires or develops the rights to use copyright rights in the U.S. pursuant to the cost sharing agreement. However, the actual sales of the computer software copies from a CFC to end-user customers in the U.S. do not in themselves give rise to an investment in U.S. property within the meaning of § 956(c)(1)(D). Furthermore, the actual transfer of copies of the software by CFC to the end-user U.S. customers does not affect the calculation of the CFC § 956 inclusion amount,

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because the CFC does not acquire or develop additional rights (or relinquish any rights) to use the software in the U.S. as a result of the sale of copies to a U.S. person.

X. Foreign Currency Regulations

A. Treasury and the IRS issued temporary and proposed regulations designed to prevent "legging out" under Treas. Reg. § 1.988-5(a)(6)(ii) in a manner that would potentially enable taxpayers to recognize a loss on a hedged debt instrument without recognizing corresponding gain on the related hedges.

B. The rules apply to taxpayers that have identified multiple hedges as being part of a qualified hedging transaction. They also apply to situations in which part or any component of a hedge has been terminated (whether a hedge consists of a single or multiple components).

C. When the taxpayer "legs out" of integrated treatment by (1) disposing of all or part of the qualifying debt instrument or hedge prior to the maturity of the qualified hedging transaction, or (2) changing a material term of the qualifying debt instrument or hedge, the remaining part of the hedge that is still in existence, as well as the qualifying debt instrument, will be treated similarly.

XI. Debt v. Equity Cases

A. *PepsiCo*

1. *PepsiCo v. Commissioner*, T.C. Memo 2012-269 (2012), involved whether advance agreements ("AAs") issued by certain of PepsiCo's Netherlands subsidiaries to PepsiCo domestic entities should be treated as debt or equity for tax purposes. The court, agreeing with PepsiCo, held that the AAs should be treated as equity.

2. PepsiCo undertook a global restructuring of its international operations to allow for a more effective use of overseas earnings and to avoid using cash from the U.S. to fund its overseas expansion. In implementing its new international business model, PepsiCo reconfigured its existing foreign operations by moving certain holdings from the Netherlands Antilles to The Netherlands. Certain existing notes were transferred to a Dutch BV (PepsiCo Global Investments, "PGI") in exchange for the AAs.

3. The AAs were to be classified, partially, as debt in the Netherlands and treated as equity in the U.S. It was contemplated that the tax treatment of these instruments would preserve the foreign tax benefits previously achieved through a Netherlands Antilles financing structure. From a U.S. tax perspective, PepsiCo anticipated that payments to the U.S. pursuant to the AAs would be treated as distributions on equity. With PGI's E&P predicted to be drastically reduced or eliminated by certain flow-through entities' losses, it appeared unlikely that PepsiCo would be subject to Subpart F income or dividend treatment on the distributions.

4. A ruling was obtained from the Netherlands tax authorities that PGI's income for Netherlands tax purposes would be equal to an agreed spread between the interest income received and a "preferred return" deemed paid by PGI on the AAs. Payment of the preferred return was subject to satisfying certain cash flow requirements.

5. PepsiCo argued that the form of the AAs comported with their substance and that this should lead to the conclusion that the AAs were equity for U.S. tax purposes. The IRS, on the other hand, argued that the substance of the transactions, revealed primarily through PepsiCo's discussions with the Netherlands tax authorities during negotiations to secure the Dutch tax ruling, evidenced PepsiCo's intentions in structuring the AA's and that their intentions gave rise to a debtor-creditor relationship.

6. PGI paid out nearly all of the amounts it received on its notes from 1997 through 2009, amounts aggregating approximately $3 billion.

7. The court considered 13 factors germane to the debt/equity analysis: (1) the names or labels given to the instruments; (2) presence or absence of a fixed maturity date; (3) source of payments; (4) right to enforce payments; (5) participation in management as a result of the advances; (6) status of the advances in relation to regular corporate creditors; (7) intent of the parties; (8) identity of interest between creditor and stockholder; (9) "thinness" of capital structure in relation to debt; (10) ability of the corporation to obtain credit from outside sources; (11) use to which the advances were put; (12) failure of debtor to repay; and (13) risk involved in making advances.

8. *Fixed Maturity Date.* The court stated that the AA's had terms of 40 years which could be unilaterally extended by their holders for an additional 15 years. However, to the extent a related party defaulted on any note receivable held by PGI, those AA repayment terms were voided thus rendering the AAs perpetual. PepsiCo argued that the extended "maturity dates" of the AAs, viewed in isolation, effectively subjected the holder's investments to the business risks of the PGI business. The uncertainty of PGI's financial condition at a future "maturity date", PepsiCo argued, made speculative any repayment of principal, thereby exhibiting the capital nature of the investments.

9. The court stated that while a lengthy repayment period doesn't necessarily preclude debt treatment, there also were additional relevant facts present in PepsiCo's situation. Repayment of the loans was subject to the success of speculative new investments in unestablished foreign markets. Given both the magnitude of the loans and the financially precarious nature of the foreign investments, PGI could not be certain that its foreign affiliates would be able to fulfill all their payment obligations. The court felt that this favor weighed heavily in favor of finding that the AA's were capital investments. The "perpetual" clause engendered the real obligations between the parties. The AA's could not be viewed as having a fixed maturity date.

10. *Source of Payments.* The provisions of the AA's were meticulously structured to ensure that annual payments remained, effectively, discretionary. PGI was required to make preferred return payments only to the extent its "net cash flow" exceeded "accrued but unpaid operating expenses incurred" and "capital expenditures made or approved" by PGI during the applicable year. PepsiCo contended that this language tied the payments to PGI's speculative investments in new markets. PGI also could indefinitely defer "mandatory" payments merely by approving capital expenditures.

11. The IRS argued that PepsiCo's negotiations with the Dutch tax authorities were relevant in this regard. The court agreed, stating that an objective interpretation of PepsiCo's extended dialogue with the Dutch tax authorities in seeking its ruling, supplemental by communications between PepsiCo's employees and Dutch counsel, leads to the conclusion that PepsiCo internally

committed itself to a distinct course of conduct. At least for the period the Dutch ruling remained valid, PepsiCo assured the Dutch tax authorities that each payment of interest received by PGI on its notes would, in turn, be used to fund payments of that amount to the holders of the AA's. PepsiCo also did not dispute that PGI paid nearly all of the amounts received under the notes to the holders of the AA's.

12. The court concluded that this factor (source of payments) evidenced a debt characteristic of the AA's. Nonetheless, the court also noted that the significance of this factor was tempered to an extent given the long terms of the AA's and the limited time the Dutch ruling would remain effective.

13. *Right to Enforce Payments.* The IRS conceded that there was no mechanism which provided the holders of the AAs with the right to demand immediate payment of all outstanding principal and interest in the event PGI defaulted on payment of the base preferred return. The IRS argued that, nonetheless, PepsiCo controlled all of the entities involved and would be economically disadvantaged if PGI were to default under the AA's. Thus, the IRS argued, there was no real possibility that PGI would default.

14. The court found the Service's argument untenable. Suggesting that the success of PepsiCo's numerous speculative investments in foreign subsidiaries was absolute and that PepsiCo could therefore ensure the timely payment on the intercompany obligations, based solely on the subsidiaries' inter-relatedness, had no basis in fact or law. PepsiCo's finance expert testified that PGI held notes evincing substantial outstanding indebtedness of its affiliates during the years in issue. Many of these affiliates were funded to help foster the development of the PepsiCo brand in then-uncultivated foreign markets, in effect subjecting repayment of PGI's advances to the business risks of these entities. Upon default of any of these intercompany receivables, the payment terms of the AAs became void.

15. The court stated that the Service also failed to appreciate that any payment on the AAs remained subject to the "net cash flow" restrictions and, more importantly, would remain subordinate to all indebtedness of PGI and the rights of all creditors. The subordination was both meaningful and

significant in light of PGI's $1 billion in outstanding indebtedness to affiliates during the years at issue. PGI also was exposed to liabilities of several of its subsidiaries for two of the years in issue in amounts exceeding $150 million.

16. The court believed that the absence of any legitimate creditor or safeguards afforded to the holders of the AA's was a significant factor evidencing the equity nature of the investments.

17. *Intent of Parties*. The court stated that PepsiCo engaged in legitimate tax planning and designed the AAs with an expectation that they would be characterized as equity for U.S. federal income tax purposes and as debt under Dutch tax law. PepsiCo's actions with respect to seeking a Dutch ruling during the taxable years at issue did not subvert or vitiate the company's clear intentions to create a legitimate hybrid instrument. The court stated that transactions are often purposefully structured to produce favorable tax consequences, and this planning, alone, does not compel a disallowance of the transaction's tax effects.

18. *Debt/Equity Ratio*. PepsiCo's finance expert testified that if the AA's were treated debt for U.S. tax purposes, PGI's debt-equity ratio would have been 14.1 to 1 in 1996 and 26.2 to 1 in 1997. The Service did not contest this portion of the expert's analysis. Given PGI's untenable debt-to-equity ratio according to industry standards, the court concluded that this factor supported the AA's equity characterization.

19. *Ability to Obtain Credit from Third Parties*. PepsiCo's finance expert testified that no third-party lending institution or lender in the capital markets would have loaned funds to PGI in the amounts of the AA's under any reasonably similar financial terms. The Service, misconstruing relevant legal precedent, initially submitted that a certain third-party credit facility evidenced that outside lenders in fact were willing to advance funds to PGI. However, the focus of the law is not simply on the ability of a corporation to obtain the funds from outside sources. Rather, the focus is whether an outside lender would have lent the funds on the same or similar terms.

20. The court stated that the Service did not substantively address whether an independent creditor would have advanced funds to PGI on the "same or similar" terms as the AA's. Rather, the

Service sought summarily to dismiss the expert's conclusions as irrelevant. Thus, the court felt that PepsiCo's expert's opinion remained unrebutted.

B. *Hewlett-Packard*

1. *Hewlett-Packard Co. v. Commissioner*, T.C. Memo. 2012-135, addressed a complex structure in which Hewlett-Packard owned a partial interest in a foreign entity ("X"). Distributions would bring with them deemed paid foreign tax credits. HP's interest was in the form of preferred stock. The common stock was owned by ABN, a Dutch bank. Warrants and put and call and other agreements also were involved.

2. HP received 97% of the amounts available for distribution each year and claimed foreign tax credits for withholding taxes and indirect foreign tax credits under § 902. After seven years, HP exited the structure through the exercise of certain warrants. HP incurred a loss on exit and claimed a deduction for that loss.

3. The parties submitted three issues to the court: (1) whether HP's investment in X is more appropriately characterized as debt, rather than equity; (2) whether HP's investment in X was a sham under the economic substance doctrine; and (3) whether X should be treated as a conduit under the step-transaction doctrine and the transaction recharacterized as a direct loan from HP to ABN.

4. The court held that HP's investment is more appropriately characterized as debt for U.S. federal income tax purposes. Thus, HP would not be able to claim deemed paid foreign tax credits with respect to distributions on the instrument. The court stated that this rendered the other issues moot, and did not address them.

5. The court stated that the case rests on the substance of HP's investment in X. The court stated that the IRS made several arguments, each with the goal of disallowing HP's foreign tax credits arising from the transaction as well as the capital loss from the disposition of its investment.

6. The court cited a number of debt-equity cases and stated that classification of an interest as debt or equity "must be considered in the context of the overall transaction." Generally, stated the court, the focus of the debt-vs.-equity inquiry narrows

to whether there was an intent to create a debt with a reasonable expectation of repayment and if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship.

7. The court used the Ninth Circuit's debt/equity factors: (1) the labels on the documents evidencing the alleged indebtedness; (2) the presence or absence of a maturity date; (3) the source of payments; (4) the right of the alleged lender to enforce payment; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) the adequacy of the (supposed) borrower's capitalization; (9) whether stockholders' advances to the corporation are in the same proportion as their equity ownership in the corporation; (10) the payments of interest out of "dividend money"; and (11) the borrower's ability to obtain loans from outside lenders.

8. As a preliminary matter, HP contended that its put right agreement should not be integrated with the terms of its preference shares for purposes of characterizing the interest as equity or debt because the right was not enforceable against the issuer of the preference shares, but rather against a shareholder (ABN). Here, however, the court stated that the put agreement was one of many transactional documents signed as a package at the transaction's closing and it is referenced in the shareholder's agreement. Accordingly, the court stated that it would construe the put option, as well as other agreements expressly listed in the shareholder's agreement, as integrated pieces of the overall transaction.

9. The court addressed each of the Ninth Circuit debt/equity factors. We address the most material ones below.

10. *Fixed Maturity Date*. The court stated that HP never offered any legitimate financial or business reason for remaining in the transaction after the seventh-year put date. The court concluded that there was never any serious consideration by HP of extending its interest to a later time. Rather from the time HP purchased its interest in X, it was apparent that the investment would be limited by a seven-year term. Thus, the court agreed with the IRS that the initial put date in effect functioned as a maturity date.

11. *Participation in Management.* The court stated that HP's shares collectively represented approximately 20% of the entity's voting power, allowing HP to designate 1 of 4 board members. While these basic rights weigh in factor of equity treatment, the court stated that HP did not view these rights as important. No evidence was submitted that HP's representatives ever attended any board meetings. It also did not formally object to ABN's impermissible investments. HP did not replace another entity (AIG) as a managing director until a couple of years after the transaction started, and a shareholder resolution effecting the substitution was not filed for two years after that. Thus, although HP was afforded basic voting rights in the entity, the court concluded that it did not value those rights.

11. *Intent of the parties.* The court concluded that regardless of the labels placed on HP's interest in the entity, all relevant parties were aware from the inception of the transaction that in substance it was a limited term investment of HP's funds at a specified rate of return to be repaid in full after seven years.

C. <u>NA General Partnership</u>

1. NA General Partnership v. Commissioner, T.C. Memo 2012-172 (1972), involves ScottishPower Plc, a U.K. publicly held multi-utility company that owned 100% of NA General Partnership ("NAGP"), a Nevada general partnership that elected to be treated as a corporation for U.S. tax purposes. Scottish Power made a loan to NAGP in connection with NAGP's acquisition of PacifiCorp ("Target"). The issue was whether the loan constituted debt or equity. The court held for debt.

2. ScottishPower and Target a merger under which Target became a direct subsidiary of NAGP and an indirect subsidiary of ScottishPower. Target's shareholders received shares in ScottishPower in the transaction. NAGP also issued notes to ScottishPower equal to 75% of the share value given to the public shareholders of Target. It did so in exchange for ScottishPower's transferring ScottishPower shares to Target shareholders in the acquisition. The loan notes consisted of $4 billion of fixed-rate loans and nearly $1 billion of floating-rate notes. Shortly after closing, Target sold a large Australian subsidiary for approximately $700 million.

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3. Under the loan notes, interest was payable quarterly in arrears. The loan notes were unsecured and ranked equally and ratably with other debt obligations of NAGP. ScottishPower, as the noteholder, could require NAGP to repay all or a portion of the loan notes at any time with proper notice. NAGP had the right to redeem the loan notes without penalty at an agreed "market rate." ScottishPower could require repayment of all of the loan notes at a market rate if any principal or interest was not paid within thirty days of the due date. The loan notes were transferable.

4. ScottishPower and NAGP both reflected the loan notes as debt on their books. They also represented to the U.S. SEC that the loan notes were debt.

5. NAGP borrowed $200 million on a short-term basis from ScottishPower to fund the first two interest payments. NAGP also entered into a $360 million credit facility with Royal Bank of Scotland. The RBS credit facility matured after just a few months. ScottishPower's right to repayment of the loan notes was subordinated to the amount that NAGP owed to RBS.

6. NAGP borrowed under the RBS credit facility to repay the short-term loan from ScottishPower and to fund certain additional interest payments to ScottishPower. NAGP repaid the RBS loans with proceeds from Target's sale of its Australian business.

7. The court looked to the same Ninth Circuit factors discussed above in the context of *Hewlett-Packard*. The most material factors are discussed below

8. *Source of Payments*. The taxpayer's expert testified that Target had reasonably anticipated cash flows at the time of the acquisition sufficient for NAGP to timely service and retire the intercompany debt as it became due. He also concluded that NAGP likely could have refinanced the intercompany debt if NAGP had been unable to fully repay it when due. The Service's expert contended that NAGP would have a substantial cash shortfall when the fixed rate notes matured. His analysis, however, excluded consideration of expected proceeds from the sale of Target's Australian operations. He acknowledged that

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the parties contemplated that sale at the time of the acquisition. This factor favored the taxpayer.

9. *Participation in Management.* The "participation in management" factor was neutral. ScottishPower was effectively NAGP's sole owner when it advanced the funds to NAGP. The loan did not increase, nor could it have decreased, ScottishPower's right to participate in management.

10. *Status equal to or inferior to that of regular corporate creditors.* The loan notes did not subordinate ScottishPower's right to the repayment of other creditors. The Service argued that the advance resembled equity more than debt because the loan notes did not restrict NAGP from taking on more senior debt, and NAGP did in fact subordinate ScottishPower's right to repayment when obtained the RBS credit facility. The court stated that it has recognized that certain creditor protections are not as important in a related-party context. In one case, for example, the court had previously found that a parent's 100% ownership interest in its subsidiary adequately substituted for a security interest, or at least minimized its importance.

11. The court believed that subordination of ScottishPower's right to repayment to RBS was not significant under the circumstances. NAGP obtained the RBS credit facility to pay interest to ScottishPower on the loan notes. Moreover, NAGP reasonably expected Target to pay a dividend sufficient to repay the RBS credit facility on or before its maturity, which was within the same tax year that NAGP entered into the facility. The dividend was expected due to Target's sale of its Australian operations.

12. *Intent of the Parties.* The court stated that this factor favored debt. The Service argued that ScottishPower capitalized NAGP with the intercompany debt primarily to obtain interest expense deductions. The IRS posited that NAGP had tax avoidance motives indicating that the advances were really an equity investment. However, the court stated that tax considerations permeate any decision whether to capitalize a business enterprise with debt or equity.

13. The facts in the record showed NAGP took seriously its obligation to pay interest. It made regular payments by or near the interest payment dates, with the exception of the first two

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interest payments. The fact that NAGP borrowed $200 million from ScottishPower to make early interest payments was acceptable. The court stated that it had previously held that an advance from a parent corporation to its subsidiary may be characterized as debt even though the parent makes subsequent re-advances to cover interest on the initial advance.

14. *Debt/Equity Ratio.* The court also found NAGP was adequately capitalized, the eighth factor. This, too, favored debt characterization. The court stated capital adequacy must not be viewed in a vacuum. The debt-to-equity ratio that is adequate in one industry may be inadequate in another. For example, companies with high levels of business risk, such as those in highly uncertain environments or in cyclical or volatile industries generally cannot bear the risk of significant leverage. The opposite is true generally for companies with low business risks, such as utilities.

15. The Service argued that NAGP's debt would likely have been rated below investment grade by an independent rating agency such as Standard & Poors. The taxpayer's expert determined that NAGP would be assigned a rating of BB+. The Service's expert argued that NAGP would receive a lower rating of B. The court felt that the taxpayer's expert witness was more credible in this regard. It stated that the Service's expert's assigned rating was flawed because it failed to take into account NAGP's business risk. However, even if NAGP had actually been assigned a B credit rating, stated the court, a B rating does indicate imminent distress or bankruptcy. Thus, even a B rating would not establish that NAGP was so thinly capitalized that it would have been unable to repay the intercompany debt.

16. *Ability to Obtain Comparable Financing.* Both experts analyzed whether NAGP could have obtained comparable financing with respect to the advances. The Service's expert concluded that NAGP could not have obtained comparable financing. The question he sought to answer, however, was whether NAGP could have obtained financing from third party creditors on the same terms and at the same price. The requirement of precise matching misses the point, stated the court.

17. The taxpayer's expert, on the other hand, concluded that fixed-rate notes could have been purchased by third-party fixed-

income investors on substantially similar terms as the $4 billion fixed rate notes. He determined that the interest rate in the market would have been slightly higher, but the debt could have been sold in the debt capital markets to third-party investors.

18. The record contained no facts to persuade the court that NAGP could have obtained financing from an unrelated party comparable to the terms of the $1 billion floating-rate notes. The taxpayer's expert, however, testified that including the floating rate notes would not change his conclusions regarding the fixed-rate notes. He stated that, if the floating-rate notes would have resulted in a rating downgrade for all of the loan notes such that they would have been below investment grade, then he would have recommended dividing the debt offering into senior and subordinated tranches. Accordingly, the court concluded that this factor favored characterizing the fixed-rate notes as debt and was neutral regarding characterization of the floating-rate notes.

XII. Final Regulations on OFLs and ODLs

A. The IRS published final regulations on OFLs and ODLs earlier this year. They are substantially similar as proposed and temporary regulations in 2007 with notable changes discussed below.

B. The final regulations address an issue regarding dispositions in which gain is recognized irrespective of □§ 904(f)(3) and the recognized gain is otherwise treated as U.S. source income. Treasury and the IRS believe that the language of § 904(f)(3)(A) is clear that gain on such dispositions is characterized as foreign source income only to the extent of the applicable § 904(f)(3) recapture account. Consistent with the statutory language, the regulations clarify that this limit applies. The amount of gain recharacterized as foreign source is equal to the lesser of the total recognized gain or the balance in the OFL account remaining after any other OFL recapture pursuant to § 904(f)(1) has been made.

C. Adjustments for Capital Gains and Losses and Qualifying Dividend Income

1. The 2007 temporary regulations provide rules coordinating the application of § 904(b), which addresses the effect of capital gains and losses on the foreign tax credit limitation, and □§ 904(g), which addresses ODLs and the recapture of those losses. Temp. Treas. Reg.□§ 1.904(g)-1T(c)(2), which defines the term

domestic loss, provides that if a taxpayer has any capital gains or losses, the amount of the domestic loss is determined by taking into account adjustments under § 904(b)(2) and Treas. Reg. § 1.904(b)-1. If the taxpayer has capital gains or losses, Temp. Treas. Reg. § 1.904(g)-1T(d)(3) provided that the amount by which an ODL reduces foreign source income in a taxable year is determined in accordance with Treas. Reg. §§ 1.904(b)-1(h)(1)(i) and (h)(1)(iii).

2. The 2007 temporary regulations followed the approach of the coordination rules in Treas. Reg. § 1.904(b)-1(h), which generally provide that adjustments under § 904(b) to capital gains and losses and qualified dividend income (§ 904(b) adjustments) are taken into account first before applying the OFL provisions of § 904(f). The final regulations retain that basic approach. However, they revised several provisions of the 2007 temporary regulations and added new provisions to implement the mechanics of the coordination rule.

3. First, Treas. Reg. §§ 1.904(g)-1(c)(2) and (d)(3) were revised with respect to the calculation of an ODL. The revisions reflect the fact that the regulations under § 904(b) do not provide specific adjustments to determine U.S. source loss on a standalone basis, but rather define the amount of U.S. source loss that offsets foreign source income under § 904(f)(5)(D) as adjusted foreign taxable income, less adjusted worldwide taxable income. The calculation of the ODL is therefore expressly coordinated with the calculation of the § 904(f)(5)(D) amount as determined under Treas. Reg. § 1.904(b)-1(h)(1)(iii).

4. Second, Treas. Reg. § 1.904(g)-2(b) was revised to clarify that § 904(b) adjustments must be made for capital gains and losses and qualified dividend income before determining how much U.S. source taxable income is available to recapture an ODL account. Because the regulations under § 904(b) do not provide specific adjustments to determine U.S. source taxable income on a standalone basis, Treas. Reg. § 1.904(g)-2(b) provides that U.S. source taxable income available to recapture an ODL account is determined following the principles of Treas. Reg. § 1.904(b)-1(h)(1)(i) which provides rules on making the § 904(b) adjustments in determining foreign source taxable income.

5. Third, a new step was added to the ordering rules in Treas. Reg. § 1.904(g)-3 to provide that any § 904(b) adjustments for capital

gains and losses and qualified dividend income are made after determining the amount of net operating loss carryover, if any, in step 1, but before allocating losses or recapturing loss accounts in steps 3-7.

6. Finally, the regulations were revised to clarify that coordination with the § 904(b) provisions requires adjustments not only the capital gains and losses but the qualified dividend income as well.

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Navigating the Tax Terrain of the Great White North:

What Every U.S. Tax Practitioner Should Know About Canadian Federal Income Tax

Michael Friedman, Partner

Presented at:

15th Annual International Tax Symposium – State Bar of Texas

Houston, Texas – November 1, 2012

Plano, Texas – November 2, 2012

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Canada: Familiar,...yet Unique

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Agenda

- Canada: An Overview
- The Canadian Tax Net: How Far Does It Extend?
- Structuring Canadian Business Operations
  - *What are your options?*
  - *How do you efficiently repatriate income and capital?*
  - *What are your registration/filing obligations?*
- Canadian Transfer Pricing Rules
- Canadian Thin Capitalization Limitations
- Questions

Canada: An Overview

Government in Canada

- Parliamentary democracy
- Three principal levels – federal *(45%)*, provincial/territorial *(43%)*, and municipal *(13%)*
- Each level of government possesses different taxing authority

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Canada: An Overview

Types of Canadian taxation

- Income taxation *(52.5%)*
- Tax on capital *(0.5%)*
- Sales and commodity taxation *(23%)*
  - Goods and Services Tax/Harmonized Sales Tax, Provincial Retail Sales Taxes, Excise Taxes
- "Social Security" taxes *(7.5%)*
  - Canada Pension Plan, Quebec Pension Plan, Employment Insurance
- Specialized taxes
  - Land Transfer Taxes
  - Employer Health Tax (Ontario)

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Canada: An Overview

Recent Canadian Tax Trends

- Reduction of corporate tax rates
- Increase in provincial personal income tax rates
- Revenue authorities increasingly aggressive in audit and enforcement
- Greater emphasis on taxation of non-residents, multi-national groups, and cross-border transactions

Basic Canadian Tax Framework

- Statutes (e.g., *Income Tax Act*) – primary source of Canadian tax law
- Wide body of case law
- Detailed pool of revenue authority interpretive statements and rulings

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Canada: An Overview

Basic Canadian Tax Principles

- Canadian tax law is principally form-driven
- Residence-based system of income taxation
    - Canadian residents generally subject to tax on their worldwide incomes
    - Non-residents generally only subject to income tax:
        - (i) where there is a sufficient connection to Canada, or
        - (ii) in respect of certain passive receipts
    - Special deeming rules give rise to Canadian taxation in respect of:
        - (i) controlled foreign affiliates of Canadian residents, and
        - (ii) certain non-resident trusts and non-resident investment entities

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The Canadian Tax Net: How Far Does It Extend?

Basic Principles

I. A Canadian resident is generally subject to tax on its worldwide income

- Common law tests of residency
- Statutory deemed residency rules
- Treaty tie-breakers

II. A non-resident is generally only subject to Canadian income tax if:

- Employed in Canada
- Carrying on business in Canada
- Disposed of “taxable Canadian property”

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The Canadian Tax Net: How Far Does It Extend?

Carrying on Business in Canada

- Low threshold – captures most types of substantive commercial activity
- Statutory deeming rules
  - Solicits orders or offers anything for sale in Canada through an agent or servant
- Absent treaty relief, income attributable to Canadian business taxable in Canada

"Taxable Canadian Property"

- Comprised of property with a close connection to Canada, including
  - Property used in a business carried on in Canada
  - Canadian real property
  - "Canadian resource property"

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The Canadian Tax Net: How Far Does It Extend?

"Taxable Canadian Property" (cont.)

o Shares of private corporations that, at any time over the past five years, derived more than 50% of their fair market value, directly or indirectly, from Canadian real property, "Canadian resource property" and/or options in respect thereof

- Gains on the disposition of "taxable Canadian property" are generally subject to Canadian taxation
- The statutory definition of "taxable Canadian property" has been narrowed in recent years
- Special withholding, remittance, and reporting obligations are triggered on the sale of certain types of "taxable Canadian property" by a non-resident (*the "Section 116 withholding regime"*)

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The Canadian Tax Net: How Far Does It Extend?

Tax Treaty Relief

- Canada has entered into 90 bilateral income tax treaties
- Most of Canada's tax treaties are based on the OECD Model Treaty
- Canadian tax treaties generally restrict the taxation of non-resident corporations to:
  - Income from businesses carried on in Canada through a "permanent establishment"
  - Gains derived from the sale of "taxable Canadian property" that are not excluded from Canadian taxation under the applicable treaty

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The Canadian Tax Net: How Far Does It Extend?

Canadian Tax Registration/Filing Obligations

- Obligation to file a Canadian federal income tax return is triggered whenever a non-resident corporation carries on business in Canada – even if no tax is owing by virtue of a treaty
- Penalty imposed on non-residents that fail to file a required Canadian tax return
- Filing of a Canadian corporate tax return will give rise to registration for a Business Number

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Structuring Canadian Business Operations

What Are The Options?

- Sole proprietorship
- Canadian corporation
- Branch of a non-resident corporation
- Partnership/Joint Venture
- Trust

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Structuring Canadian Business Operations

Canadian Corporations

- Corporations are separate taxpayers for Canadian tax purposes
- May be formed under federal law (CBCA) or various provincial/territorial statutes
- Many Canadian statutes have minimum Canadian-resident director requirements, although certain exceptions (NB, BC, Yukon)
- Certain provincial statutes allow for the formation of “unlimited liability companies” (NS, BC, Alta)
  - May “check-the-box” and treat a ULC as a disregarded entity for US tax purposes
  - However, 5th Protocol to the Canada-US Treaty has introduced certain traps when using ULCs in cross-border structures

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Structuring Canadian Business Operations

Repatriation of Capital and Profits

- Return of capital
- Repayment of the principal amount of indebtedness
- Interest
- Dividends
- Royalties

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Structuring Canadian Business Operations

Withholding Tax Considerations

- Statutory rate of Canadian non-resident withholding tax is 25%, subject to reduction under an applicable treaty
- Some cross-border payments may be made free of withholding tax

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Structuring Canadian Business Operations

I. Return of Capital

- Private Canadian corporations are generally entitled to return the "paid-up capital" in respect of shares free of Canadian withholding tax
- **"Paid-up Capital"** is a tax concept defined in the *Income Tax Act*
  - Computation of "paid-up capital" ("**PUC**") starts with the stated capital of the relevant shares for corporate law purposes and is modified to account for certain statutory adjustments
    - Note that PUC does not automatically capture contributed surplus
  - PUC is an attribute of a share and is distinct from the adjusted cost base ("**ACB**") of a share (i.e., it is possible to have shares with a high ACB and low PUC)

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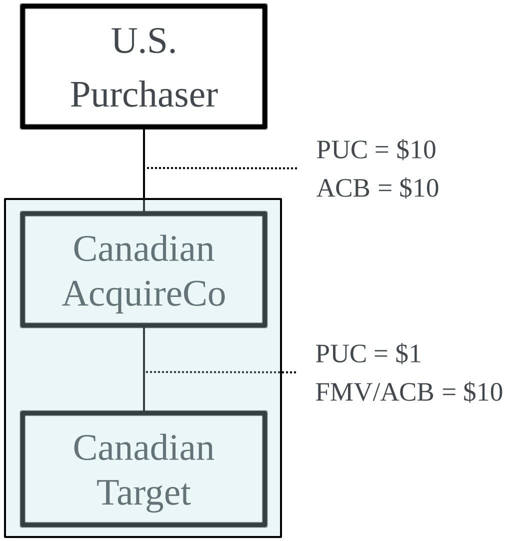
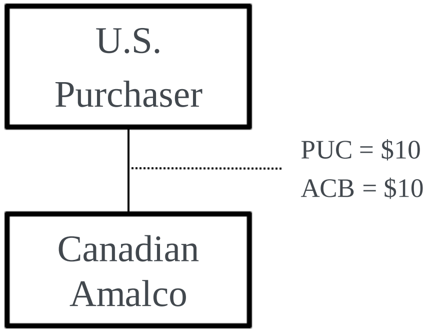
Structuring Canadian Business Operations

I. Return of Capital (cont.)

- In the context of cross-border share acquisitions, the importance of PUC explains why a Canadian AcquireCo is often formed to acquire the shares of a Canadian target corporation





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Structuring Canadian Business Operations

II. Indebtedness

- The principal amount of cross-border indebtedness may be repaid without withholding tax
- Conventional interest payments by a Canadian borrower to a non-resident lender with whom the borrower deals at "arm's length" may also be made free of withholding tax
    - Under the Canada-US treaty, conventional interest payments between non-arm's length parties that are entitled to the benefits of the treaty may further be made free of withholding tax
- Statutory withholding tax exemption does not apply in respect of "participating debt interest"

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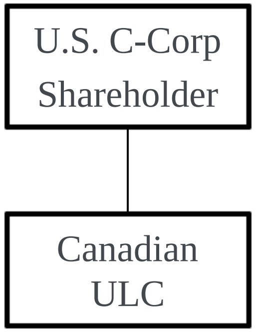
Structuring Canadian Business Operations

III. Dividends

- Subject to withholding tax – at rates that may be reduced to as low as 5% under an applicable treaty
- Note inability to claim treaty-reduced rates of withholding tax in respect of dividends paid by a disregarded ULC
- Two-step "work-around" has been accepted by the CRA whereby (i) the PUC of the ULC is increased (giving rise to a deemed dividend subject to the treaty-reduced rate of withholding tax), followed by (ii) a return of PUC (that is not subject to withholding tax)


U.S. C-Corp Shareholder

Canadian ULC

Step 1: PUC = $1

Step 2: PUC increased to $5, giving rise to a deemed dividend of $4

Step 3: $5 of PUC is returned to the US shareholder

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Structuring Canadian Business Operations

IV. Royalties

- Intellectual/intangible property rights are often licensed to a Canadian operating company as a means of creating a repatriation stream
- Under select treaties, certain cross-border royalties may be paid free of Canadian withholding tax:
  - Payments for the use of, or the right to use,

    (i) computer software, or

    (ii) any patent or any information concerning industrial, commercial, or scientific experience (generally subject to a franchising exception)

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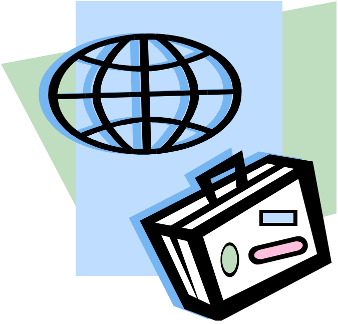
Structuring Canadian Business Operations

Branch Operations

- Non-resident corporation carries on business in Canada and becomes a Canadian taxpayer
- Requirement to allocate income between home jurisdiction and Canada for tax purposes
    - Canada-US treaty generally limits the Canadian taxation of business profits to those attributable to a business carried on through a "permanent establishment" in Canada



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Structuring Canadian Business Operations

Branch Operations (cont.)

- Important to remain mindful of Canadian "branch profits" tax
  - Intended to serve as a proxy for dividend withholding tax, yet certain key distinctions
  - 25% "branch profits" tax generally applies to an amount effectively equal to after-tax profits *minus* an "investment allowance"
  - When a treaty applies, rate of branch profits tax reduced to the rate that applies to dividends paid to a wholly-owned parent corporation that is entitled to claim the benefits of the treaty
  - Certain treaties, including the Canada-US treaty, provide an exemption from "branch profits" tax in respect of the first CDN$500,000 of profits

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Canadian Transfer Pricing Rules

Overview

- Canada has enacted a relatively wide-spanning set of transfer pricing provisions that apply to the cross-border sale of property and services
- Generally, the Canadian transfer pricing rules impute arm’s length prices to transactions entered into between Canadian-resident taxpayers and non-residents with whom they do not deal at “arm’s length”

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Canadian Transfer Pricing Rules

The Basics

- The transfer pricing rules apply where (i) a Canadian taxpayer and a non-resident person with whom the taxpayer does not deal at arm’s length are (ii) participants in a transaction/series of transactions and

(iii) the terms or conditions made or imposed between any of the participants to the transaction or series differ from those that would have been made between persons dealing at arm’s length, or

(iv) the transaction or series

(A) would not have been entered into between persons dealing at arm’s length, and

(B) can reasonably be considered not to have been entered into primarily for *bona fide* purposes other than to obtain a tax benefit

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Canadian Transfer Pricing Rules

The Basics (cont.)

- Until recently, relatively little Canadian transfer pricing jurisprudence; however, cases are now making their way through the Canadian courts
  - *The Queen v. GlaxoSmithKline Inc.*
    - First transfer pricing case to be considered by the Supreme Court of Canada
    - Case focused on the reasonable price to be charged to a Canadian affiliate for the active ingredient used in Zantac

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Canadian Transfer Pricing Rules

The Basics (cont.)

- The judgment of the Supreme Court in *GlaxoSmithKline* introduces principles that will be relevant to the adjudication of future Canadian transfer pricing disputes
  - Important to consider all "economically relevant characteristics" of sets of dealings to ensure that they are "sufficiently comparable"
  - The independent interests of each party to a transaction must be considered in a transfer pricing analysis
  - OECD commentaries and guidelines are influential, yet not controlling
  - "Transfer pricing is not an exact science"

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Canadian Transfer Pricing Rules

Transfer Pricing Penalties

- Where a transfer pricing adjustment is made, a transfer pricing penalty may also be applicable
- The transfer pricing penalty is equal to 10% of:

  the total transfer pricing income and capital adjustments for the year

  minus

  the total transfer pricing income and capital adjustments and the total transfer pricing income and capital setoff adjustments relating to transactions in respect of which “reasonable efforts” have been made to determine and use arm’s length transfer prices or allocations (the “**Penalty Base**”)

- Penalty applies where the Penalty Base exceeds the lesser of 10% of the taxpayer’s adjusted gross revenues and $5 million

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Canadian Transfer Pricing Rules

"Reasonable Efforts" Deeming Rule

- Unless a taxpayer prepares documentation containing certain required information by the relevant "documentation-due date", the taxpayer is deemed not to have made reasonable efforts to determine and use arm's length transfer prices
- To comply with the reasonable efforts deeming rule, a taxpayer must also:
  - update contemporaneous documentation for subsequent taxation years to account for material changes; and
  - provide contemporaneous documentation to the government within three months of a written request served personally or by registered or certified mail.

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Canadian Transfer Pricing Rules

CRA Transfer Pricing Red Flags

- Persistent Losses/Profitability Variances
- Intangibles and Royalties
- Bundled Supplies
- Contract Manufacturing Arrangements
- Intragroup Services
- Business Reorganizations, IP Migrations
- Management or Guarantee Fees
- Transactions involving low tax jurisdictions
- Overlapping Transactions (commissions, reimbursements)
- T106 reporting issues
- Changes in transfer pricing methodologies

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Canadian Transfer Pricing Rules

Common Transfer Pricing Errors/Pitfalls

- Insufficient/incomplete contemporaneous documentation
- Inappropriate use of comparables/methodologies
- Failure to update contemporaneous documentation
- Failure to provide contemporaneous documentation within 3 months of a written request
- Failure to appreciate jurisdictional differences
- No organizational agreements in writing
- No inter-affiliate coordination/consistency
- Compromise of legal privilege
- Lack of institutional memory
- T106 reporting errors

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Canadian Thin Capitalization Limitations

Overview

- Canada has enacted a detailed set of statutory provisions, commonly referred to as the "thin capitalization rules", that generally restrict the deductibility of interest payments made by a Canadian borrower to certain, connected non-resident lenders.
- Significant amendments were proposed to the Canadian thin capitalization rules in the 2012 federal Budget that will tighten the rules and broaden their scope

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Canadian Thin Capitalization Limitations

The Current Basics

- The thin capitalization rules currently prohibit a Canadian-resident corporation from deducting interest expenses in respect of the portion of its “outstanding debts to specified non-residents” that *exceeds two times* (i) the corporation’s non-consolidated retained earnings *plus* (ii) equity contributed by, or attributed to shares owned by, “specified non-resident shareholders”
- Interest deductions denied under the thin capitalization rules are permanently disallowed and may not be carried forward to reduce income earned in subsequent taxation years

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Canadian Thin Capitalization Limitations

Key Definitions

- "Specified non-resident shareholder" – includes a "specified shareholder" who is, at the relevant time, a non-resident person
- "Specified shareholder" – captures a person who either alone, or together with persons with whom the person does not deal at "arm's length", owns shares representing 25% or more of the votes or fair market value of the issued and outstanding shares of the corporation
- The thin capitalization rules generally only apply where a Canadian-resident corporation owes interest-bearing obligations to a "specified non-resident shareholder" of the corporation or a non-resident person who does not deal at "arm's length" with a "specified shareholder" of the corporation

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Canadian Thin Capitalization Limitations

2012 Federal Budget Proposals

- Reduce the operative debt-to-equity ratio from 2:1 to 1.5:1
- Extend the scope of the thin capitalization rules to apply to partnerships of which a Canadian corporation is a member
- Deem interest expenses disallowed under the thin capitalization rules to be dividends for non-resident withholding tax purposes
- ***Tips and Traps***
  - Remain conscious of retroactive application of proposed amendments
  - Deemed dividend treatment of disallowed interest can give rise to late withholding tax remittances
  - Deemed dividend treatment may give rise to withholding tax savings

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Questions?

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IT-221R3 - *Determination of an Individual's Residence Status*
http://www.cra-arc.gc.ca/E/pub/tp/it221r3-consolid/it221r3-consolid-e.pdf

IT-303 – *Know-How and Similar Payments to Non-Residents*
http://www.cra-arc.gc.ca/E/pub/tp/it303/it303-e.html
http://www.cra-arc.gc.ca/E/pub/tp/it303sr/it303sr-e.txt

IT-420R3 – *Non-Residents – Income Earned in Canada*
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IC87-2R – *International Transfer Pricing*

http://www.cra-arc.gc.ca/E/pub/tp/ic87-2r/ic87-2r-e.pdf

Canada Revenue Agency – *Businesses – International and Non-Resident Taxes page*

http://www.cra-arc.gc.ca/tx/nnrsdnts/bsnss/menu-eng.html

Canada Revenue Agency – *Transfer Pricing Page*

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Cautionary Note

The foregoing commentary is summary in nature and does not address all of the issues and considerations that may be relevant under any particular set of circumstances.

The statements and material presented herein do not represent legal or tax advice.

No transactions should be executed on the basis of the foregoing statements and commentary.

Formal legal, tax, and accounting advice should be obtained prior to making any investment or executing any transaction.

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Navigating the Tax Terrain of the Great White North:

What Every U.S. Tax Practitioner Should Know About Canadian Federal Income Tax

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STATE BAR OF TEXAS SECTION OF TAXATION
INTERNATIONAL TAX SYMPOSIUM
Houston, Texas

November 1, 2012

DOING BUSINESS IN THE MIDDLE EAST – KEY TREASURY ANTI-BOYCOTT OPERATIONAL AND COMPLIANCE ISSUES

By: *Andrius R. Kontrimas and Zhusong Yang**

The Arab League is an umbrella organization comprising 22 Middle Eastern and African countries and entities.[1] It was established in 1944, and formally declared its economic boycott against Israel and non-Israelis having business relationships with Israel in 1948. Although the Arab League does not enforce the boycott and boycott regulations are not binding on its members, many member states of the Arab League (such as Qatar, Saudi Arabia and the UAE) have adopted and implemented the boycott through legislation enacted under their respective domestic law.[2]

There are generally three types of boycott provisions against Israel: the "primary boycott" prohibits the importation of Israeli-origin goods and services into boycotting countries; the "secondary boycott" prohibits business dealings with any person that does business in Israel; and the "tertiary boycott" prohibits business dealings with any person that does business with companies that have been "blacklisted" by the Arab League.[3]

In the 1970s, in an effort to counteract the increased participation of U.S. persons in the boycott of Israel to obtain or maintain business relationships with Arabic countries, Congress adopted two sets of anti-boycott rules: Section 8 of the U.S. Export Administration Act of 1979, administered by the U.S. Commerce Department ("Commerce Anti-boycott Rules"), and Section 999 of the Internal Revenue Code,[4] enacted under the Tax Reform Act of 1976 and administered by the U.S. Treasury Department and the Internal Revenue Service ("Treasury Anti-boycott Rules, and together with Commerce Anti-boycott Rules, "U.S. Anti-boycott Rules").

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[1] *See* CRS Report for Congress, *Arab League Boycott of Israel*, by Martin A. Weiss (December 29, 2011) (the member states of the Arab League include: Algeria, Bahrain, Comoros, Djibouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, the Palestinian Authority, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, United Arab Emirates, and Yemen).

[2] For example, Qatar enacted Law No. 13 of 1963 on Regulating the Israel Boycott Office in Qatar, Saudi enacted Royal Decree No. A/19 dated 25/6/1382H (corresponding to 23/11/1962G), and the UAE enacted Federal Law No. 15 of 1972 Regarding the Boycott of Israel.

[3] *See* Martin A. Weiss, *Arab League Boycott of Israel*, CRS Report for Congress, December 29, 2011 (A blacklist of global firms that engage in business with Israel is maintained by the Central Boycott Office, and disseminated to Arab League members).

[4] Unless otherwise indicated, all "Section" references contained in this article are to the Internal Revenue Code of 1986, as amended (the "Code").

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Over the years, the Commerce and Treasury statutes have been supplemented and elaborated with comprehensive regulations and guidelines issued by the agencies, including Part 760 of the Export Administration Regulations and three sets of Treasury guidelines (the "Treasury Guidelines") published in the Federal Register.[5]

Although the U.S. Anti-boycott Rules were promulgated largely in response to the Arab League boycott of Israel, such rules are technically applicable to any international boycott unsanctioned by the United States. The boycott of Israel by the Arab League, however, continues to be the focal point of the U.S. anti-boycott efforts. Actually, all nine countries identified in Treasury's most recent "List of Countries Requiring Cooperation with an International Boycott" are member states of the Arab League.[6] Therefore, companies doing or developing business in a Middle East country should take note of the boycott of Israel by the Arab League, conduct due diligence regarding whether the boycott has been locally implemented by the Middle East country, and inquire into the potential applicability of the U.S. Anti-boycott Rules to the company's business activities in the Middle East country.

Generally speaking, both Commerce and Treasury Anti-boycott Rules impose a reporting obligation to the federal government. Specifically, a quarterly report on BIS Form 621-P must be filed with the Commerce Department to report the receipt of boycott-related requests, while from the Treasury perspective, an annual report on IRS Form 5713 must be filed to report operations in, with or related to boycotting countries and any boycott-related requests and agreements. Substantively, Commerce Anti-boycott Rules *prohibit* participation in and cooperation with unsanctioned boycotts and impose civil and criminal penalties for any violation. Treasury Anti-boycott Rules, on the other hand, do not prohibit but *impose potentially adverse tax consequences on* boycott participation and cooperation. Such adverse tax consequences may include a forfeiture of foreign tax credits otherwise allowable or an elimination of tax deferral otherwise available (through an increase in subpart F income otherwise excludable).

The Commerce and Treasury Anti-boycott Rules are overlapping rules that can differ substantially. For example, a contractual clause requiring a U.S. person to "*comply with* all the laws, rules and regulations of a boycotting country" could pass muster under the Commerce Anti-boycott Rules, yet trigger negative tax consequences under the Treasury Anti-boycott Rules.[7] On the other hand, a contractual clause providing that "the boycotting laws of a boycotting country shall *apply*" is generally permitted under the Treasury Anti-boycott Rules,

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[5] *See* 15 C.F.R. Part 760 (2008); 43 Fed. Reg. 3454 (January 25, 1978) (the "Treasury 1978 Guideline"); 44 Fed. Reg. 66272 (November 19, 1979) (the "Treasury 1979 Guideline"); 49 Fed. Reg. 18061 (April 26, 1984) (the "Treasury 1984 Guideline").

[6] *See* 77 Fed. Reg. 160 (August 17, 2012) (listing Iraq, Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, United Arab Emirates, and Yemen as the boycotting countries).

[7] Note that Commerce permits an agreement to comply with all the laws of a boycotting country even though such an agreement implies compliance with the boycotting laws of the boycotting country. Treasury, however, would interpret such an agreement as participation or cooperation in a boycott.

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yet prohibited under the Commerce Anti-boycott Rules.[8] Consequently, companies doing business in Middle East countries should seek counsel under both the Commerce and Treasury regimes.

This outline and today's presentation will focus on the Treasury Anti-boycott Rules and their impact on companies doing business in the Middle East area. In particular, the following parts of the outline will discuss when a company's business activities in a Middle East country may be subject to adverse tax consequences and/or reporting obligations under the Treasury Anti-boycott Rules.

I. ADVERSE FEDERAL INCOME TAX CONSEQUENCES.

A. TAX CONSEQUENCES.

1. Loss of Foreign Tax Credits.

A company, and when the company is foreign, domestic corporations owning at least 10% voting interest in the company (i.e., the company's "United States shareholders"), may suffer a reduction in foreign tax credits otherwise allowable to them for a taxable year if the company (i) "participates in or cooperates with an international boycott" or (ii) is a member of a "controlled group" of which one or more members "participate in or cooperate with an international boycott" during the taxable year.[9] A "controlled group" generally refers to a group of corporations connected through more than 50% stock ownership.[10]

When a "boycott participation or cooperation" is identified, the amount of foreign tax credits otherwise allowable to the company under Section 901 or the company's "United States shareholders" under Section 902 or 960 would be reduced by the amount of foreign tax credits otherwise allowable times the "international boycott factor."[11] The "international boycott factor" is a fraction the numerator of which reflects worldwide boycott operations of the company (or the "controlled group") and the denominator of which reflects worldwide foreign operations of the company (or the "controlled group").[12] If, however, the company can "clearly demonstrate" that foreign taxes paid are "attributable to specific operations," the denial of foreign tax credits extends solely to taxes "specifically attributable" to the "boycott participation and cooperation."[13]

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[8] According to the Treasury Guidelines, an agreement to "be subject to" the laws of a boycotting country, or an agreement that the laws of a boycotting country "will apply" or "shall govern" the contract performance, or that disputes arising under the contract will be resolved "in accordance with" the laws of a boycotting country would generally not constitute an agreement to participate in or cooperate with an international boycott. *See* Q&A H-3 and H-16 of the Treasury 1978 Guidelines and Q&A H-39 of the Treasury 1984 Guidelines. Conversely, an agreement to "comply with" the laws of a boycotting country would generally constitute an agreement to participate in or cooperate with an international boycott. *See* H-4 of the Treasury 1978 Guidelines.

[9] Section 908(a).

[10] Sections 993(a)(3); 1563(a).

[11] Section 908(a).

[12] Section 999(c)(1), (c)(3).

[13] Section 999(c)(2).

2. Loss of Tax Deferral/ Increase in Subpart F Income.

When a "controlled foreign corporation" ("CFC") engages in a "boycott participation or cooperation," the CFC's subpart F income would include income attributable to boycott operations. Consequently, the "United States shareholders" of the CFC may lose the tax deferral on that portion of the CFC's income.[14] Specifically, the addition to the CFC's subpart F income equals (i) the product of the CFC's income (excluding amounts otherwise includible as subpart F income and U.S.-source effectively connected income) multiplied by the "international boycott factor," or (ii) income "specifically attributable" to the "boycott participation or cooperation."[15]

Based on the foregoing, the adverse tax consequences under Treasury Anti-boycott Rules are tied closely to the concept of "boycott participation and cooperation," and the most important inquiry facing any company doing business in the Middle East is when business activities in a boycotting country rise to the level of "boycott participation and cooperation."

B. BOYCOTT PARTICIPATION AND COOPERATION.

1. General Rules and Exceptions.

Generally, a "boycott participation and cooperation" is deemed to occur if a company refrains from doing business with others for boycott-related reasons. Accordingly, the mere conduct by a company of commercial operations in a boycotting country and its knowledge of the existence of boycott rules in that country do not automatically result in a finding of "participation in or cooperation with an international boycott." The key question is whether the company has entered into an *agreement* to engage in specified boycott conducts as provided under the Code.

A boycott agreement can be formal or informal, written or oral, and express or implied from a course of conduct. Specified boycott conduct includes a person's refrainment, as a condition of *doing business* within a boycotting country or with the government, companies or nationals of that boycotting country, from:

- doing business in a boycotted country or with the government, companies or nationals of that boycotted country,
- doing business with any United States person engaged in business in a boycotted country or with the government, companies or nationals of that boycotted country,
- doing business with any company owned or managed by individuals of a particular nationality, race, or religion, or
- employing individuals of a particular nationality, race, or religion.[16]

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[14] Section 952(a)(3).

[15] Section 999(c)(2); Treas. Reg. § 1.952-1(a)(3).

[16] Section 999(b)(3)(A).

A person is also deemed to "participate in or cooperate with an international boycott" if it agrees, as a condition of *selling a product* to the government, companies or nationals of a boycotting country, not to ship or insure that product on a carrier owned, leased, or operated by a person who does not "participate in or cooperate with an international boycott."[17]

The Treasury Anti-boycott Rules, however, permit a company's compliance with a boycotting country's prohibition on the importation of goods produced in whole or in part in, or containing any parts, raw materials or labor from, a boycotted country.[18] Similarly, Treasury respects a company's agreement not to export goods obtained in the boycotting country to a boycotted country.[19]

In addition, when a company transports goods to or from a boycotting country, the company will not violate the Treasury Anti-boycott Rules if it agrees *not* to ship the goods on a vessel that (i) flies the flag of a boycotted country, (ii) is owned, controlled, operated or chartered by a boycotted country or its companies or nationals, or (iii) calls at the boycotted country during the voyage enroute to or from the boycotting country. Treasury recognizes that such requirements are not restrictive boycott practice, but arise from the need to protect goods from damage or loss by a hostile country.[20]

2. Attribution Rules and Exceptions.

When a company is found to "participate in or cooperate with an international boycott," there may be repercussions to other entities affiliated with such company.

a. *All operations presumption*. If a person (or a member of a "controlled group" that includes such person) "participates in or cooperates with an international boycott" in the taxable year, all operations of the person (or the group) in that country and in any other country that requires boycott participation and cooperation as a condition of doing business shall be presumed as "participation in or cooperation with an international boycott" to which adverse tax treatment may be applied.[21]

This presumption, however, may be rebutted if the person can demonstrate that a particular operation is a "clearly separate and identifiable operation" in connection with which there was no "participation in or cooperation with an international boycott."[22] The determination as to whether an operation constitutes a "clearly separate and identifiable operation" must be based on an examination of all the facts and circumstances.[23]

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[17] Section 999(b)(3)(B).

[18] Section 999(b)(4)(B); Q&A I-1 of the Treasury 1978 Guideline.

[19] Section 999(b)(4)(C).

[20] *See* Q&A M-5 of the Treasury 1984 Guideline.

[21] Section 999(b)(1).

[22] *Id.*

[23] *See* Q&A D-3 of the Treasury 1978 Guidelines (apart from the five non-exclusive sample factors for the facts-and-circumstances test, six examples are given to demonstrate what constitutes "clearly separate and identifiable operations").

In the Treasury 1978 Guidelines, five non-exclusive sample factors are listed as applicable to the facts-and-circumstances test. The five non-exclusive sample factors are:

- Were the two operations conducted by different corporations, partnerships, or other business entities?
- Were the operations, whether conducted by separate entities or not, supervised by different management personnel?
- Did the operations involve distinctly different products or services?
- Were the operations undertaken pursuant to separate and distinct contracts?
- If business operations in the countries conducting the international boycott in question were not continuous over time, was each transaction separately negotiated and performed?

b. *Partnership attribution rule*. When a partnership "participates in or cooperates with" an international boycott, the partnership's "boycott participation and cooperation" would be attributed to all its partners, regardless of whether the partner owns a majority or minority interest in the partnership.[24] In other words, if a U.S. person invests in a foreign partnership that "participates in or cooperates with an international boycott," the U.S. person would be subject to the Treasury Anti-boycott Rules even though the U.S. person practically has no control over the business conduct of the foreign partnership.

Note that the "all operations presumption" discussed above is not applicable to a person who is deemed to "participate in or cooperate with an international boycott" solely by reason of the "partnership attribution rule." In other words, when a partner is found to be engaged in "boycott participation or cooperation" solely as a result of the partnership's boycott activities, there would be no presumption that operations of the partner in other boycotting countries or of any person that controls or is controlled by the partner also constitute "boycott participation or cooperation." Nor would there be a presumption that all operations of each member of the "controlled group" that includes the partner in boycotting countries are operations that would give rise to a "boycott participation or cooperation."[25]

II. REPORTING OBLIGATIONS.

A U.S. person must file annually an IRS Form 5713, International Boycott Report, with the Internal Revenue Service, if the U.S. person is deemed to (1) have operations in or related to a boycotting country (including with the government, a company, or a national of the boycotting country) ("Operation Reporting"), (2) participate in and cooperate with an international boycott ("Boycott Participation Reporting"), or (3) receive a request to participate in and cooperate with an international boycott ("Request Reporting").

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[24] *See* Q&A D-6 of the Treasury 1979 Guideline.

[25] *Id.*

Form 5713 is due when the U.S. person's income tax return is due (including extensions).

A. OPERATION REPORTING.

Section 999(a)(1) and the Treasury Guidelines impose a reporting obligation on a U.S. person if (i) the person or a member of a "controlled group" that includes such person has operations in or related to a boycotting country, (ii) the person is a "United States shareholder" of a foreign corporation that has operations in or related to a boycotting country, or (iii) the person is a partner in a partnership that has operations in or related to a boycotting country.[26]

1. Controlled Group.

As discussed above, a "controlled group" is defined in Section 993(a)(3) and generally refers to a group of corporations connected through a chain of more than 50% ownership.[27] Generally, as long as one member of a "controlled group" has operations in or related to a boycotting country, every member of that group must file a Form 5713.[28] However, for a "controlled group" that files a consolidated income tax return, the common parent can file a Form 5713 on behalf of all those members that join in the filing of the consolidated income tax return.[29]

2. United States Shareholder.

A "United States shareholder" is defined in Section 951(b) and refers to a U.S. person owning 10% or more voting power in a foreign corporation.[30] For Operation Reporting purposes, however, the 10% threshold is based solely upon foreign corporation stock *directly* owned by the U.S. person, or *indirectly* owned by the U.S. person through his ownership in another foreign corporation or foreign partnership.[31]

When a foreign corporation has operations in or related to a boycotting country, a "United States shareholder" of such foreign corporation would have a Form 5713 reporting obligation regardless of the fact that the "United States shareholder" may only hold a minority interest in the foreign corporation, or that the foreign corporation is not a "controlled foreign corporation."[32]

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[26] *See* Q&A A-1 of the Treasury 1978 Guidelines.

[27] Sections 993(a)(3), 1563(a).

[28] *See* Q&A A-3 of the Treasury 1978 Guidelines.

[29] *Id.*

[30] Section 999(a)(1).

[31] *See* Q&A A-2 of the Treasury 1978 Guidelines. In other words, only Section 958(a) rules (but not Section 958(b) constructive ownership rules) apply in determining whether a person constitutes a "United States shareholder" of a foreign corporation for boycott reporting purposes.

[32] *See* Q&A A-2 and A-4 of the Treasury 1978 Guidelines.

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3. Partnership.

Generally, when a partnership has operations in or related to a boycotting country, each partner of such partnership must file a Form 5713.[33] If the partnership, however, has no "boycott participation or cooperation" and files a Form 5713 to report its operations in the boycotting country, each of the partners' Form 5713 reporting obligation would be waived.[34]

4. Operations in Boycotting Countries.

The term "operation" encompasses all forms of business or commercial activities and transactions (or parts of transactions), whether or not productive of income, including, but not limited to, selling, purchasing, leasing, licensing, banking, financing, and similar activities, extracting, processing, manufacturing, producing, constructing, transporting, performing activities ancillary to the foregoing (e.g., contract negotiating, advertising, site selecting), and performing services, whether or not ancillary to the foregoing.[35]

Given the broad scope of "operations" for purposes of Treasury Anti-boycott Rules, it is possible that a U.S. company with no presence in a boycotting country could be treated as having operations related to that boycotting country if company executives conducted a business trip to the boycotting country to seek business opportunities.

B. BOYCOTT PARTICIPATION REPORTING.

Section 999(a)(2) requires a U.S. person to file a boycott report if (i) the person, (ii) a foreign corporation of which the person is a "United States shareholder" or (iii) any member of a "controlled group" that includes the person or the foreign corporation "participates in or cooperates with an international boycott." In addition, under the "partnership attribution rule," a U.S. person must also file a boycott report if the partnership in which he is a partner "participates in or cooperates with an international boycott."[36]

As explained above, the determination of "boycott participation or cooperation" is a very technical yet subtle fact-intensive analysis.

C. REQUEST REPORTING.

Section 999(a)(2) requires a person to file a boycott report if (i) the person, (ii) a foreign corporation of which the person is a "United States shareholder" or (iii) any member of a "controlled group" that includes the person or the foreign corporation *receives a request* to "participate in or cooperate with an international boycott." It is worth noting that no "partnership attribution rule" appears to exist for purposes of request-based reporting. In other words, when a partnership receives a boycott request, the partners of the partnership do not appear to have a Form 5713 reporting obligation based on the receipt of such request alone.

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[33] *See* Q&A A-17 of the Treasury 1978 Guidelines.

[34] *Id.*

[35] *See* Q&A B-1 of the Treasury 1978 Guidelines.

[36] *See* Q&A D-6 of the Treasury 1979 Guidelines.

A boycott request is reportable even if no boycott agreement is ultimately reached. Therefore, if a U.S. contractor receives an invitation to tender that contains, for example, a provision to "comply with all laws and regulations" of the boycotting country, then the receipt of such tender document would be reportable even if the contract is later modified with such provision revised or removed. Note, however, that there would be no request-based reporting obligation if the U.S. contractor neither solicited the invitation to tender nor responded to the invitation.[37]

D. PENALTIES FOR FAILURE TO REPORT.

Willful failure to file Form 5713 may result in a fine of up to $25,000 or imprisonment of no more than one year, or both.[38] For the non-willful failure to file a Form 5713, the penalty regime is less clear. The Internal Revenue Manual (the "IRM") noted that if a Form 5713 is not filed, the examiner "should determine the reason for the failure to file and whether this constitutes a willful omission."[39] In cases where the failure to file is willful, the examiner is instructed by the IRM to refer the case to the Criminal Investigation Division, while in cases where no willfulness is involved, the IRM simply requests the examiner to solicit the delinquent Form 5713 without discussing any applicable penalties.[40]

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[37] *See* Q&A A-15 of the Treasury 1978 Guidelines.

[38] Section 999(f).

[39] Internal Revenue Manual 4.61.6.6.1 (May 1, 2006).

[40] *Id.*

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Form **5713**

(Rev. December 2010)

Department of the Treasury
Internal Revenue Service

International Boycott Report

For tax year beginning ______________________, 20 ______,
and ending ______________________, 20 ______.
▶ Controlled groups, see instructions.

OMB No. 1545-0216

Attachment
Sequence No. 123

Paper filers must file in duplicate (see When and Where to File in the instructions)

Name

Identifying number

Number, street, and room or suite no. If a P.O. box, see instructions.

City or town, state, and ZIP code

Address of service center where your tax return is filed

Type of filer (check one):
☐ Individual ☐ Partnership ☐ Corporation ☐ Trust ☐ Estate ☐ Other

1 **Individuals**—Enter adjusted gross income from your tax return (see instructions)

2 **Partnerships and corporations:**

a Partnerships—Enter each partner's name and identifying number.

b Corporations—Enter the name and employer identification number of each member of the controlled group (as defined in section 993(a)(3)). Do not list members included in the consolidated return; instead, attach a copy of Form 851. List all other members of the controlled group not included in the consolidated return.
If you list any corporations below or if you attach Form 851, you must designate a common tax year. Enter on line 4b the name and employer identification number of the corporation whose tax year is designated.

Name	**Identifying number**

If more space is needed, attach additional sheets and check this box . . . . ▶ ☐

	Code	Description
c Enter principal business activity code and description (see instructions)		
d IC-DISCs—Enter principal product or service code and description (see instructions)		

3 **Partnerships**—Each partnership filing Form 5713 must give the following information:

a Partnership's total assets (see instructions) . . . .

b Partnership's ordinary income (see instructions) . . . .

4 **Corporations**—Each corporation filing Form 5713 must give the following information:

a Type of form filed (Form 1120, 1120-FSC, 1120-IC-DISC, 1120-L, 1120-PC, etc.) . . .

b Common tax year election (see instructions)

(1) Name of corporation ▶ ______________________

(2) Employer identification number . . . .

(3) Common tax year beginning ______________________, 20______, and ending ______________________, 20______ .

c Corporations filing this form enter:

(1) Total assets (see instructions) . . . .

(2) Taxable income before net operating loss and special deductions (see instructions) . .

5 **Estates or trusts**—Enter total income (Form 1041, page 1) . . . .

6 Enter the total amount (before reduction for boycott participation or cooperation) of the following tax benefits (see instructions):

a Foreign tax credit . . . .

b Deferral of earnings of controlled foreign corporations . . . .

c Deferral of IC-DISC income . . . .

d FSC exempt foreign trade income . . . .

e Foreign trade income qualifying for the extraterritorial income exclusion . . . .

Please Sign Here

Under penalties of perjury, I declare that I have examined this report, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

▶ Signature ______________________ Date ______________ ▶ Title ______________________

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		Yes	No
7a	Are you a U.S. shareholder (as defined in section 951(b)) of any foreign corporation (including a FSC that does not use the administrative pricing rules) that had operations reportable under section 999(a)?		
b	If the answer to question 7a is "Yes," is any foreign corporation a controlled foreign corporation (as defined in section 957(a))?		
c	Do you own any stock of an IC-DISC?		
d	Do you claim any foreign tax credit?		
e	Do you control (within the meaning of section 304(c)) any corporation (other than a corporation included in this report) that has operations reportable under section 999(a)?		
	If "Yes," did that corporation participate in or cooperate with an international boycott at any time during its tax year that ends with or within your tax year?		
f	Are you controlled (within the meaning of section 304(c)) by any person (other than a person included in this report) who has operations reportable under section 999(a)?		
	If "Yes," did that person participate in or cooperate with an international boycott at any time during its tax year that ends with or within your tax year?		
g	Are you treated under section 671 as the owner of a trust that has reportable operations under section 999(a)? .		
h	Are you a partner in a partnership that has reportable operations under section 999(a)?		
i	Are you a foreign sales corporation (FSC) (as defined in section 922(a), as in effect before its repeal)?		
j	Are you excluding extraterritorial income (defined in section 114(e), as in effect before its repeal) from gross income?		

Part I Operations in or Related to a Boycotting Country (see instructions)

		Yes	No
8	**Boycott of Israel**—Did you have any operations in or related to any country (or with the government, a company, or a national of that country) associated in carrying out the boycott of Israel which is on the list maintained by the Secretary of the Treasury under section 999(a)(3)? (See **Boycotting Countries** in the instructions.)		

If "Yes," complete the following table. If more space is needed, attach additional sheets using the exact format and check this box . . . . ▶ ☐

	Name of country (1)	Identifying number of person having operations (2)	Principal business activity		IC-DISCs only—Enter product code (5)
			Code (3)	Description (4)	
a					
b					
c					
d					
e					
f					
g					
h					
i					
j					
k					
l					
m					
n					
o					

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	Yes	No
9 **Nonlisted countries boycotting Israel—** Did you have operations in any nonlisted country which you know or have reason to know requires participation in or cooperation with an international boycott directed against Israel?		

If "Yes," complete the following table. If more space is needed, attach additional sheets using the exact format and check this box . . . . ▶ ☐

	Name of country (1)	Identifying number of person having operations (2)	Principal business activity		IC-DISCs only—Enter product code (5)
			Code (3)	Description (4)	
a					
b					
c					
d					
e					
f					
g					
h					

	Yes	No
10 **Boycotts other than the boycott of Israel—**Did you have operations in any other country which you know or have reason to know requires participation in or cooperation with an international boycott other than the boycott of Israel?		

If "Yes," complete the following table. If more space is needed, attach additional sheets using the exact format and check this box . . . . ▶ ☐

	Name of country (1)	Identifying number of person having operations (2)	Principal business activity		IC-DISCs only—Enter product code (5)
			Code (3)	Description (4)	
a					
b					
c					
d					
e					
f					
g					
h					

	Yes	No
11 Were you requested to participate in or cooperate with an international boycott?		
If "Yes," attach a copy (in English) of any and all such requests received during your tax year. If the request was in a form other than a written request, attach a separate sheet explaining the nature and form of any and all such requests. (See instructions.)	▨	▨
12 Did you participate in or cooperate with an international boycott?		

If "Yes," attach a copy (in English) of any and all boycott clauses agreed to, and attach a general statement of the agreement. If the agreement was in a form other than a written agreement, attach a separate sheet explaining the nature and form of any and all such agreements. (See instructions.)

Note: *If the answer to either question 11 or 12 is "Yes," you must complete the rest of Form 5713. If you answered "Yes" to question 12, you must complete Schedules A and C or B and C (Form 5713).*

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Part II Requests for and Acts of Participation in or Cooperation With an International Boycott

		Requests		Agreements	
		Yes	No	Yes	No
13a	Did you receive requests to enter into, or did you enter into, any agreement (see instructions):	▨	▨	▨	▨
(1)	As a condition of doing business directly or indirectly within a country or with the government, a company, or a national of a country to—				
(a)	Refrain from doing business with or in a country which is the object of an international boycott or with the government, companies, or nationals of that country?				
(b)	Refrain from doing business with any U.S. person engaged in trade in a country which is the object of an international boycott or with the government, companies, or nationals of that country?				
(c)	Refrain from doing business with any company whose ownership or management is made up, in whole or in part, of individuals of a particular nationality, race, or religion, or to remove (or refrain from selecting) corporate directors who are individuals of a particular nationality, race, or religion?				
(d)	Refrain from employing individuals of a particular nationality, race, or religion?				
(2)	As a condition of the sale of a product to the government, a company, or a national of a country, to refrain from shipping or insuring products on a carrier owned, leased, or operated by a person who does not participate in or cooperate with an international boycott?				

b **Requests and agreements**—if the answer to any part of 13a is "Yes," complete the following table. If more space is needed, attach additional sheets using the exact format and check this box . . . . ▶ ☐

	Name of country (1)	Identifying number of person receiving the request or having the agreement (2)	Principal business activity		IC-DISCs only—Enter product code (5)	Type of cooperation or participation			
						Number of requests		Number of agreements	
			Code (3)	Description (4)		Total (6)	Code (7)	Total (8)	Code (9)
a									
b									
c									
d									
e									
f									
g									
h									
i									
j									
k									
l									
m									
n									
o									
p									

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Instructions for Form 5713

(Rev. December 2010)

International Boycott Report

Department of the Treasury
Internal Revenue Service

Section references are to the Internal Revenue Code unless otherwise noted.

General Instructions

Purpose of Form

Use Form 5713 to report:

- Operations in or related to boycotting countries (see list on page 2) and
- The receipt of boycott requests and boycott agreements made.

Who Must File

You must file Form 5713 if you are a U.S. person (defined in section 7701(a)(30)) that has operations (defined on page 2) in or related to a boycotting country, or with the government, a company, or a national of a boycotting country.

The following U.S. persons also must file Form 5713:

- A member of a controlled group (as defined in section 993(a)(3)), a member of which has operations;
- A U.S. shareholder (within the meaning of section 951(b)) of a foreign corporation that has operations (but only if you own (within the meaning of section 958(a)) stock of that foreign corporation);
- A partner in a partnership that has operations; or
- A person treated (under section 671) as the owner of a trust that has operations.

Ban on importing or exporting. Although you can comply with a ban on importing or exporting of products described in sections 999(b)(4)(B) and (C) without incurring the loss of tax benefits, you must report the boycott operations from such agreements on Form 5713.

Exceptions From Filing

Foreign person. A foreign person is not required to file Form 5713 unless that person:

1. Claims the benefits of the foreign tax credit,
2. Owns stock in an interest charge domestic international sales corporation (IC-DISC),
3. Is a foreign sales corporation (FSC) that has exempt foreign trade income, or
4. Has extraterritorial income (defined in section 114(e), as in effect before its repeal) excluded from gross income.

Members of a controlled group. A corporation that is a member of a controlled group (as defined in section 1563) is not required to file Form 5713 if all members of the controlled group joined in the filing of a consolidated income tax return and the common parent files Form 5713 on behalf of all members of the controlled group.

If all members of a controlled group did not join in the filing of a consolidated income tax return, each member of the controlled group must file Form 5713 separately.

A member of a controlled group (as defined in section 993(a)(3)) is not required to file Form 5713 if all of the following conditions apply:

- The member has no operations in or related to a boycotting country (or with the government, a company, or a national of a boycotting country);
- The member did not own stock, directly or indirectly, in any corporation having such operations;
- The member did not receive any boycott requests;
- The member did not own stock, directly or indirectly, of any corporation receiving a request;
- The member is not entitled to (or forfeits) the benefits of the foreign tax credit, the deferral of earnings of a controlled foreign corporation (CFC), IC-DISC benefits, FSC benefits, or the extraterritorial income exclusion; and
- The member attaches to its tax return a certificate stating that Form 5713 was filed on the member's behalf. This certificate must be signed by a person authorized to sign the income tax return of the common parent of the group.

Partners. A partner is not required to file Form 5713 if:

- That partner has no boycott operations that are independent of the partnership,
- The partnership files Form 5713 with Form 1065, and
- The partnership did not cooperate with or participate in an international boycott.

U.S. approved boycotts. You can comply with an international boycott imposed by a foreign country if the boycott is approved by United States law, regulations, or an Executive order. Do not report U.S. approved boycotts on Form 5713.

Unsolicited invitation to bid. If you receive an unsolicited invitation to bid for a contract that contains a request to participate in or cooperate with an international boycott, you are required to file Form 5713 only if you accept the invitation.

Foreign corporation with U.S. subsidiary or sister corporation. A U.S. corporation that is a subsidiary or sister corporation of a foreign corporation can waive the requirement to report boycott operations of its foreign parent or sister corporation if the following conditions are met:

- The foreign corporation is not required to file Form 5713 independent of its relationship with the U.S. subsidiary or sister corporation.
- The U.S. subsidiary or sister corporation agrees to forfeit the benefits of the foreign tax credit, deferral of taxation of earnings of a CFC, IC-DISC benefits, FSC benefits, and the extraterritorial income exclusion.

Foreign corporation with U.S. branch. A foreign corporation engaged in a U.S. trade or business through a U.S. branch generally is required to file Form 5713 to report the boycott activities of its controlled group, including the U.S. branch. When reporting for the U.S. branch, report all information related to the U.S. branch's boycott activities, including the boycott activities that do not relate to the U.S. trade or business.

The foreign corporation can, however, waive the requirements to report information about its U.S. branch if it does not claim or forfeits the benefits of the foreign tax credit, deferral of taxation of earnings of a CFC, IC-DISC benefits, and FSC benefits. This waiver does not relieve the foreign corporation of reporting boycott activities of all U.S. corporations that are members of the same controlled group of which the foreign corporation is a member.

When and Where To File

Form 5713 is due when your income tax return is due, including extensions. Attach the original copy of the Form 5713 (and Schedules A, B, and C, if applicable) to your income tax return. Do not sign the copy that is attached to your income tax return. Paper filers must file a duplicate copy of the form and required schedules with the Internal Revenue Service Center, P. O. Box 409101, Ogden, UT 84409. However, see *Electronic Filing of Form 5713* next.

Electronic Filing of Form 5713. If you file your original Form 5713 electronically (as an attachment to your electronically filed income tax return), you are not required to file a duplicate Form 5713. See the instructions for your income tax return for general information about electronic filing.

Penalties

Willful failure to file Form 5713 may result in:

- A $25,000 fine,

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- Imprisonment for no more than 1 year, or
- Both.

Tax Benefits That May Be Lost

If you cooperate with or participate in an international boycott, you may lose a portion of the following:

- The foreign tax credit (section 908(a)),
- Deferral of taxation of earnings of a CFC (section 952(a)(3)),
- Deferral of taxation of IC-DISC income (section 995(b)(1)(F)(ii)),
- Exemption of foreign trade income of a FSC (section 927(e)(2), as in effect before its repeal), and
- Exclusion of extraterritorial income from gross income (section 941(a)(5), as in effect before its repeal).

Schedules A, B, and C

Figure the loss of tax benefits on Schedules A and C or Schedules B and C (Form 5713). You must use the international boycott factor (Schedule A) to figure the reduction to foreign trade income qualifying for the extraterritorial income exclusion. To figure the loss of all other tax benefits, you can use either the international boycott factor (Schedule A) or determine taxes and income specifically attributable to boycott operations (Schedule B).

Compute the loss of tax benefits on Schedule C. See the instructions for these separate schedules for more details.

Complete Schedule C if you are a partner. Partnerships do not complete Schedule C. But partnerships must complete parts of both Schedules A and B. However, if all partners figure the loss of their tax benefits using the boycott factor exclusively, or specifically identifiable taxes and income attributable to boycott operations exclusively, then the partnership is only required to complete parts of Schedule A or parts of Schedule B.

Report the appropriate amounts from Schedule C on the following forms.

Form 1116, Foreign Tax Credit (Individual, Estate, or Trust).

Form 1118, Foreign Tax Credit—Corporations.

Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations.

Form 1120-IC-DISC, Interest Charge Domestic International Sales Corporation Return.

Form 1120-FSC, U.S. Income Tax Return of a Foreign Sales Corporation.

Form 8873, Extraterritorial Income Exclusion.

Definitions

Boycotting Countries

A boycotting country is:

- Any country that is on the list maintained by the Secretary of the Treasury under section 999(a)(3). As of the date these instructions were revised, the most recent list (dated November 2010) included Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, United Arab Emirates, and the Republic of Yemen.
- Any other country in which you (or a member of the controlled group of which you are a member) have operations and of which you know (or have reason to know) requires any person to cooperate with or participate in an international boycott. However, see *Exceptions From Filing* on page 1.

Boycott Request

A boycott request is any request to enter into an agreement that would constitute cooperation with or participation in an international boycott.

Operations

The term "operations" means all forms of business or commercial activities and transactions (or parts of transactions), whether or not productive of income, including, but not limited to: selling; purchasing; leasing; licensing; banking, financing, and similar activities; extracting; processing; manufacturing; producing; constructing; transporting; performing activities related to the activities above (for example, contract negotiating, advertising, site selecting, etc.); and performing services, whether or not related to the activities above.

Operations in a boycotting country. You are considered to have operations "in a boycotting country" if you have an operation that is carried out, in whole or in part, in a boycotting country, either for or with the government, a company, or a national of a boycotting country.

Operations with the government, a company, or a national of a boycotting country. You are considered to have operations "with the government, a company, or a national of a boycotting country" if you have an operation that is carried on outside a boycotting country either for or with the government, a company, or a national of a boycotting country.

Operations related to a boycotting country. You are considered to have operations "related to a boycotting country" if you have an operation that is carried on outside a boycotting country for the government, a company, or a national of a nonboycotting country if you know or have reason to know that specific goods or services produced by the operation are intended for use in a boycotting country, or for use by or for the benefit of the government, a company, or a national of a boycotting country, or for use in forwarding or transporting to a boycotting country.

Specific Instructions

Address

Include the suite, room, or other unit number after the street address. If the Post Office does not deliver mail to the street address and the filer has a P.O. box, show the box number instead.

If you receive your mail in care of a third party (such as an accountant or an attorney), enter on the street address line "C/O" followed by the third party's name and street address or P.O. box.

Address of Service Center

Enter the address of the service center where your tax return was filed. If the return was e-filed, enter "e-file".

Lines 1 Through 6

Note. All line references are to 2010 forms unless otherwise noted.

Line 1. Individuals

Enter your adjusted gross income (from Form 1040, line 37).

Line 2c. Partnerships and Corporations

Enter your principal business activity code number and description from the list beginning on page 6. Enter the code number for the specific industry group from which the largest percentage of total receipts was derived. Total receipts are defined in the instructions for the Codes for Principal Business Activity located at the end of the instructions for partnership and corporate returns.

Line 2d. IC-DISCs

Enter on line 2d the major product code number for the major product or service (as measured by export gross receipts) sold or provided by the IC-DISC (Form 1120-IC-DISC, Schedule N, line 1a).

Line 3a. Partnership's Total Assets

Enter the total assets of the partnership (Form 1065 and Form 1065-B, line 14, column (d) of Schedule L).

Line 3b. Partnership's Ordinary Income

Enter the partnership's ordinary income (Form 1065, page 1, line 22). For electing large partnerships, enter the portion of taxable income (Form 1065-B, page 1, line 25) that is attributable to trade or business activities.

Line 4b. Common Tax Year Election

The common tax year of a controlled group is generally the tax year of the common parent. The members of the controlled group can, however, elect the tax year of any member of the group as the common tax year. This election is made by entering the name, tax year, and employer identification number (EIN) of the designated corporation on line 4b.

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All members of a controlled group must consent, in writing, to the common tax year election. A common parent can consent to the common tax year election on behalf of all members of the controlled group that joined with the common parent in filing a consolidated return. Foreign corporations that are members of a controlled group should not sign the consent if they are not required to file Form 5713. However, if a foreign corporation subsequently becomes liable to file Form 5713, then it is bound by the common tax year election previously made by the group. A copy of the consent must be attached to each member's Form 5713 filed for the first tax year of such member to which the common tax year election applies. If no common parent exists or no agreement is reached by the members of the controlled group, the common tax year of the group will be the tax year of the member of the controlled group whose tax year ends in the latest month of the calendar year. The common tax year election is a binding election and can be changed only with the approval of the Secretary.

Line 4c(1). Corporation's Total Assets

Enter the amount of total assets as follows.

Form 1120. Schedule L, line 15, column (d).

Form 1120-F. Schedule L, line 17, column (d).

Form 1120-FSC. Schedule L, line 15, column (d).

Form 1120-IC-DISC. Schedule L, line 3, column (b).

Form 1120-L. Schedule L, Part I, line 6, column (b).

Form 1120-PC. Schedule L, line 15, column (d).

Form 1120S. Schedule L, line 15, column (d).

Line 4c(2). Corporation's Taxable Income

Enter the amount of taxable income before net operating loss (NOL) and special deductions as follows.

Form 1120. Page 1, line 28.

Form 1120-F. Page 3, line 29.

Form 1120-FSC. Page 3, Schedule B, line 18.

Form 1120-IC-DISC. Page 1, line 5.

Form 1120-L. Page 1, line 24, plus line 21c.

Form 1120-PC. Page 2, Schedule A, line 35.

Form 1120S. Page 1, line 21 (ordinary business income).

Line 6. Totals

Line 6a. Foreign tax credit. Enter on line 6a the foreign tax credit before adjustment from Form 1116, line 27, or Form 1118, Schedule B, Part III, line 4.

Line 6b. Deferral of earnings of CFCs. Enter on line 6b your pro rata share of total earnings from controlled foreign corporations (as defined in section 952(a)(3)(A)).

Line 6c. Deferral of IC-DISC income. Shareholders of an IC-DISC should compute the deferral as follows:

Shareholder that is not a C corporation. Enter on line 6c your pro rata share of the section 995(b)(1)(F)(i) amount (pro rata share of Form 1120-IC-DISC, Schedule J, Part I, line 8).

Shareholder that is a C corporation. Enter on line 6c your pro rata share of the section 995(b)(1)(F)(i) amount multiplied by 16/17 (16/17 times your pro rata share of Form 1120-IC-DISC, Schedule J, Part I, line 8).

Line 6d. FSC exempt foreign trade income. Enter on line 6d the total exempt foreign trade income (the total of columns (a) and (b) of Form 1120-FSC, Schedule B, line 10).

Line 6e. Foreign trade income qualifying for extraterritorial income exclusion. Enter on line 6e your foreign trade income that otherwise qualifies for the extraterritorial income exclusion (Form 8873, line 49).

Lines 8 Through 13

Filers that are not members of a controlled group. If you are not a member of a controlled group, report on lines 8 through 13 your own boycott information and the boycott information with respect to:

- Any foreign corporation in which you are a U.S. shareholder,
- Any partnership in which you are a partner, or
- Any trust of which you are treated as the owner under section 671.

When reporting on behalf of a foreign corporation, partnership, or trust, report the boycott activities for the tax year of the foreign corporation, partnership, or trust that ends with or within your tax year.

Members of a controlled group of corporations. If you are a member of a controlled group of corporations, the answers to the questions on lines 8 through 13 for your tax year must reflect:

- Your boycott information (and the boycott information of any trust of which you are treated as the owner under section 671) for your tax year that ends with or within the common tax year that ends with or within your tax year (see instructions for line 4b).
- The boycott information of each other member of the controlled group (and that of any trust of which a member of the controlled group is treated as the owner under section 671) for each member's tax year that ends with or within the common tax year that ends with or within your tax year.
- The boycott information of each foreign corporation or partnership on whose behalf you are reporting as a U.S. shareholder or as a partner, for the tax year of the foreign corporation or the partnership that ends with or within your tax year that ends with or within the common tax year that ends with or within your tax year.
- The boycott information of each foreign corporation or partnership on whose behalf a member (other than you) of the controlled group is reporting as a U.S. shareholder or as a partner, for the tax year of the foreign corporation or the partnership that ends with or within such member's tax year that ends with or within the common tax year that ends with or within your tax year.

The effect of these reporting requirements is that the answers to the questions on lines 8 through 13 generally are identical for each member of the controlled group and should only be updated on a group basis once a year. The information is updated at the close of the common tax year, and is reported by each member of the group for its tax year that ends with or after the common tax year. If the tax years of all members, foreign corporations, and partnerships are the same as the common tax year, then all information is reported on a current basis.

If all tax years are different, then all or some of the information reported will reflect a time period that is different from the reporter's tax year.

Example. Assume that Corporations A, B, C, and D are all members of a controlled group. Corporation A is the common parent and no common tax year election is made. Corporations A, B, and C report on the basis of a calendar year. Corporation D reports on the basis of a July 1–June 30 tax year. Corporation C owns 15% of Foreign Corporation X. Corporation X reports on the basis of an April 1–March 31 tax year. Corporations A, B, C, D, and X have operations in boycotting countries. The answers to the questions on lines 8 through 13 on the Forms 5713 filed by Corporations A, B, and C for their 2009 tax years will reflect the operations of Corporations A, B, and C for the 2009 tax year, the operations of Corporation D for the period July 1, 2008–June 30, 2009, and the operations of Corporation X for the period April 1, 2008–March 31, 2009. The answers to the questions on lines 8 through 13 on the Form 5713 filed by Corporation D for its tax year ending June 30, 2010, will be identical to those on Forms 5713 filed by Corporations A, B, and C for their tax years ending December 31, 2009. The answers on lines 8 through 13 on the Form 5713 filed by Corporation D for its tax year ending June 30, 2010, will not reflect any of Corporation D's operations for its July 1, 2009–June 30, 2010, tax year.

Part I. Operations in or Related to a Boycotting Country

Line 8. Boycott of Israel

The question on line 8 concerns operations in or related to countries on the Secretary's list of countries associated in the boycott of Israel. Use a separate line for each country or each person having operations in that country. Do not use separate lines for separate operations by the same person in the same country.

Column (2). Enter the identifying number of each person having operations in or related to any of the listed countries. If you are a member of a controlled group of corporations, include the EIN of all members of your controlled group that have operations in or related to the listed countries. If you or a member of your controlled group is the U.S. shareholder of a foreign corporation which has operations in or related to the listed countries (or with the governments, companies, or nationals of those countries), enter your EIN or the EIN of the member of your group who is the U.S. shareholder. Then, in parentheses, enter the name and EIN, if available, of the foreign corporation having the operation in or related to the listed countries.

Columns (3) and (4). Enter in column (3) the principal business activity code number (see the list beginning on page 6) of the person that has the boycott operation. Enter a brief description of the principal business activity in column (4).

Column (5). IC-DISCs, enter the product code from Form 1120-IC-DISC, Schedule N, line 1a.

Line 9. Nonlisted Countries Boycotting Israel

If the answer to the question on line 9 is "Yes," use the same procedure outlined in the instructions for line 8 for any nonlisted countries which you know or have reason to know require participation in or cooperation with the international boycott of Israel.

Line 10. Boycotts of Countries Other Than Israel

If the answer to the question on line 10 is "Yes," use the same procedure outlined in the instructions for line 8 for an international boycott other than the boycott of Israel.

Line 11. Boycott Requests

If you receive a substantial number of similar requests, you can attach a copy of one of these requests and a statement showing the number and nature of all other similar requests received.

Line 12. Boycott Agreements

If a substantial number of boycott agreements were entered into or were effective for the period covered by the report, and the boycott clauses are similar, you can attach a sample boycott clause and a statement showing the number and general nature of all other boycott clauses and agreements entered into. An agreement to participate in or cooperate with an international boycott continues for the entire period that it is in effect and must be reported each year that it is in effect.

Part II. Requests for and Acts of Participation in or Cooperation With an International Boycott

Line 13a(1) and 13a(2)

Check "Yes" for any requests received or agreements entered into or continuing in effect during the period covered by the report for any international boycott not excluded under *U.S. approved boycotts* on page 1. Also see *Unsolicited invitation to bid* on page 1. If no requests were received and no agreements were entered into or in effect, enter "No."

Line 13b

Use a separate line for each country, person, and type of participation or cooperation. Do not use separate lines for similar types of participation or cooperation by the same person in the same country.

Column (2). Enter the identifying number of the person receiving the request or having the agreement.

Columns (3) and (4). Enter in column (3) the principal business activity code number (see the list beginning on page 6) of the person receiving the request or the person who has the agreement. Enter in column (4) a brief description of the principal business activity of that person.

Column (5). IC-DISCs are required to enter the product code from Form 1120-IC-DISC, Schedule N, line 1a.

Columns (6) and (8). Enter in column (6) the total number of requests of the same type that were received by the same person in the same country. Enter in column (8) the total number of agreements of the same type that were entered into by the same person in the same country.

Columns (7) and (9). Enter in column (7) the code number listed in the following chart that indicates the type of participation or cooperation requested. Enter in column (9) the code number listed in the following chart that indicates the type of participation or cooperation agreed to.

Code Number	Type of Cooperation or Participation Requested or Agreed to
01	Refrain from doing business with or in a country that is the object of the boycott or with the government, companies, or nationals of that country.
02	Refrain from doing business with any U.S. person engaged in trade in a country that is the object of the boycott or with the government, companies, or nationals of that country.
03	Refrain from doing business with any company whose ownership or management is made up, in whole or in part, of individuals of a particular nationality, race, or religion, or to remove (or refrain from selecting) corporate directors who are individuals of a particular nationality, race, or religion.
04	Refrain from employing individuals of a particular nationality, race, or religion.
05	As a condition of the sale of a product to the government, a company, or a national of a country, to refrain from shipping or insuring products on a carrier owned, leased, or operated by a person who does not participate in or cooperate with an international boycott.

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Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated burden for individual taxpayers filing this form is approved under OMB control number 1545-0074 and is included in the estimates shown in the instructions for their individual income tax return. The estimated burden for all other taxpayers who file this form is shown below.

Form	Recordkeeping	Learning about the law or the form	Preparing and sending the form to the IRS
5713	22 hr., 0 min.	2 hr., 21 min.	4 hr., 1 min.
Sch. A (5713)	3 hr., 6 min.	12 min.	15 min.
Sch. B (5713)	3 hr., 21 min.	1 hr., 59 min.	2 hr., 7 min.
Sch. C (5713)	5 hr., 15 min.	1 hr., 47 min.	1 hr., 57 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form and related schedules simpler, we would be happy to hear from you. You can write to the Internal Revenue Service, Tax Products Coordinating Committee, SE:W:CAR:MP:T:T:SP, 1111 Constitution Ave. NW, IR-6526, Washington, DC 20224. **Do not** send the tax form to this office. Instead, see *When and Where To File* on page 1.

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Form 5713

Principal Business Activity Codes

This list of principal business activities and their associated codes is designed to classify an enterprise by the type of activity in which it is engaged to facilitate the administration of the Internal Revenue Code. These principal business activity codes are based on the North American Industry Classification System.

Using the list below enter the code for the specific industry group from which the largest percentage of the total receipts is derived.

Agriculture, Forestry, Fishing and Hunting

Crop Production

Code	
111100	Oilseed & Grain Farming
111210	Vegetable & Melon Farming (including potatoes & yams)
111300	Fruit & Tree Nut Farming
111400	Greenhouse, Nursery, & Floriculture Production
111900	Other Crop Farming (including tobacco, cotton, sugarcane, hay, peanut, sugar beet & all other crop farming)

Animal Production

Code	
112111	Beef Cattle Ranching & Farming
112112	Cattle Feedlots
112120	Dairy Cattle & Milk Production
112210	Hog & Pig Farming
112300	Poultry & Egg Production
112400	Sheep & Goat Farming
112510	Aquaculture (including shellfish & finfish farms & hatcheries)
112900	Other Animal Production

Forestry and Logging

Code	
113110	Timber Tract Operations
113210	Forest Nurseries & Gathering of Forest Products
113310	Logging

Fishing, Hunting and Trapping

Code	
114110	Fishing
114210	Hunting & Trapping

Support Activities for Agriculture and Forestry

Code	
115110	Support Activities for Crop Production (including cotton ginning, soil preparation, planting, & cultivating)
115210	Support Activities for Animal Production
115310	Support Activities For Forestry

Mining

Code	
211110	Oil & Gas Extraction
212110	Coal Mining
212200	Metal Ore Mining
212310	Stone Mining & Quarrying
212320	Sand, Gravel, Clay, & Ceramic & Refractory Minerals Mining & Quarrying
212390	Other Nonmetallic Mineral Mining & Quarrying
213110	Support Activities for Mining

Utilities

Code	
221100	Electric Power Generation, Transmission & Distribution
221210	Natural Gas Distribution
221300	Water, Sewage & Other Systems
221500	Combination Gas & Electric

Construction

Construction of Buildings

Code	
236110	Residential Building Construction
236200	Nonresidential Building Construction

Heavy and Civil Engineering Construction

Code	
237100	Utility System Construction
237210	Land Subdivision
237310	Highway, Street, & Bridge Construction
237990	Other Heavy & Civil Engineering Construction

Specialty Trade Contractors

Code	
238100	Foundation, Structure, & Building Exterior Contractors (including framing carpentry, masonry, glass, roofing, & siding)
238210	Electrical Contractors
238220	Plumbing, Heating, & Air-Conditioning Contractors
238290	Other Building Equipment Contractors
238300	Building Finishing Contractors (including drywall, insulation, painting, wallcovering, flooring, tile, & finish carpentry)
238900	Other Specialty Trade Contractors (including site preparation)

Manufacturing

Food Manufacturing

Code	
311110	Animal Food Mfg
311200	Grain & Oilseed Milling
311300	Sugar & Confectionery Product Mfg
311400	Fruit & Vegetable Preserving & Specialty Food Mfg
311500	Dairy Product Mfg
311610	Animal Slaughtering and Processing
311710	Seafood Product Preparation & Packaging
311800	Bakeries & Tortilla Mfg
311900	Other Food Mfg (including coffee, tea, flavorings & seasonings)

Beverage and Tobacco Product Manufacturing

Code	
312110	Soft Drink & Ice Mfg
312120	Breweries
312130	Wineries
312140	Distilleries
312200	Tobacco Manufacturing

Textile Mills and Textile Product Mills

Code	
313000	Textile Mills
314000	Textile Product Mills

Apparel Manufacturing

Code	
315100	Apparel Knitting Mills
315210	Cut & Sew Apparel Contractors
315220	Men's & Boys' Cut & Sew Apparel Mfg
315230	Women's & Girls' Cut & Sew Apparel Mfg
315290	Other Cut & Sew Apparel Mfg
315990	Apparel Accessories & Other Apparel Mfg

Leather and Allied Product Manufacturing

Code	
316110	Leather & Hide Tanning & Finishing
316210	Footwear Mfg (including rubber & plastics)
316990	Other Leather & Allied Product Mfg

Wood Product Manufacturing

Code	
321110	Sawmills & Wood Preservation
321210	Veneer, Plywood, & Engineered Wood Product Mfg
321900	Other Wood Product Mfg

Paper Manufacturing

Code	
322100	Pulp, Paper, & Paperboard Mills
322200	Converted Paper Product Mfg

Printing and Related Support Activities

Code	
323100	Printing & Related Support Activities

Petroleum and Coal Products Manufacturing

Code	
324110	Petroleum Refineries (including integrated)
324120	Asphalt Paving, Roofing, & Saturated Materials Mfg
324190	Other Petroleum & Coal Products Mfg

Chemical Manufacturing

Code	
325100	Basic Chemical Mfg
325200	Resin, Synthetic Rubber, & Artificial & Synthetic Fibers & Filaments Mfg
325300	Pesticide, Fertilizer, & Other Agricultural Chemical Mfg
325410	Pharmaceutical & Medicine Mfg
325500	Paint, Coating, & Adhesive Mfg
325600	Soap, Cleaning Compound, & Toilet Preparation Mfg
325900	Other Chemical Product & Preparation Mfg

Plastics and Rubber Products Manufacturing

Code	
326100	Plastics Product Mfg
326200	Rubber Product Mfg

Nonmetallic Mineral Product Manufacturing

Code	
327100	Clay Product & Refractory Mfg
327210	Glass & Glass Product Mfg
327300	Cement & Concrete Product Mfg
327400	Lime & Gypsum Product Mfg
327900	Other Nonmetallic Mineral Product Mfg

Primary Metal Manufacturing

Code	
331110	Iron & Steel Mills & Ferroalloy Mfg
331200	Steel Product Mfg from Purchased Steel
331310	Alumina & Aluminum Production & Processing
331400	Nonferrous Metal (except Aluminum) Production & Processing
331500	Foundries

Fabricated Metal Product Manufacturing

Code	
332110	Forging & Stamping
332210	Cutlery & Handtool Mfg
332300	Architectural & Structural Metals Mfg
332400	Boiler, Tank, & Shipping Container Mfg
332510	Hardware Mfg
332610	Spring & Wire Product Mfg
332700	Machine Shops; Turned Product; & Screw, Nut, & Bolt Mfg
332810	Coating, Engraving, Heat Treating, & Allied Activities
332900	Other Fabricated Metal Product Mfg

Machinery Manufacturing

Code	
333100	Agriculture, Construction, & Mining Machinery Mfg
333200	Industrial Machinery Mfg
333310	Commercial & Service Industry Machinery Mfg
333410	Ventilation, Heating, Air-Conditioning, & Commercial Refrigeration Equipment Mfg
333510	Metalworking Machinery Mfg
333610	Engine, Turbine & Power Transmission Equipment Mfg
333900	Other General Purpose Machinery Mfg

Computer and Electronic Product Manufacturing

Code	
334110	Computer & Peripheral Equipment Mfg
334200	Communications Equipment Mfg
334310	Audio & Video Equipment Mfg
334410	Semiconductor & Other Electronic Component Mfg
334500	Navigational, Measuring, Electromedical, & Control Instruments Mfg
334610	Manufacturing & Reproducing Magnetic & Optical Media

Electrical Equipment, Appliance, and Component Manufacturing

Code	
335100	Electric Lighting Equipment Mfg
335200	Household Appliance Mfg
335310	Electrical Equipment Mfg
335900	Other Electrical Equipment & Component Mfg

Transportation Equipment Manufacturing

Code	
336100	Motor Vehicle Mfg
336210	Motor Vehicle Body & Trailer Mfg
336300	Motor Vehicle Parts Mfg
336410	Aerospace Product & Parts Mfg
336510	Railroad Rolling Stock Mfg
336610	Ship & Boat Building
336990	Other Transportation Equipment Mfg

Furniture and Related Product Manufacturing

Code	
337000	Furniture & Related Product Manufacturing

Miscellaneous Manufacturing

Code	
339110	Medical Equipment & Supplies Mfg
339900	Other Miscellaneous Manufacturing

Wholesale Trade

Merchant Wholesalers, Durable Goods

Code	
423100	Motor Vehicle & Motor Vehicle Parts & Supplies
423200	Furniture & Home Furnishings
423300	Lumber & Other Construction Materials
423400	Professional & Commercial Equipment & Supplies
423500	Metal & Mineral (except Petroleum)
423600	Electrical & Electronic Goods
423700	Hardware, & Plumbing & Heating Equipment & Supplies
423800	Machinery, Equipment, & Supplies
423910	Sporting & Recreational Goods & Supplies
423920	Toy & Hobby Goods & Supplies
423930	Recyclable Materials
423940	Jewelry, Watch, Precious Stone, & Precious Metals
423990	Other Miscellaneous Durable Goods

Merchant Wholesalers, Nondurable Goods

Code	
424100	Paper & Paper Products
424210	Drugs & Druggists' Sundries

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Form 5713 *(continued)*

Code	
424300	Apparel, Piece Goods, & Notions
424400	Grocery & Related Products
424500	Farm Product Raw Materials
424600	Chemical & Allied Products
424700	Petroleum & Petroleum Products
424800	Beer, Wine, & Distilled Alcoholic Beverages
424910	Farm Supplies
424920	Book, Periodical, & Newspapers
424930	Flower, Nursery Stock, & Florists' Supplies
424940	Tobacco & Tobacco Products
424950	Paint, Varnish, & Supplies
424990	Other Miscellaneous Nondurable Goods

Wholesale Electronic Markets and Agents and Brokers

425110	Business to Business Electronic Markets
425120	Wholesale Trade Agents & Brokers

Retail Trade

Motor Vehicle and Parts Dealers

441110	New Car Dealers
441120	Used Car Dealers
441210	Recreational Vehicle Dealers
441221	Motorcycle Dealers
441222	Boat Dealers
441229	All Other Motor Vehicle Dealers
441300	Automotive Parts, Accessories, & Tire Stores

Furniture and Home Furnishings Stores

442110	Furniture Stores
442210	Floor Covering Stores
442291	Window Treatment Stores
442299	All Other Home Furnishings Stores

Electronics and Appliance Stores

443111	Household Appliance Stores
443112	Radio, Television, & Other Electronics Stores
443120	Computer & Software Stores
443130	Camera & Photographic Supplies Stores

Building Material and Garden Equipment and Supplies Dealers

444110	Home Centers
444120	Paint & Wallpaper Stores
444130	Hardware Stores
444190	Other Building Material Dealers
444200	Lawn & Garden Equipment & Supplies Stores

Food and Beverage Stores

445110	Supermarkets and Other Grocery (except Convenience) Stores
445120	Convenience Stores
445210	Meat Markets
445220	Fish & Seafood Markets
445230	Fruit & Vegetable Markets
445291	Baked Goods Stores
445292	Confectionery & Nut Stores
445299	All Other Specialty Food Stores
445310	Beer, Wine, & Liquor Stores

Health and Personal Care Stores

446110	Pharmacies & Drug Stores
446120	Cosmetics, Beauty Supplies, & Perfume Stores
446130	Optical Goods Stores
446190	Other Health & Personal Care Stores

Gasoline Stations

447100	Gasoline Stations (including convenience stores with gas)

Code

Clothing and Clothing Accessories Stores

448110	Men's Clothing Stores
448120	Women's Clothing Stores
448130	Children's & Infants' Clothing Stores
448140	Family Clothing Stores
448150	Clothing Accessories Stores
448190	Other Clothing Stores
448210	Shoe Stores
448310	Jewelry Stores
448320	Luggage & Leather Goods Stores

Sporting Goods, Hobby, Book, and Music Stores

451110	Sporting Goods Stores
451120	Hobby, Toy, & Game Stores
451130	Sewing, Needlework, & Piece Goods Stores
451140	Musical Instrument & Supplies Stores
451211	Book Stores
451212	News Dealers & Newsstands
451220	Prerecorded Tape, Compact Disc, & Record Stores

General Merchandise Stores

452110	Department Stores
452900	Other General Merchandise Stores

Miscellaneous Store Retailers

453110	Florists
453210	Office Supplies & Stationery Stores
453220	Gift, Novelty, & Souvenir Stores
453310	Used Merchandise Stores
453910	Pet & Pet Supplies Stores
453920	Art Dealers
453930	Manufactured (Mobile) Home Dealers
453990	All Other Miscellaneous Store Retailers (including tobacco, candle, & trophy shops)

Nonstore Retailers

454110	Electronic Shopping & Mail-Order Houses
454210	Vending Machine Operators
454311	Heating Oil Dealers
454312	Liquefied Petroleum Gas (Bottled Gas) Dealers
454319	Other Fuel Dealers
454390	Other Direct Selling Establishments (including door-to-door retailing, frozen food plan providers, party plan merchandisers, & coffee-break service providers)

Transportation and Warehousing

Air, Rail, and Water Transportation

481000	Air Transportation
482110	Rail Transportation
483000	Water Transportation

Truck Transportation

484110	General Freight Trucking, Local
484120	General Freight Trucking, Long-distance
484200	Specialized Freight Trucking

Transit and Ground Passenger Transportation

485110	Urban Transit Systems
485210	Interurban & Rural Bus Transportation
485310	Taxi Service
485320	Limousine Service
485410	School & Employee Bus Transportation
485510	Charter Bus Industry
485990	Other Transit & Ground Passenger Transportation

Code

Pipeline Transportation

486000	Pipeline Transportation

Scenic & Sightseeing Transportation

487000	Scenic & Sightseeing Transportation

Support Activities for Transportation

488100	Support Activities for Air Transportation
488210	Support Activities for Rail Transportation
488300	Support Activities for Water Transportation
488410	Motor Vehicle Towing
488490	Other Support Activities for Road Transportation
488510	Freight Transportation Arrangement
488990	Other Support Activities for Transportation

Couriers and Messengers

492110	Couriers
492210	Local Messengers & Local Delivery

Warehousing and Storage

493100	Warehousing & Storage (except lessors of miniwarehouses & self-storage units)

Information

Publishing Industries (except Internet)

511110	Newspaper Publishers
511120	Periodical Publishers
511130	Book Publishers
511140	Directory & Mailing List Publishers
511190	Other Publishers
511210	Software Publishers

Motion Picture and Sound Recording Industries

512100	Motion Picture & Video Industries (except video rental)
512200	Sound Recording Industries

Broadcasting (except Internet)

515100	Radio & Television Broadcasting
515210	Cable & Other Subscription Programming

Telecommunications

517000	Telecommunications (including paging, cellular, satellite, cable & other program distribution, resellers, & other telecommunications) and internet service providers

Data Processing Services

518210	Data Processing, Hosting, & Related Services

Other Information Services

519100	Other Information Services (including news syndicates & libraries), internet publishing and broadcasting

Finance and Insurance

Depository Credit Intermediation

522110	Commercial Banking
522120	Savings Institutions
522130	Credit Unions
522190	Other Depository Credit Intermediation

Nondepository Credit Intermediation

522210	Credit Card Issuing
522220	Sales Financing
522291	Consumer Lending
522292	Real Estate Credit (including mortgage bankers & originators)
522293	International Trade Financing
522294	Secondary Market Financing
522298	All Other Nondepository Credit Intermediation

Code

Activities Related to Credit Intermediation

522300	Activities Related to Credit Intermediation (including loan brokers, check clearing, & money transmitting)

Securities, Commodity Contracts, and Other Financial Investments and Related Activities

523110	Investment Banking & Securities Dealing
523120	Securities Brokerage
523130	Commodity Contracts Dealing
523140	Commodity Contracts Brokerage
523210	Securities & Commodity Exchanges
523900	Other Financial Investment Activities (including portfolio management & investment advice)

Insurance Carriers and Related Activities

524140	Direct Life, Health, & Medical Insurance & Reinsurance Carriers
524150	Direct Insurance & Reinsurance (except Life, Health & Medical) Carriers
524210	Insurance Agencies & Brokerages
524290	Other Insurance Related Activities (including third-party administration of insurance and pension funds)

Funds, Trusts, and Other Financial Vehicles

525100	Insurance & Employee Benefit Funds
525910	Open-End Investment Funds (Form 1120-RIC)
525920	Trusts, Estates, & Agency Accounts
525990	Other Financial Vehicles (including closed-end investment funds) including mortgage REITs

"Offices of Bank Holding Companies" and "Offices of Other Holding Companies" are located under Management of Companies (Holding Companies) on page 8.

Real Estate and Rental and Leasing

Real Estate

531110	Lessors of Residential Buildings & Dwellings (including equity REITs)
531114	Cooperative Housing (including equity REITs)
531120	Lessors of Nonresidential Buildings (except Miniwarehouses) (including equity REITs)
531130	Lessors of Miniwarehouses & Self-Storage Units (including equity REITs)
531190	Lessors of Other Real Estate Property (including equity REITs)
531210	Offices of Real Estate Agents & Brokers
531310	Real Estate Property Managers
531320	Offices of Real Estate Appraisers
531390	Other Activities Related to Real Estate

Rental and Leasing Services

532100	Automotive Equipment Rental & Leasing
532210	Consumer Electronics & Appliances Rental
532220	Formal Wear & Costume Rental
532230	Video Tape & Disc Rental

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Form 5713 *(continued)*

Code

532290	Other Consumer Goods Rental
532310	General Rental Centers
532400	Commercial & Industrial Machinery & Equipment Rental & Leasing

Lessors of Nonfinancial Intangible Assets (except copyrighted works)

533110	Lessors of Nonfinancial Intangible Assets (except copyrighted works)

Professional, Scientific, and Technical Services

Legal Services

541110	Offices of Lawyers
541190	Other Legal Services

Accounting, Tax Preparation, Bookkeeping, and Payroll Services

541211	Offices of Certified Public Accountants
541213	Tax Preparation Services
541214	Payroll Services
541219	Other Accounting Services

Architectural, Engineering, and Related Services

541310	Architectural Services
541320	Landscape Architecture Services
541330	Engineering Services
541340	Drafting Services
541350	Building Inspection Services
541360	Geophysical Surveying & Mapping Services
541370	Surveying & Mapping (except Geophysical) Services
541380	Testing Laboratories

Specialized Design Services

541400	Specialized Design Services (including interior, industrial, graphic, & fashion design)

Computer Systems Design and Related Services

541511	Custom Computer Programming Services
541512	Computer Systems Design Services
541513	Computer Facilities Management Services
541519	Other Computer Related Services

Other Professional, Scientific, and Technical Services

541600	Management, Scientific, & Technical Consulting Services
541700	Scientific Research & Development Services
541800	Advertising & Related Services
541910	Marketing Research & Public Opinion Polling
541920	Photographic Services
541930	Translation & Interpretation Services
541940	Veterinary Services
541990	All Other Professional, Scientific, & Technical Services

Management of Companies (Holding Companies)

551111	Offices of Bank Holding Companies
551112	Offices of Other Holding Companies

Code

Administrative and Support and Waste Management and Remediation Services

Administrative and Support Services

561110	Office Administrative Services
561210	Facilities Support Services
561300	Employment Services
561410	Document Preparation Services
561420	Telephone Call Centers
561430	Business Service Centers (including private mail centers & copy shops)
561440	Collection Agencies
561450	Credit Bureaus
561490	Other Business Support Services (including repossession services, court reporting, & stenotype services)
561500	Travel Arrangement & Reservation Services
561600	Investigation & Security Services
561710	Exterminating & Pest Control Services
561720	Janitorial Services
561730	Landscaping Services
561740	Carpet & Upholstery Cleaning Services
561790	Other Services to Buildings & Dwellings
561900	Other Support Services (including packaging & labeling services, & convention & trade show organizers)

Waste Management and Remediation Services

562000	Waste Management & Remediation Services

Educational Services

611000	Educational Services (including schools, colleges, & universities)

Health Care and Social Assistance

Offices of Physicians and Dentists

621111	Offices of Physicians (except mental health specialists)
621112	Offices of Physicians, Mental Health Specialists
621210	Offices of Dentists

Offices of Other Health Practitioners

621310	Offices of Chiropractors
621320	Offices of Optometrists
621330	Offices of Mental Health Practitioners (except Physicians)
621340	Offices of Physical, Occupational & Speech Therapists, & Audiologists
621391	Offices of Podiatrists
621399	Offices of All Other Miscellaneous Health Practitioners

Outpatient Care Centers

621410	Family Planning Centers
621420	Outpatient Mental Health & Substance Abuse Centers

Code

621491	HMO Medical Centers
621492	Kidney Dialysis Centers
621493	Freestanding Ambulatory Surgical & Emergency Centers
621498	All Other Outpatient Care Centers

Medical and Diagnostic Laboratories

621510	Medical & Diagnostic Laboratories

Home Health Care Services

621610	Home Health Care Services

Other Ambulatory Health Care Services

621900	Other Ambulatory Health Care Services (including ambulance services & blood & organ banks)

Hospitals

622000	Hospitals

Nursing and Residential Care Facilities

623000	Nursing & Residential Care Facilities

Social Assistance

624100	Individual & Family Services
624200	Community Food & Housing, & Emergency & Other Relief Services
624310	Vocational Rehabilitation Services
624410	Child Day Care Services

Arts, Entertainment, and Recreation

Performing Arts, Spectator Sports, and Related Industries

711100	Performing Arts Companies
711210	Spectator Sports (including sports clubs & racetracks)
711300	Promoters of Performing Arts, Sports, & Similar Events
711410	Agents & Managers for Artists, Athletes, Entertainers, & Other Public Figures
711510	Independent Artists, Writers, & Performers

Museums, Historical Sites, and Similar Institutions

712100	Museums, Historical Sites, & Similar Institutions

Amusement, Gambling, and Recreation Industries

713100	Amusement Parks & Arcades
713200	Gambling Industries
713900	Other Amusement & Recreation Industries (including golf courses, skiing facilities, marinas, fitness centers, & bowling centers)

Accommodation and Food Services

Accommodation

721110	Hotels (except Casino Hotels) & Motels
721120	Casino Hotels
721191	Bed & Breakfast Inns
721199	All Other Traveler Accommodation

Code

721210	RV (Recreational Vehicle) Parks & Recreational Camps
721310	Rooming & Boarding Houses

Food Services and Drinking Places

722110	Full-Service Restaurants
722210	Limited-Service Eating Places
722300	Special Food Services (including food service contractors & caterers)
722410	Drinking Places (Alcoholic Beverages)

Other Services

Repair and Maintenance

811110	Automotive Mechanical & Electrical Repair & Maintenance
811120	Automotive Body, Paint, Interior, & Glass Repair
811190	Other Automotive Repair & Maintenance (including oil change & lubrication shops & car washes)
811210	Electronic & Precision Equipment Repair & Maintenance
811310	Commercial & Industrial Machinery & Equipment (except Automotive & Electronic) Repair & Maintenance
811410	Home & Garden Equipment & Appliance Repair & Maintenance
811420	Reupholstery & Furniture Repair
811430	Footwear & Leather Goods Repair
811490	Other Personal & Household Goods Repair & Maintenance

Personal and Laundry Services

812111	Barber Shops
812112	Beauty Salons
812113	Nail Salons
812190	Other Personal Care Services (including diet & weight reducing centers)
812210	Funeral Homes & Funeral Services
812220	Cemeteries & Crematories
812310	Coin-Operated Laundries & Drycleaners
812320	Drycleaning & Laundry Services (except Coin-Operated)
812330	Linen & Uniform Supply
812910	Pet Care (except Veterinary) Services
812920	Photofinishing
812930	Parking Lots & Garages
812990	All Other Personal Services

Religious, Grantmaking, Civic, Professional, and Similar Organizations

813000	Religious, Grantmaking, Civic, Professional, & Similar Organizations (including condominium and homeowners associations)

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International Investing Inbound and Outbound Considerations & Techniques

15th Annual International Tax Symposium

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Overview

- Tax issues abound in international transactions
- Structures are extremely important
- Advance planning is essential to avoid future surprises
- Available time only permits us to skim the treetops

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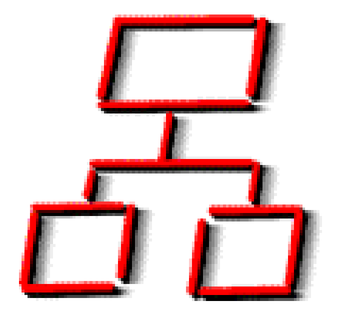
International Tax Issues Abound . . .



- Investment Stage
  - Choice of entity (type, jurisdiction, *etc*.)
  - Funding
  - Affects formation, repatriation, and exit
- Operations Stage
  - Timing recognition of income
  - Deferral?
- Remittances/Exit
  - Types
  - Relief from double tax

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Objectives

- Efficient cash flows
- Avoidance of double (or triple) tax
- Deferral

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Considerations

- Income taxes
- Withholding taxes
- State & local taxes
- Inheritance, estate & gift taxes
- Other taxes
  - VAT, stamp taxes
  - Wealth, asset taxes
- Transfer pricing
- Offsets
  - Exclusions, credits

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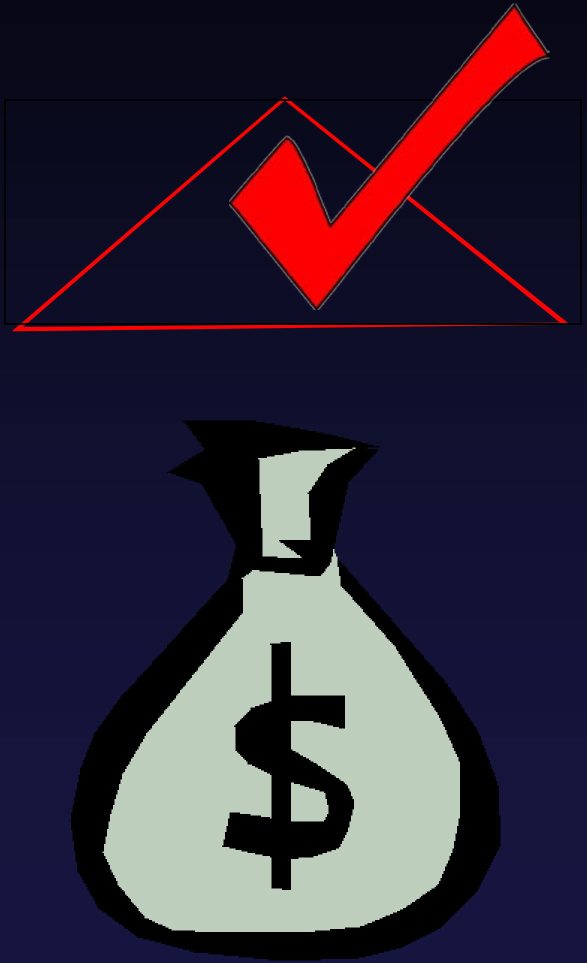
Typical techniques



- Structures
  - Check-the-box entities
  - Treaty shopping
  - FTC planning
- Financing/cash flow methods
  - Equity
  - Debt
    - Current deductions
    - Withholding taxes
  - Hybrid instruments
  - Components
    - Services
    - Royalties, rentals, etc.

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Recent techniques

- Canadian income trusts
- Canadian amalgamation issue
- In-bound private equity investments
- Private REITs

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Canadian Income Trusts

- An exchange traded investment vehicle to hold equities, debt instruments, royalty interests or real properties.
- Goal: paying out consistent cash flows for investors
  - Particularly attractive when yields on bonds are low
- U.S. equivalent: master limited partnerships (MLPs)

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Canadian Income Trusts – Canadian tax

- An operating entity makes deductible payments (*e.g.*, interest) to an income trust, which can reduce the operating entity’s tax to zero.
- The trust in turn, distributes all of its income received from the operating entity out to unitholders, reducing the trust's taxable income.
- Net result:
  - The trust would also pay little to no income tax.
  - The income is taxed at the unitholder level.

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Canadian Income Trusts – Near Death

- Income trusts became wildly successful in Canada.
- From 2005-11, government announcements and tax revisions ended the tax advantage of income trusts (except REITs) investing in most *Canadian* property.
  - "Halloween Massacre" – October 31, 2006
  - Income trust sector lost 15% of its value

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Canadian Income Trusts – Near Death

- Income trusts have revived with respect to U.S. oil and gas properties.
  - "Foreign asset income trusts" ("FAITs")

- Eagle Energy Trust (2010) – C$169MM IPO
- Parallel Energy Trust (2011) – C$393MM IPO
- Argent Energy Trust (September 2012) – C$212MM IPO

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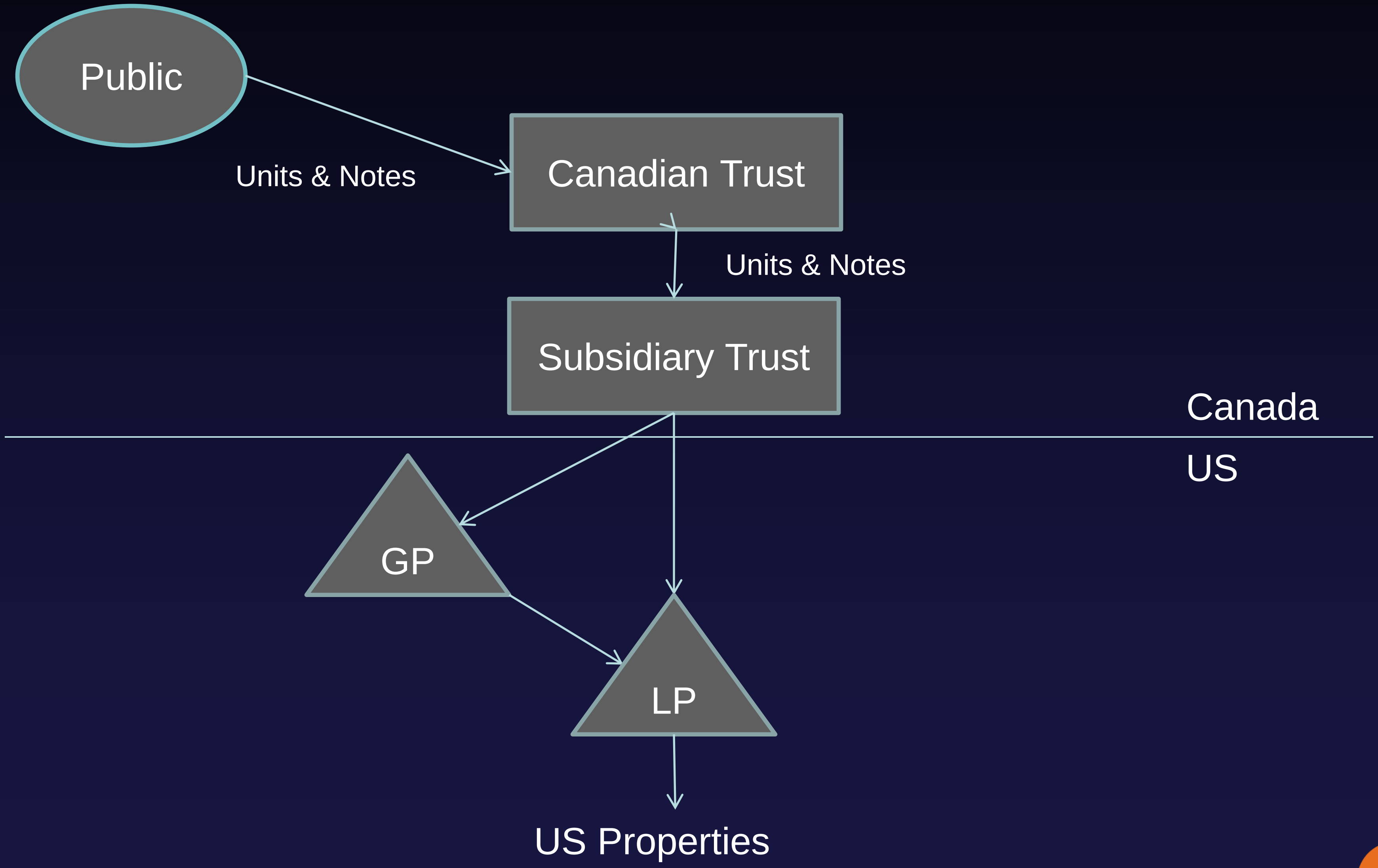
Canadian Income Trusts



Public

Units & Notes

Canadian Trust

Units & Notes

Subsidiary Trust

Canada

US

GP

LP

US Properties

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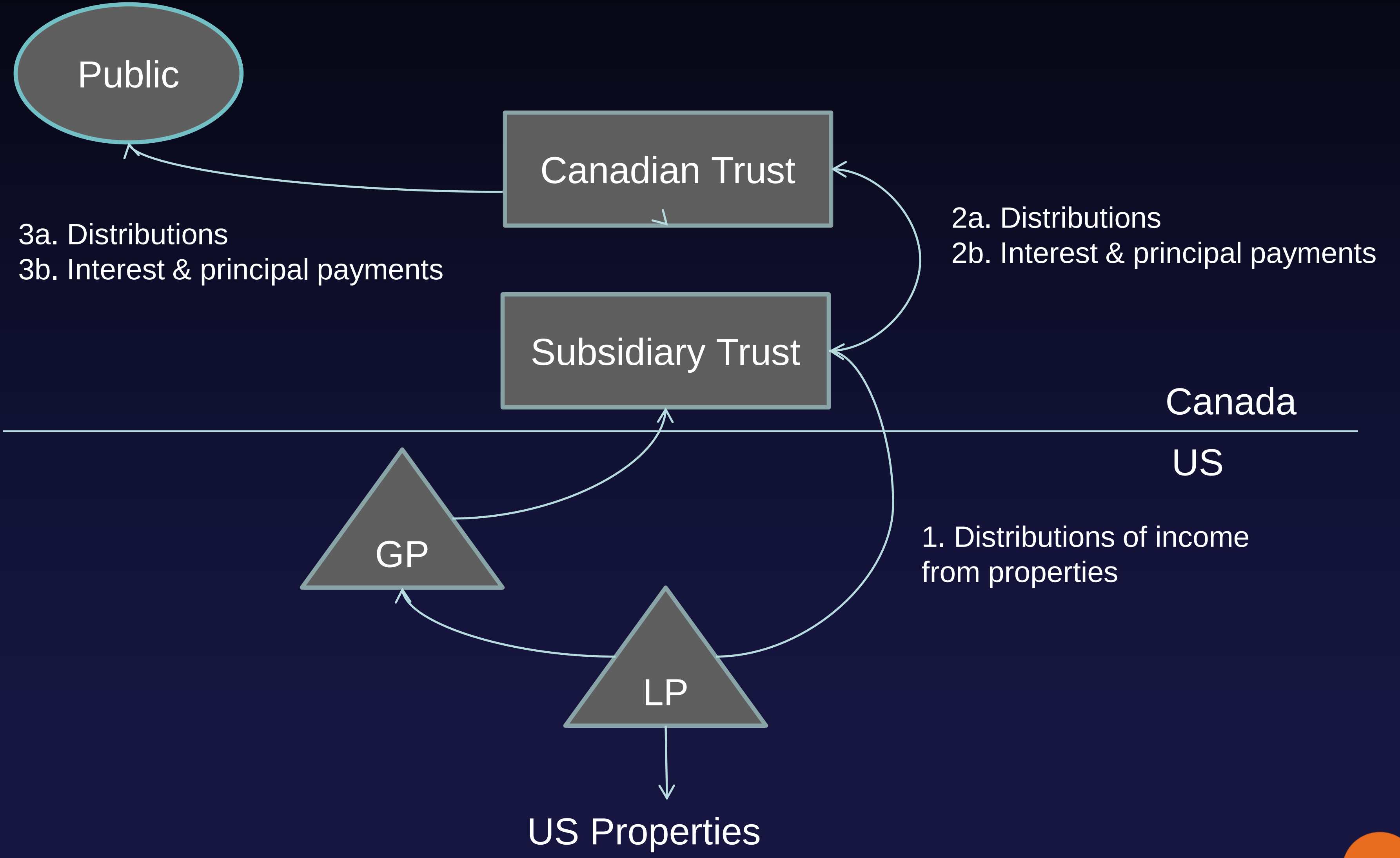
Canadian Income Trusts – Cash Flows



Public

Canadian Trust

3a. Distributions
3b. Interest & principal payments

2a. Distributions
2b. Interest & principal payments

Subsidiary Trust

Canada

US

GP

1. Distributions of income
from properties

LP

US Properties

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Canadian Income Trusts Taxation of Entities

- US GP and US LP are DREs

- Subsidiary Trust
  - Foreign corporation with ECI
  - Branch profits tax (treaty rate of 5%)

- Canadian Trust
  - No US tax
  - Taxed as a Canadian “unit trust”

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Canadian Income Trusts – Tax Issues

- Internal Debt of the Subsidiary Trust
  - Transfer pricing study to support amount of debt and interest rate
  - Section 163(j) limitation
- Anti-Inversion Rules should not apply to the Canadian Trust
  - But see Treas. Reg. 1.7874-2(i)(1)(i) & Treas. Reg. 1.7874-2(k)(2), Example 18.
- Anti-Conduit Financing

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Speaking of Canada . . .

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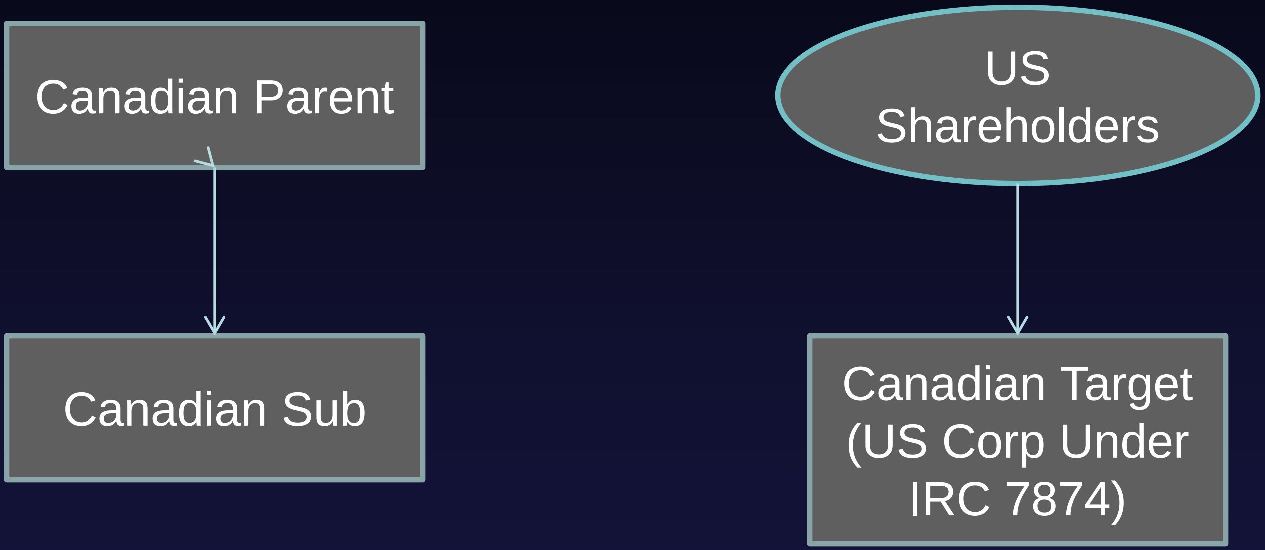
Acquisitions Involving Entities Subject to Section 7874



Canadian Parent

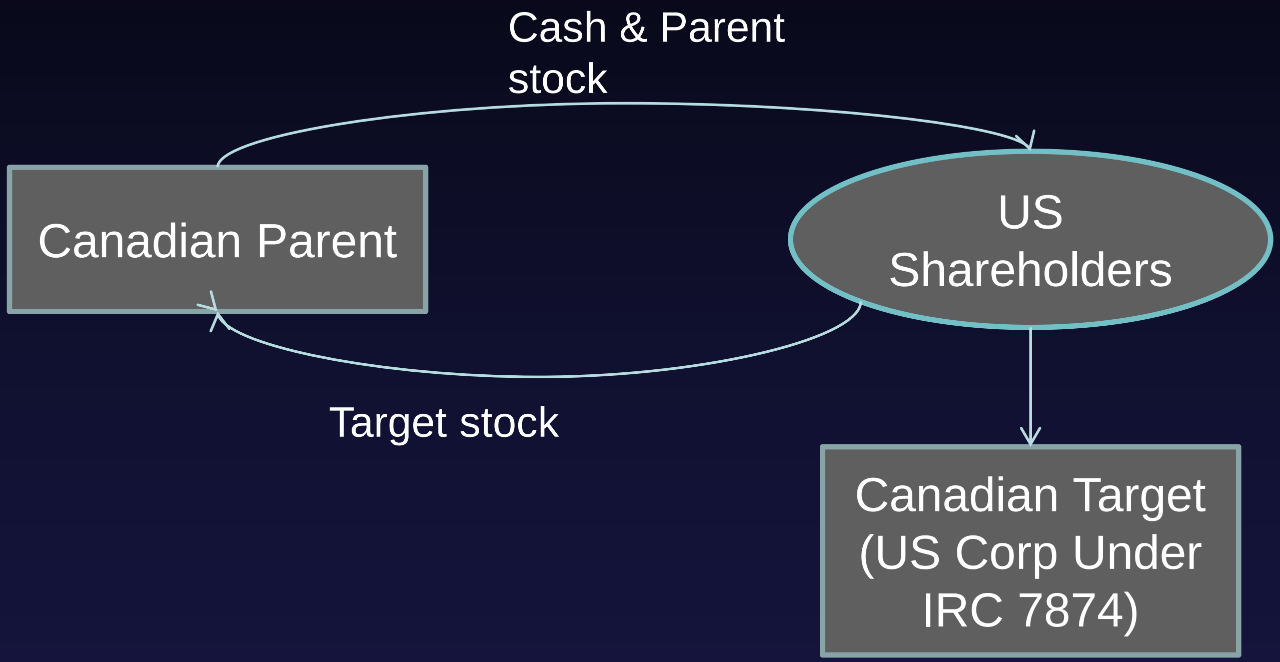
Canadian Sub

US Shareholders

Canadian Target (US Corp Under IRC 7874)

Canadian Parent wants to acquire Target for cash and stock.

Alternative 1 - Parent Stock



Fully taxable exchange for US Shareholders. Cannot qualify as a Type B reorganization.

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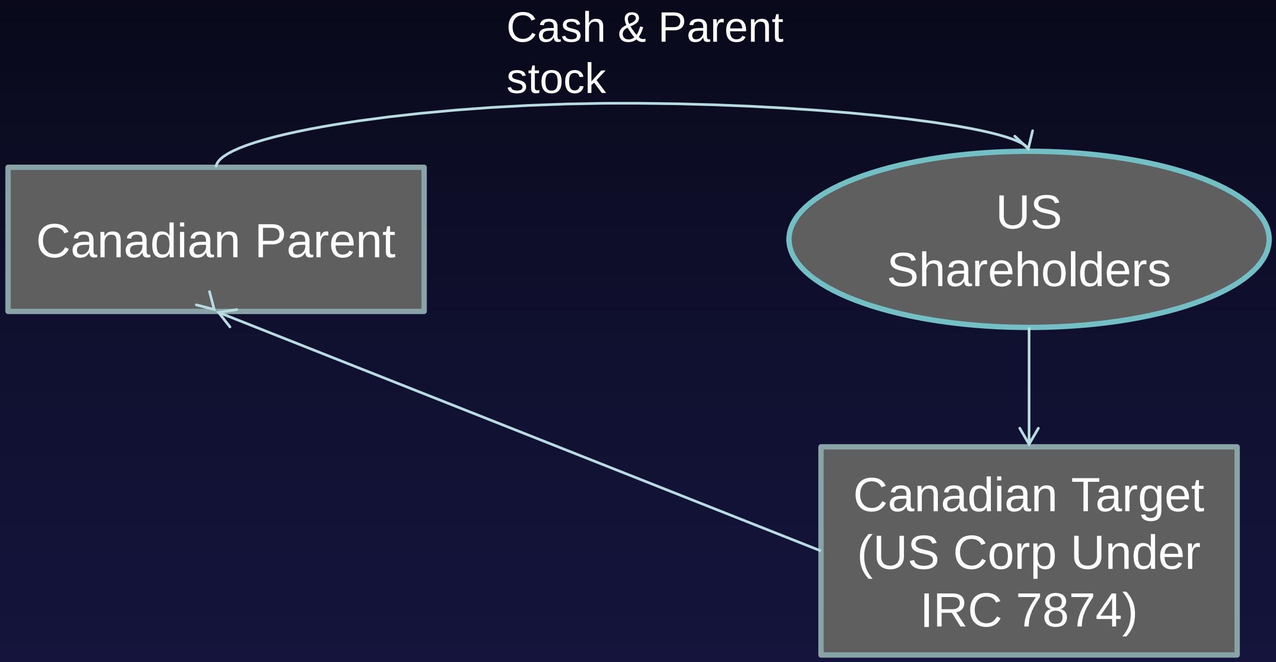
Alternative 2 - Merger into Parent



Cash & Parent stock

Canadian Parent

US Shareholders

Canadian Target (US Corp Under IRC 7874)

Potential corporate level tax under Section 367(a). Consider Sections 367(a)(3) & 367(a)(5).

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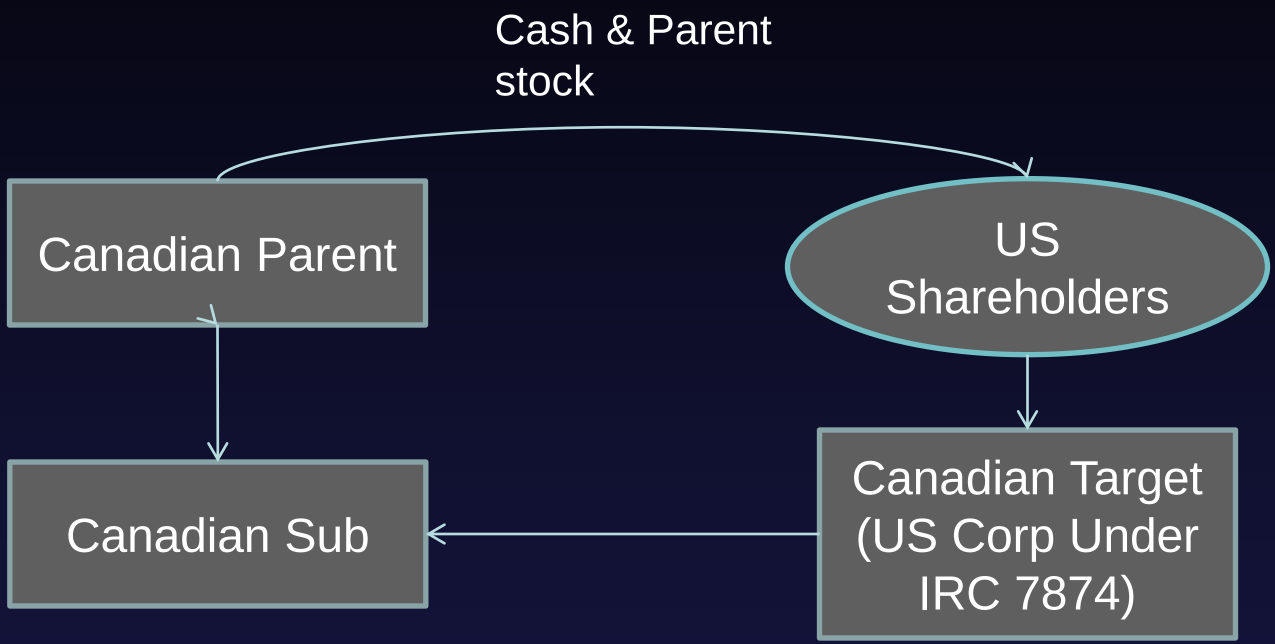
Alternative 3 – Reverse Triangular Merger


Cash & Parent stock

Canadian Parent

US Shareholders

Canadian Sub

Canadian Target (US Corp Under IRC 7874)

1. If Canadian Target survives, not subject to Section 367.
2. If transaction qualifies under Section 368(a)(2)(E), transaction is tax-free except to the extent of boot.
3. Treas. Reg. 1.368-2(j)(2) provides that Section 368(a)(2)(E) does not apply to a consolidation.

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Private Equity – Foreign Investors

- Foreign taxable investors
  - Portfolio interest planning
- Sovereign wealth funds
  - Proposed changes

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Section 892

- Section 892(a) - Income of a foreign government is excluded from gross income if the income is from:
  - Investments in the U.S. in stocks, bonds and other domestic securities;
  - Financial instruments held in the execution of financial or monetary policy; or
  - Interest on deposits in U.S. banks

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Section 892

- Section 892(b) – The exclusion in Section 892(a) does not apply to:
  - Income derived from the conduct of a commercial activity;
  - Income received by or from a controlled commercial entity; or
  - Income derived from the disposition of a controlled commercial entity.

- Controlled commercial entity
  - Engaged in commercial activities anywhere in the world
  - Foreign government owns 50% or more or has effective control of the entity

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Why Does This Matter?

- The significance of the Section 892 exemption is less than may be supposed.

- Capital gains from stock or securities are generally exempt anyway under Section 864(b), but Section 892 trumps FIRPTA by extending to gains on the sale of a noncontrolling (less than 50%) interests in a U.S. real property holding corporation.

- Interest may be exempt as portfolio interest or under a tax treaty…
  - But 892 probably extends to contingent interest, unlike most treaties.
  - And extends to interest received by a 10% or greater shareholder (but must be less than 50% or you have a controlled commercial entity).
  - Section 892 is helpful if the foreign government has no treaty with the US.
- Dividends are generally not entitled to zero rate of withholding under treaties, so this is a clear benefit.
- Exempt dividends include dividends from a non-controlled USRPHCs or REITs.

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Illustration of Practical §892 Applications

The Ideal Situation

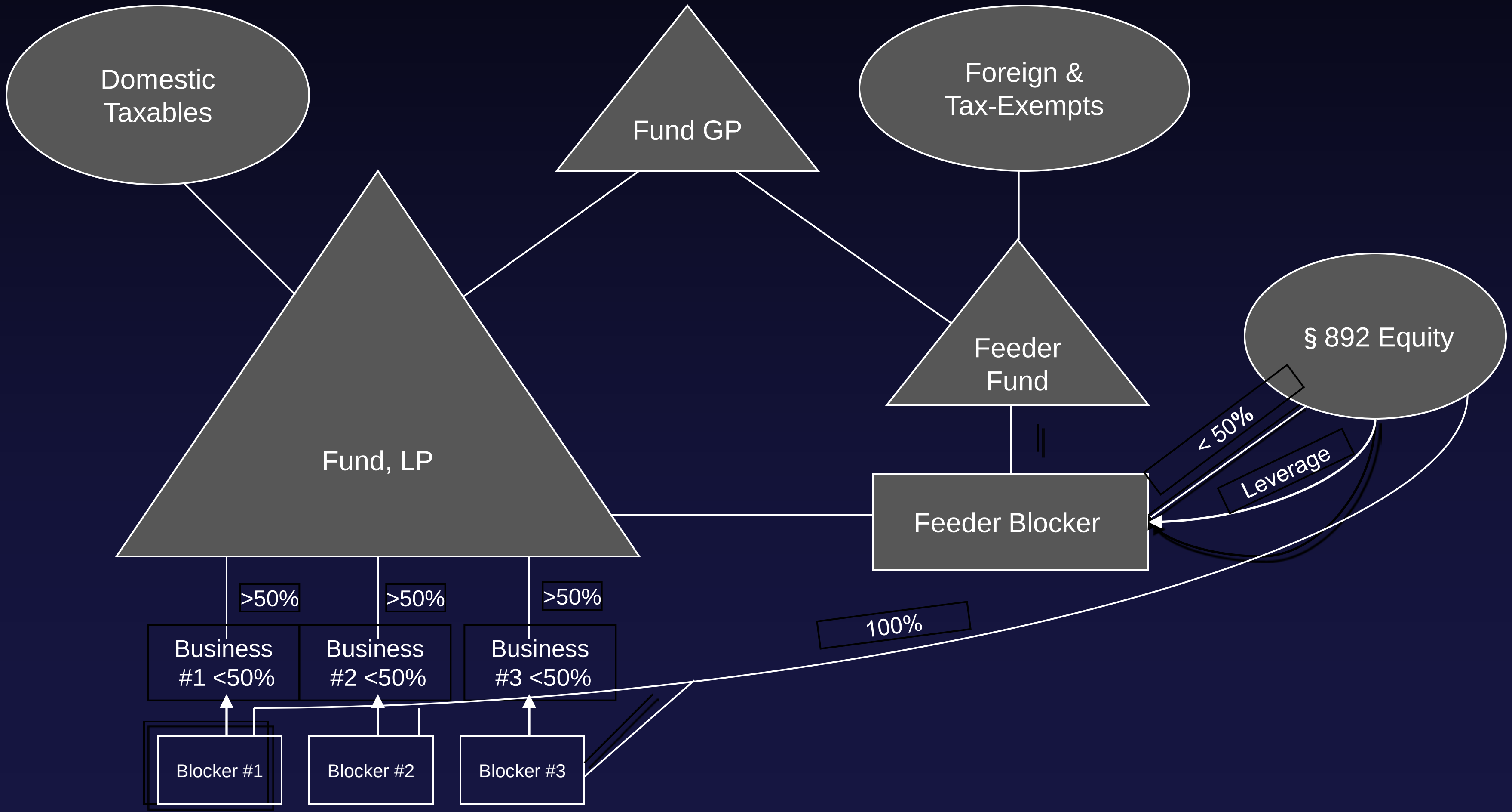

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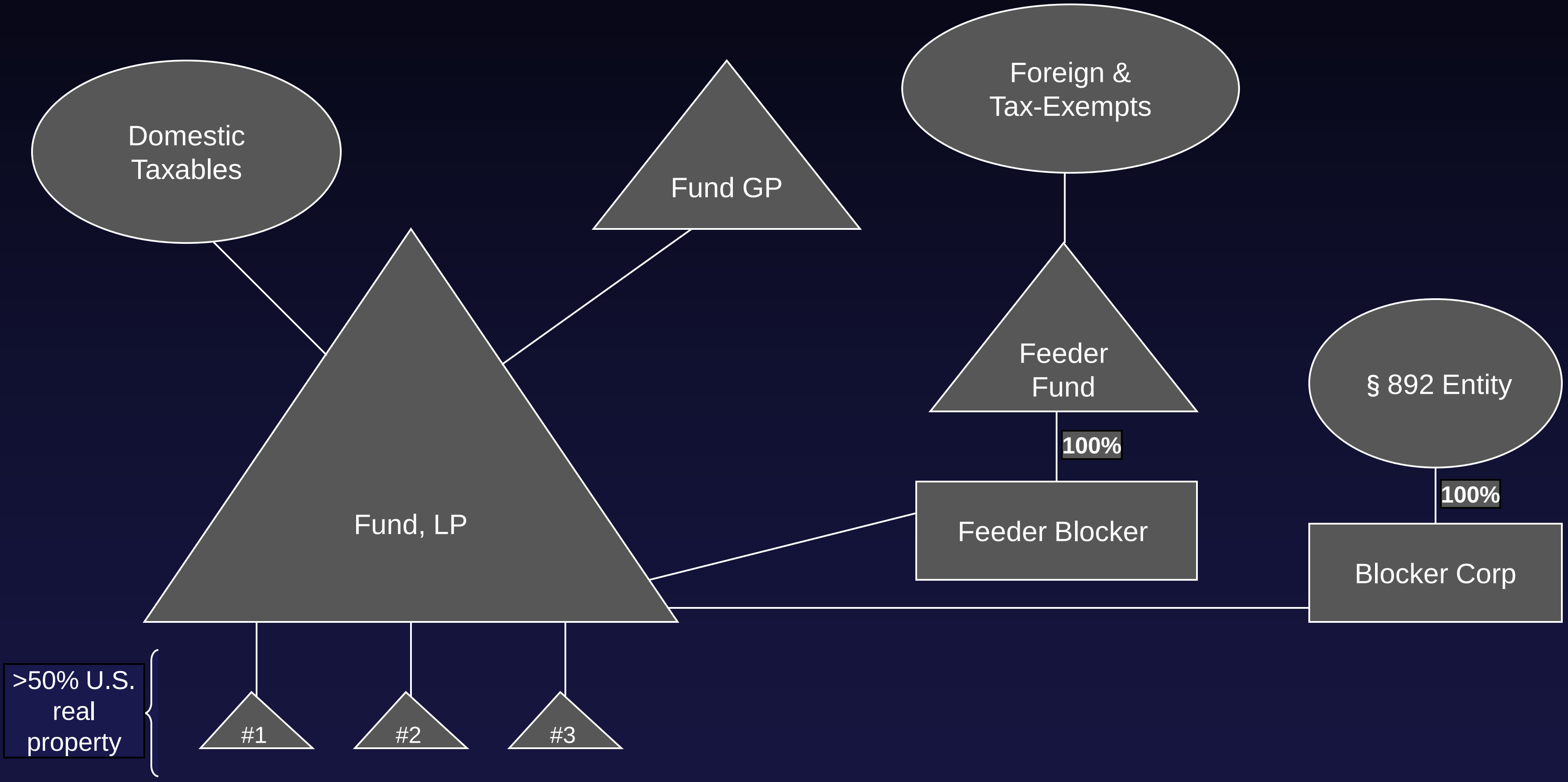
Illustration of Practical §892 Applications (continued)

Situation to Avoid



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Section 892 – Proposed Regulations

- Proposed regulations issued on November 3, 2011
- Proposed regulations liberalize rules regarding when an entity will be engaged in commercial activities.
- Taxpayers can rely on the proposed regulations until final regulations are issued.

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Inadvertent Commercial Activity

- An entity is not considered to engage in commercial activities if it conducts only inadvertent commercial activity. Prop. Reg. 1.892-5(a)(2).

- Three Requirements:
  - Failure to avoid conducting the activity was reasonable;
  - Commercial activity is promptly cured; and
  - Certain record maintenance requirements are met.

- Note: The income from the inadvertent activity does not qualify for the Section 892 exclusion

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Annual Determination of Controlled Commercial Entity Status

- The determination of whether an entity is a controlled commercial entity will be made on an annual basis. Prop. Reg. 1.892-5(a)(3).
- Thus, an entity will not be a controlled commercial entity merely because the entity engaged in commercial activities in a prior year.

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Definition of Commercial Activities

- Investments in financial instruments are not commercial activities, regardless of whether held in the execution of governmental financial or monetary policy. Prop. Reg. 1.892-4(e)(1)(i).

- Trading in financial instruments also is not commercial activity, regardless of whether such financial instruments are held in the execution of governmental financial or monetary policy. Prop. Reg. 1.892-4(e)(1)(ii).

- Disposition of a U.S. real property interest does not constitute the conduct of a commercial activity. Prop. Reg. 1.892-4(e)(1)(iv).

- These new rules apply only for purposes of determining whether a government derives income from a commercial activity or whether an entity is engaged in commercial activities. They do not address whether the income is exempt under Section 892.

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Treatment of Partnerships

- Under Treas. Reg. 1.892-5T(d)(3), commercial activities of a partnership are attributed to its partners, except for partners of MLPs.

- The proposed regulations provide that an entity that is not otherwise engaged in commercial activities will not be treated as engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership. Prop. Reg. 1.892-5(d)(5)(iii).
  - Includes any interest in an entity classified as a partnership for federal tax purposes if the holder does not have rights to participate in management.

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Private REITs

- What is a Real Estate Investment Trust (REIT)?
  - Can be organized as any type of entity (not limited to just trusts);
  - Invests primarily in real estate and real estate debt;
  - Makes a special election to be taxed as a REIT for U.S. federal income tax purposes;
  - Primary benefit is single-layer of federal tax, because dividends are deductible;
  - Must comply with very specific income and asset tests.

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Private REITs

- Why use REITs instead of LPs or LLCs?
  - Access to public markets – REITs can be publicly-traded and pay only a single-layer of tax at shareholder level (contrast other publicly-traded corporations);
  - Public LPs or LLCs generally subject to corporate double-tax unless they qualify for special exception for “MLPs”;
  - Investors prefer 1099s from REITs instead of K-1s from MLPs;
  - No state tax returns;
  - FIRPTA (as well as UBTI) advantages!

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Private REITs

- UBTI and FIRPTA Advantages:
  - For tax-exempt investors, dividends and capital gain from a REIT are exempt from UBTI. Investments in an LP or LLC are more likely to result in UBTI due to debt financing.
  - Foreign investors prefer REITs over LPs/LLCs because:
    - Avoid filing U.S. tax returns.
    - Withholding on dividends limited to 30% (often reduced to 15% or even 0% by treaty), instead of 35% for LPs and LLCs.
    - Possible to sell stock of a “domestically controlled” REIT free from FIRPTA tax! (REIT must be more than 50% U.S.-owned.)
    - Contrast sale of LP/LLC interest, or sale of underlying real estate, which are subject to FIRPTA withholding tax.

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Private REITs

- What is a “private” REIT?
  - All REITs must have at least 100 shareholders per statute.
  - Public REITs, with thousands of investors, easily meet this requirement.
  - Private REITs typically have only a few “real” investors, and “rent” 100 accommodation shareholders to fulfill the REIT requirements. Typical investment = $1,000 @ 12.5%.
  - Sold privately via PPM.
  - Must comply with all of the IRC REIT requirements applicable to public REITs.

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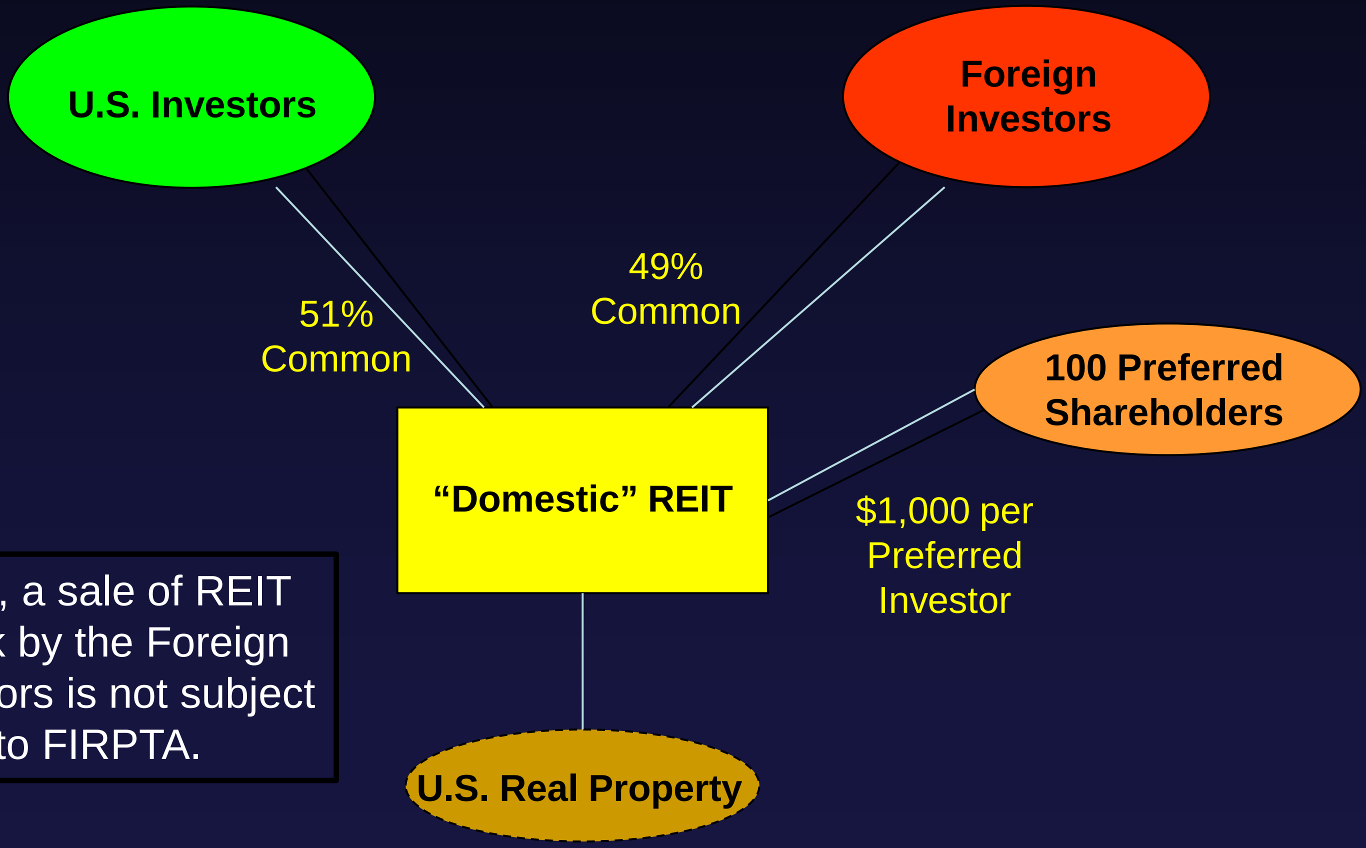
Private REITs

- Basic Example of Domestic Private REIT Structure:



Here, a sale of REIT stock by the Foreign Investors is not subject to FIRPTA.

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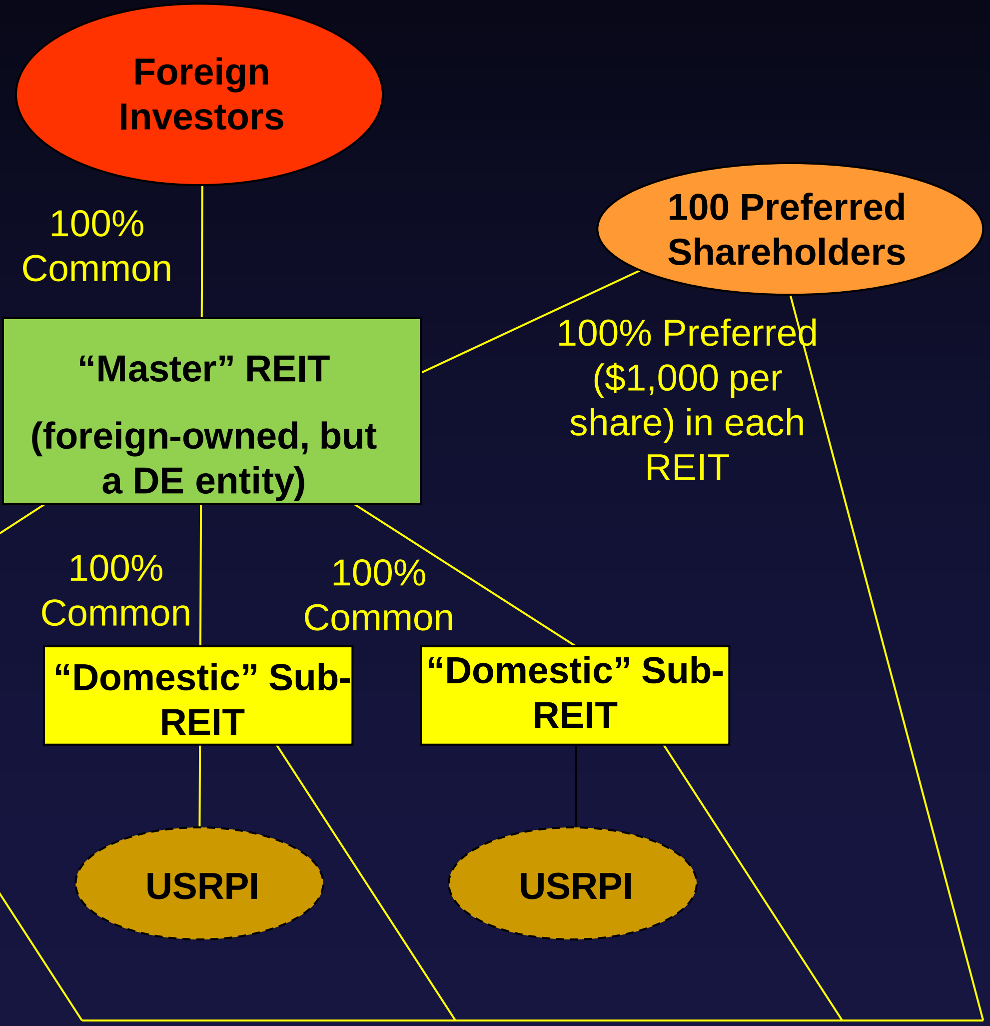
Private REITs

Example of "REIT-over-REIT Structure:

Here, a sale of Master REIT stock is subject to FIRPTA, but a sale of Sub-REIT stock by the Master REIT (a domestic entity) arguably avoids FIRPTA.



Thompson & Knight Impact
ATTORNEYS AND COUNSELORS

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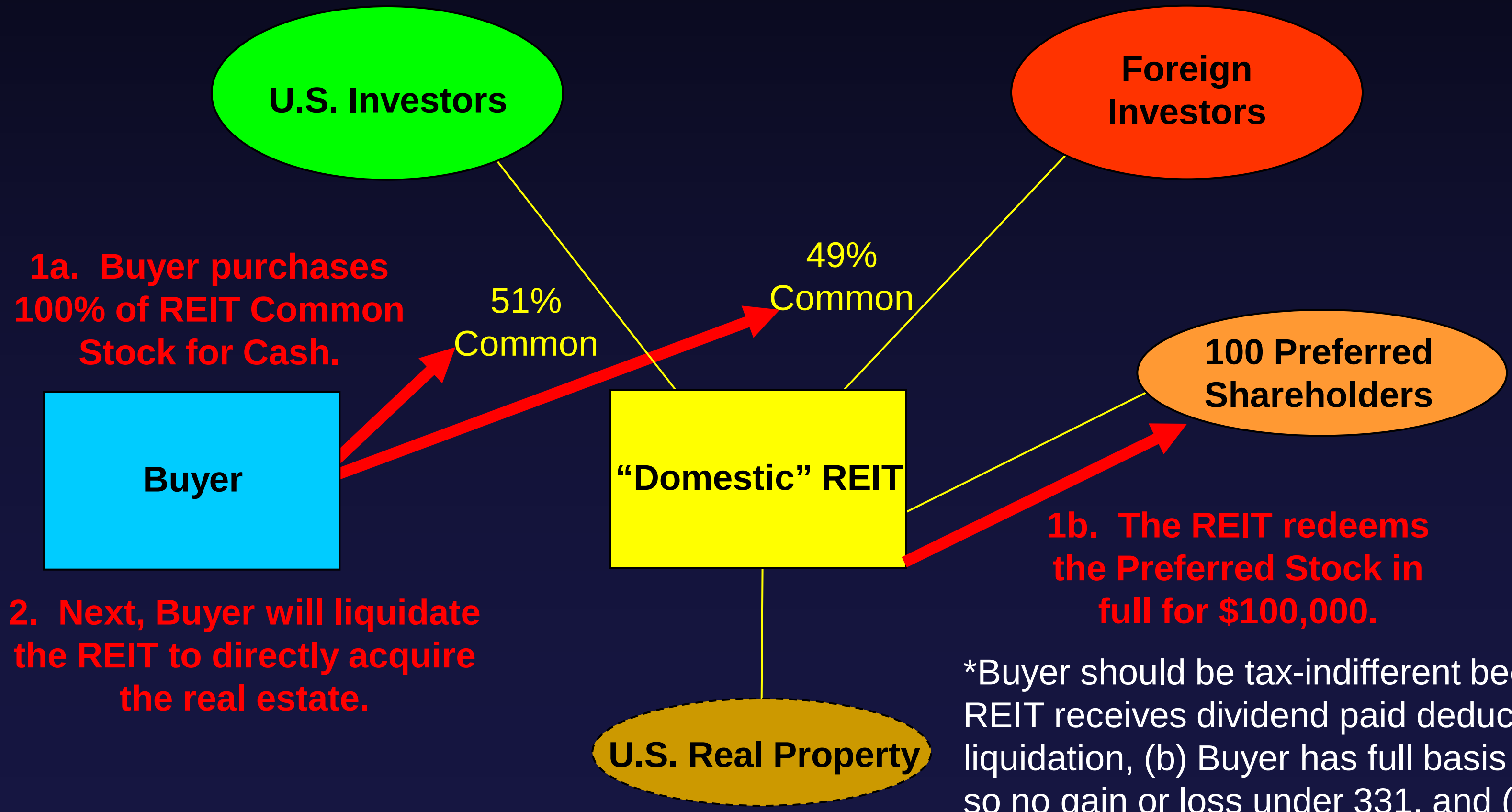
Private REITs

- Example of Sale to a Buyer:



U.S. Investors

Foreign Investors

1a. Buyer purchases 100% of REIT Common Stock for Cash.

51% Common

49% Common

100 Preferred Shareholders

Buyer

"Domestic" REIT

1b. The REIT redeems the Preferred Stock in full for $100,000.

2. Next, Buyer will liquidate the REIT to directly acquire the real estate.

U.S. Real Property

*Buyer should be tax-indifferent because (a) REIT receives dividend paid deduction on liquidation, (b) Buyer has full basis in stock so no gain or loss under 331, and (c) Buyer receives full step-up.

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Private REITs

- Does the Buyer care?
  - In theory, no. Tax result should be the same as buying real estate because the REIT can liquidate tax-free, and Buyer has stepped-up basis in REIT stock/asset.
  - Assumed entity-level liabilities are an issue.
  - Buyer will demand tax opinion from REIT’s historic counsel that the REIT is qualified.
  - Corporate buyers must ensure IRC Sec. 331 (taxable liquidation) applies and not IRC Sec. 332 (tax-free liquidation).

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Private REITs

- Should every real estate deal involving foreign or tax exempt investors be put in a private REIT?
  - Tax exempt investors may achieve same result in LP or LLC that earns only rental income and has no debt (or that complies with “fractions rule”).
  - Private REIT structure is extremely complex and expensive and not economical for smaller deals. Private REIT wrapper typically adds significant up-front and annual fees compared to normal LP/LLC (but FIRPTA advantages may be worth it).
  - REITs are far less flexible than LPs and LLCs.
  - REITs must distribute at least 90% of their taxable income annually. This can be a significant burden.
  - More expensive and cumbersome to sell REIT stock than underlying real estate upon exit; buyer may resist.

RECENT FBAR AND FATCA DEVELOPMENTS

February 26th, 2013

Deidra W. Hubenak, JD, CPA
Austin C. Carlson, JD

I. FBAR

A. Update on Current Enforcement Efforts

i. IRS Commissioner Shulman said the IRS offshore voluntary disclosure programs have so far resulted in the collection of more than $5 billion in back taxes, interest and penalties from 33,000 voluntary disclosures made under the first two programs. In addition, another 1,500 disclosures have been made under the new program announced in January 2012.

ii. The IRS closed a loophole that's been used by some taxpayers with offshore accounts. Under existing law, if a taxpayer challenges in a foreign court the disclosure of tax information by that government, the taxpayer is required to notify the U.S. Justice Department of the appeal. The IRS said that if the taxpayer fails to comply with this law and does not notify the U.S. Justice Department of the foreign appeal, the taxpayer will no longer be eligible for the Offshore Voluntary Disclosure Program (OVDP). The IRS also put taxpayers on notice that their eligibility for OVDP could be terminated once the U.S. government has taken action in connection with their specific financial institution.

iii. What we are seeing in the field –

1. IRS agents tied up with FBAR enforcement efforts; Other efforts put on hold.
2. Federal Grand Jury Subpoenas to gather information about offshore accounts.
3. Numerous foreign banks are no longer accepting U.S. customers – Credit Suisse, Deutsche Bank, HSBC, HypoVereinsbank, etc.
4. Criminal prosecution starting - Luis A. Quintero, of Miami Beach, was sentenced to four months in federal prison for failing to report $4 million in Swiss bank accounts. He was also sentenced to three years of supervised release with 250 hours of

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community service, and a $20,000 criminal fine. Quintero also paid a $2 million civil penalty. He filed FBARs for two years and then stopped. Therefore, the IRS concluded that he knew that he had an obligation to file FBARs.

5. More and more taxpayers are choosing to opt out of the OVDP.

B. Update on Disclosure Programs

i. ***2012 Offshore Voluntary Disclosure Program***

1. Deadline. Unlike the 2009 OVDP and the 2011 OVDI, there is no set deadline for taxpayers to apply. However, the terms of this program could change at any time going forward. For example, the IRS may increase penalties or limit eligibility in the program for all or some taxpayers or defined classes of taxpayers – or decide to end the program entirely at any point.

2. Penalty Rate. For the 2012 OVDP, the penalty has been raised to 27.5 percent from 25 percent in the 2011 program. The reduced penalty categories of 5 percent and 12.5 percent are still available.

3. Opt-Out. Taxpayers can enter into the OVDP then decide to opt-out of the 27.5 percent civil penalty structure. Opting out of the civil settlement structure does not affect the status of a taxpayer's voluntary disclosure under Criminal Investigation's Voluntary Disclosure Practice. The taxpayer would then face the following possibilities:

   a. *Willful FBAR Penalty*. For violations occurring prior to October 23, 2004, a penalty up to the greater of $25,000 or the amount in the account (up to $100,000) may be asserted for willfully violating the FBAR requirements, 31 U.S.C. § 5321 (a)(5).For violations occurring after October 22, 2004, a willfulness penalty may be imposed up to the greater of $100,000 or 50% of the amount in the account at the time of the violation, 31 U.S.C. § 5321 (a)(5)

      i. The test for willfulness is whether there was a voluntary, intentional violation of a known legal duty.

      ii. A finding of willfulness under the BSA must be supported by evidence of willfulness.

iii. The burden of establishing willfulness is on the Service.

iv. If it is determined that the violation was due to reasonable cause, the willfulness penalty should not be asserted.

v. Willfulness is shown by the person's knowledge of the reporting requirements and the person's conscious choice not to comply with the requirements. In the FBAR situation, the only thing that a person need know is that he has a reporting requirement. If a person has that knowledge, the only intent needed to constitute a willful violation of the requirement is a conscious choice not to file the FBAR.

vi. Under the concept of "willful blindness", willfulness may be attributed to a person who has made a conscious effort to avoid learning about the FBAR reporting and recordkeeping requirements.

   a. An example that might involve willful blindness would be a person who admits knowledge of and fails to answer a question concerning signature authority at foreign banks on Schedule B of his income tax return. This section of the return refers taxpayers to the instructions for Schedule B that provide further guidance on their responsibilities for reporting foreign bank accounts and discusses the duty to file Form 90-22.1. These resources indicate that the person could have learned of the filing and recordkeeping requirements quite easily. It is reasonable to assume that a person who has foreign bank accounts should read the information specified by the government in tax forms. The failure to follow-up on this knowledge and learn of the further reporting requirement as suggested on Schedule B may provide some evidence of willful blindness on the part of the person. For example, the failure to learn of the filing requirements coupled with other factors, such as the efforts taken to conceal the existence of the accounts and the amounts involved may lead to a conclusion that the violation was due to willful blindness. The mere fact that a person checked the wrong box, or no box, on a Schedule B is not sufficient, by itself, to establish that the FBAR violation was attributable to willful blindness.

vii. Willfulness can rarely be proven by direct evidence, since it is a state of mind. It is usually established by drawing a reasonable inference from the available facts. The government may base a determination of willfulness in the failure to file the FBAR on inference from conduct meant to conceal sources of income or other financial information. For FBAR purposes, this could include concealing

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signature authority, interests in various transactions, and interests in entities transferring cash to foreign banks.

b. *Non-Willful FBAR Penalty*. For violations occurring after October 22, 2004, a penalty, not to exceed $10,000, may be imposed on any person who violates or causes any violation of the FBAR filing and recordkeeping requirements in a manner that is not considered to be willful. The penalty should not be imposed if the violation was due to reasonable cause.

c. *Reasonable Cause Exception to Non-Willful Penalty*. Among the facts and circumstances that will be considered in determining whether reasonable cause exists are:

   i. The taxpayer's education;

   ii. Whether the taxpayer has previously been subject to the tax;

   iii. Whether the taxpayer has been penalized before;

   iv. Whether there were recent changes in the tax forms or law that the taxpayer could not reasonably be expected to know;

   v. The level of complexity of a tax or compliance issue;

   vi. Reliance upon the advice of a professional tax advisor who was informed of the existence of the foreign financial account;

   vii. Evidence that the foreign account was established for a legitimate purpose;

   viii. Evidence that there was no effort to intentionally conceal the reporting of income or assets; and

   ix. Evidence that there was no tax deficiency related to the unreported account.

ii. *New Streamlined Filing Compliance Procedures for Non-Resident, Non-Filers*

On June 26, 2012, the IRS announced new streamlined filing compliance procedures for non-resident U.S. taxpayers to go into effect on September 1, 2012. These procedures are being implemented in recognition that some U.S. taxpayers living abroad have failed to

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timely file U.S. federal income tax returns or FBAR, but have recently become aware of their filing obligations and now seek to come into compliance with the law. These new procedures are for non-residents including, but not limited to, dual citizens who have not filed U.S. income tax and information returns.

1. <u>Eligibility</u>. To be eligible the taxpayer must:

   a. Be a non-resident U.S. taxpayer;

   b. Have resided outside of the U.S. since January 1, 2009;

   c. Have not filed a U.S. tax return during the same period; and

   d. Present a low level of compliance risk.

2. <u>Compliance Risk</u>. The IRS will determine the level of compliance risk presented by the submission based on information provided on the returns filed and based on additional information provided in response to a questionnaire required as part of the submission. Low risk will be predicated on simple returns with little or no U.S. tax due. Absent any high risk factors, if the submitted returns and application show less than $1,500 in tax due in each of the years, they will be treated as low risk and processed in a streamlined manner. The risk level may rise if any of the following are present:

   a. If any of the returns submitted through this program claim a refund;

   b. If there is material economic activity in the United States;

   c. If the taxpayer has not declared all of his/her income in his/her country of residence;

   d. If the taxpayer is under audit or investigation by the IRS;

   e. If FBAR penalties have been previously assessed against the taxpayer or if the taxpayer has previously received an FBAR warning letter

   f. If the taxpayer has a financial interest or authority over a financial account(s) located outside his/her country of residence;

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g. If the taxpayer has a financial interest in an entity or entities located outside his/her country of residence;

h. If there is U.S. source income; or

i. If there are indications of sophisticated tax planning or avoidance.

3. Program Requirements. Taxpayers utilizing this procedure will be required to file delinquent tax returns, with appropriate related information returns (e.g. Form 3520 or 5471), for the past three years and to file delinquent FBARs (Form TD F 90-22.1) for the past six years.

4. Penalties. If the taxpayer is accepted into this program by meeting the requirements and not presenting a high level of compliance risk, no civil or criminal penalties relating to the delinquent FBARS will be pursued by the IRS. However, payment for the tax and interest, if applicable, must be remitted along with the delinquent filed tax returns.

5. Higher Compliance Risk Examination. Taxpayers that present higher compliance risk are not eligible for the streamlined processing procedures and will be subject to a more thorough review and possibly a full examination, which in some cases may include more than three years, in a manner similar to opting out of the Offshore Voluntary Disclosure Program

II. FATCA

The Foreign Account Tax Compliance Act (FATCA), enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act, is an important development in U.S. efforts to combat tax evasion by U.S. persons holding investments in offshore accounts. Section 511 of the HIRE Act amended the Internal Revenue Code by adding new section 6038D, Information with Respect to Foreign Financial Assets.

Under FATCA, certain U.S. taxpayers holding financial assets outside the United States must report those assets to the IRS. In addition, FATCA will require foreign financial institutions to report directly to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest.

A. Reporting by Foreign Financial Institutions

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i. FATCA will also require foreign financial institutions ("FFIs") to report directly to the IRS certain information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest.

ii. To properly comply with these new reporting requirements, an FFI will have to enter into a special agreement with the IRS by June 30, 2013.

iii. Under this agreement a "participating" FFI will be obligated to:

   1. undertake certain identification and due diligence procedures with respect to its accountholders;

   2. report annually to the IRS on its accountholders who are U.S. persons or foreign entities with substantial U.S. ownership; and

   3. withhold and pay over to the IRS 30-percent of any payments of U.S. source income, as well as gross proceeds from the sale of securities that generate U.S. source income, made to

      a. non-participating FFIs,

      b. individual accountholders failing to provide sufficient information to determine whether or not they are a U.S. person, or

      c. foreign entity accountholders failing to provide sufficient information about the identity of its substantial U.S. owners.

iv. Registration will take place through an online system which will become available by Jan. 1, 2013. FFIs that do not register and enter into an agreement with the IRS will be subject to withholding on certain types of payments relating to U.S. investments.

v. Notice 2011-53 provides the phased-in timeline of key FATCA implementation dates for FFIs. It is important to note that many details of the new reporting and withholding requirements pertaining to FFIs must be developed through Treasury Regulations. Proposed regulations were issued on Feb. 8, 2012. The Treasury Department and the IRS also are continuing to work towards finalizing the regulations implementing FATCA in the near term.

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vi. Agreements with foreign countries

1. A model bilateral agreement published in July of this year was developed in consultation with France, Germany, Italy, Spain, and the United Kingdom and marks an important step in establishing a common approach to combating tax evasion based on the automatic exchange of information.

2. On September 14, 2012, the U.S. Department of the Treasury announced that it has signed a bilateral agreement with the United Kingdom to implement the information reporting and withholding tax provisions of Foreign Account Tax Compliance Act (FATCA). The United Kingdom is the first jurisdiction to sign a bilateral agreement.

3. Since then, the U.S. has signed or initialed agreements with Italy, Norway, Mexico, Denmark, Ireland, Spain, and most recently Switzerland (Feb. 2013). The Treasury Department is in communication with around 50 other governments who have expressed interest in concluding a similar bilateral agreement to implement FATCA and expects to sign additional bilateral agreements in the near future.

B. Form 8938 – Statement of Specified Foreign Assets

FATCA requires certain U.S. taxpayers holding foreign financial assets with an aggregate value exceeding certain limits to report information about those assets on a new form (Form 8938) that must be attached to the taxpayer’s annual tax return. Reporting applies for assets held in taxable years beginning after March 18, 2010.

Who must file? - You must file Form 8938 if:

- **You are a specified person;**
- **You have an interest in a specified foreign financial asset; and**
- **The aggregate value of your specified foreign financial assets is more than the reporting threshold.**

i. **You are a specified person.**

1. *A specified individual is*:

a. A U.S. citizen;

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b. A resident alien of the United States for any part of the tax year (see Pub. 519 for more information);

c. A nonresident alien who makes an election to be treated as resident alien for purposes of filing a joint income tax return; or

d. A nonresident alien who is a bona fide resident of American Samoa or Puerto Rico (See Pub. 570 for definition of a bona fide resident).

2. *A specified domestic entity is [Prop. Reg. 1.6038D-6]*

   a. A domestic corporation, a domestic partnership, or a trust described in section 7701(a)(30)(E), if such corporation, partnership, or trust is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets.

      i. Annual Determination. Whether a domestic corporation, a domestic partnership, or a trust described in section 7701(a)(30)(E) is a specified domestic entity is determined annually.

      ii. Formed or availed of. Except as otherwise provided in paragraph (d) of this section, a domestic corporation or a domestic partnership is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets if and only if—

         a. The corporation or partnership has an interest in specified foreign financial assets (other than assets excepted from reporting as provided in §1.6038D-7T) with an aggregate value exceeding the reporting threshold in §1.6038D-2T(a)(1);

         b. The corporation or partnership is closely held by a specified individual as determined under paragraph (b)(3) of this section; and

         c. One of the following two conditions is satisfied:

            i. At least 50 percent of the corporation's or partnership's gross income for the taxable year is passive income or at least 50 percent of the assets held by the corporation or partnership at any time during the taxable

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year are assets that produce or are held for the production of passive income; or

ii. At least 10 percent of the corporation's or partnership's gross income for the taxable year is passive income or at least 10 percent of the assets held by the corporation or partnership at any time during the taxable year are assets that produce or are held for the production of passive income, and the corporation or partnership is formed or availed of by the specified individual identified in paragraphs (b)(1)(ii) and (b)(3) of this section with a principal purpose of avoiding the reporting obligations under section 6038D.

iii. Passive income. For purposes of paragraph (b) of this section, passive income means the portion of gross income that consists of—

a. Dividends;

b. Interest;

c. Rents and royalties, other than rents and royalties derived in the active conduct of a trade or business conducted by employees of the corporation or partnership;

d. Annuities;

e. The excess of gains over losses from the sale or exchange of property that gives rise to passive income described in paragraphs (b)(2)(i) through (iv) of this section;

f. The excess of gains over losses from transactions (including futures, forward, and similar transactions) in any commodity, but not including any commodity hedging transaction described in section 954(c)(5)(A) determined by treating the corporation or partnership as a controlled foreign corporation;

g. The excess of foreign currency gains over foreign currency losses (as defined in section 988(b)) attributable to any section 988 transaction; and

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   h. Net income from notional principal contracts.

iv. <u>Closely held</u>.

   a. Domestic corporation. A domestic corporation is closely held by a specified individual for purposes of paragraph (b)(1)(ii) of this section if at least 80 percent of the total combined voting power of all classes of stock of the corporation entitled to vote, or at least 80 percent of the total value of the stock of the corporation, is owned, directly, indirectly, or constructively, by one specified individual on the last day of the corporation's taxable year.

   b. Domestic partnership. A partnership is closely held by a specified individual for purposes of paragraph (b)(1)(ii) of this section if at least 80 percent of the capital or profits interest in the partnership is held, directly, indirectly, or constructively, by one specified individual on the last day of the partnership's taxable year.

v. <u>Constructive ownership</u>. For purposes of paragraphs (b)(1)(ii) and (b)(3) of this section, section 267(c) and (e)(3) apply for the purpose of determining the interest of a specified individual in a corporation or partnership, except that section 267(c)(4) is applied as if the family of an individual includes the spouses of the individual's family members.

vi. <u>Treatment of related corporations and partnerships</u>.

   a. Determination of reporting threshold. For purposes of applying paragraph (b)(1)(i) of this section and determining whether a domestic corporation or domestic partnership satisfies the reporting threshold in §1.6038D-2T(a)(1), all domestic corporations and domestic partnerships that have an interest in any specified foreign financial asset and are closely held by the same specified individual as determined under paragraphs (b)(1)(ii) and (b)(3) of this section are treated as a single entity, and each such related corporation or partnership will be treated as owning the specified foreign financial assets held by all such related corporations or partnerships.

   b. Determination of passive income and asset thresholds. For purposes of applying the passive income and asset thresholds of paragraph (b)(1)(iii) of this section, all domestic corporations and domestic partnerships that are closely held by the same specified individual as determined under paragraphs (b)(1)(ii) and (b)(3) of this section and that are connected through stock or partnership interest ownership with a common parent corporation or partnership (as determined under this paragraph (b)(4)(ii)) are treated as a single entity. A domestic corporation or a domestic partnership is considered connected through stock or partnership interest ownership with a common parent corporation or partnership if stock representing at least 80 percent of the voting power or value of each such corporation, or partnership interests representing at least 80 percent of the profits interests or capital interests of the partnership, in each case other than stock of or partnership interests in the common parent, is owned by one or more of the other connected corporations, connected partnerships, or the common parent. For purposes of applying paragraph (b)(1)(iii) of this section, each member of a closely held and connected group as determined under this paragraph (b)(4)(ii) is treated as owning the combined assets and receiving the combined income of all members of that group. For purposes of the preceding sentence, any contract, equity, or debt existing between members of such a group, as well as any items arising under or from such contract, equity, or debt relevant to the determination of the passive income percentage under paragraph (b) of this section, are eliminated.

vii. Domestic trusts. Except as provided in paragraph (d) of this section, a trust described in section 7701(a)(30)(E) is a specified domestic entity that is formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets if and only if the trust—

  a. Has an interest in specified foreign financial assets (other than assets excepted from reporting as provided in §1.6038D-7T) with an aggregate value exceeding the reporting threshold in § 1.6038D-2T(a)(1), and

  b. Has one or more specified persons as a current beneficiary. For purposes of this paragraph (c)(2), the term current beneficiary means, with respect to the taxable year, any person who at any time during such taxable year is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust (determined without regard to any power of appointment to the extent that such power remains unexercised at the end of the taxable year).

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viii. Excepted domestic entities. An entity is not considered to be a specified domestic entity if the entity is—

a. *Certain persons described in section 1473(3)*. An entity, except for a trust that is exempt from tax under section 664(c), that is excepted from the definition of the term "specified United States person" under section 1473(3) and the regulations issued under that section;

b. *Certain domestic trusts*. A trust described in section 7701(a)(30)(E) provided that the trustee of the trust—

   i. Has supervisory authority over or fiduciary obligations with regard to the specified foreign financial assets held by the trust;

   ii. Timely files (including any applicable extensions) annual returns and information returns on behalf of the trust; and

   iii. Is—

      a. A bank that is examined by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, or the National Credit Union Association;

      b. A financial institution that is registered with and regulated or examined by the Securities and Exchange Commission; or
      c. A domestic corporation described in section 1473(3)(A) or (B), and the regulations issued under that section.

c. *Domestic trusts owned by one or more specified persons*. A trust described in section 7701(a)(30)(E) to the extent such trust or any portion thereof is treated as owned by one or more specified persons under sections 671 through 678 and the regulations issued under those sections.

ii. **You have an interest in specified foreign financial assets required to be reported.**

A specified foreign financial asset is:

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1. *In general.* Except as otherwise provided in this section, a specified foreign financial asset includes any of the following assets that are held for investment and not held in an account maintained by a financial institution —

    a. Stock or securities issued by a person other than a United States person;

    b. A financial instrument or contract that has an issuer or counterparty which is other than a United States person; and

    c. An interest in a foreign entity.

2. *Mark-to-market election under section 475.* An asset is not a specified foreign financial asset if the rules of section 475(a) apply to the asset or an election under section 475(e) or (f) is made with respect to the asset.

3. *Held for investment.* An asset is held for investment for purposes of section 6038D and the regulations if that asset is not used in, or held for use in, the conduct of a trade or business of a specified person.

4. *Trade-or-business test.* For purposes of section 6038D and the regulations, an asset is used in, or held for use in, the conduct of a trade or business and not held for investment if the asset is—

    a. Held for the principal purpose of promoting the present conduct of a trade or business;

    b. Acquired and held in the ordinary course of a trade or business, as, for example, in the case of an account or note receivable arising from that trade or business; or

    c. Otherwise held in a direct relationship to the trade or business as determined under paragraph (b)(5) of this section.

5. *Direct relationship between holding an asset and a trade or business.*

    a. In general. In determining whether an asset is held in a direct relationship to the conduct of a trade or business by a specified person, principal consideration will be given to whether the asset is needed in the trade or business of the specified person. An asset shall be considered needed in a

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trade or business, for this purpose, only if the asset is held to meet the present needs of that trade or business and not its anticipated future needs. An asset shall be considered as needed in the trade or business if, for example, the asset is held to meet the operating expenses of the trade or business. Conversely, an asset shall be considered as not needed in the trade or business if, for example, the asset is held for the purpose of providing for future diversification into a new trade or business, future plant replacement, or future business contingencies. Stock is never considered used or held for use in a trade or business for purposes of applying this test.

b. Presumption of direct relationship. An asset will be treated as held in a direct relationship to the conduct of a trade or business of a specified person if—

    i. The asset was acquired with funds generated by the trade or business of the specified person or the affiliated group of the specified person, if any;

    ii. The income from the asset is retained or reinvested in the trade or business; and

    iii. Personnel who are actively involved in the conduct of the trade or business exercise significant management and control over the investment of such asset.

6. *Excepted foreign financial assets - accounts maintained by:*

    a. a U.S. payer (such as a U.S. domestic financial institution);

    b. the foreign branch of a U.S. financial institution;

    c. the U.S. branch of a foreign financial institution; or

    d. a dealer or trade in securities or commodities if all of the holdings in the account are subject to the mark-to-market accounting rules for dealers in securities or an election under section 475(e) or (f) is made for all of the holdings in the account.

7. *Financial account in a U.S. possession.* A specified foreign financial asset includes a financial account maintained by a financial institution that is organized under the laws of a U.S. possession.

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a. *Exception* - A specified individual who is a bona fide resident of a U.S. possession and who is required to file Form 8938 with the Internal Revenue Service is not required to report the following specified foreign financial assets:

   i. A financial account maintained by a financial institution organized under the laws of the U.S. possession of which the specified individual is a bona fide resident;

   ii. A financial account maintained by a branch of a financial institution not organized under the laws of the U.S. possession of which the specified individual is a bona fide resident, if the branch is subject to the same tax and information reporting requirements applicable to a financial institution organized under the laws of the U.S. possession;

   iii. Stock or securities issued by an entity organized under the laws of the U.S. possession of which the specified individual is a bona fide resident;

   iv. An interest in an entity organized under the laws of the U.S. possession of which the specified individual is a bona fide resident; and

   v. A financial instrument or contract held for investment, provided each issuer or counterparty that is not a United States person is—

      1. An entity organized under the laws of the U.S. possession of which the specified individual is a bona fide resident; or
      2. A bona fide resident of the U.S. possession of which the specified individual is a bona fide resident.

8. *Examples of financial accounts*

   a. Savings, deposit, checking, and brokerage accounts held with a bank or broker-dealer.

   b. And, to the extent held for investment and not held in a financial account, you must report stock or securities issued by someone who is not a U.S. person, any other interest in a foreign entity, and any financial instrument or contract held for investment with an issuer or counterparty that is not a U.S. person. Examples of

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these assets that must be reported if not held in an account include:

i. Stock or securities issued by a foreign corporation;

ii. A note, bond or debenture issued by a foreign person;

iii. An interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap or similar agreement with a foreign counterparty;

iv. An option or other derivative instrument with respect to any of these examples or with respect to any currency or commodity that is entered into with a foreign counterparty or issuer;

v. A partnership interest in a foreign partnership;

vi. An interest in a foreign retirement plan or deferred compensation plan;

vii. A beneficiary interest in a foreign estate or trust – HOWEVER, an interest in a foreign estate or trust is not a specified foreign financial asset unless you know or have reason to know based on readily accessible information of the interest. If you receive a distribution, you are considered to know of the interest.

viii. Any interest in a foreign-issued insurance contract or annuity with a cash-surrender value.

ix. A foreign account is a specified foreign financial asset even if its contents include, in whole or in part, investment assets issued by a U.S. person.

x. The contract with the foreign person to sell assets held for investment (such as a sales contract for precious metals) is a specified foreign financial asset investment asset that you have to report on Form 8938.

9. *Examples of holdings that would not be considered to be financial accounts*

a. Foreign real estate

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   i. Foreign real estate is not a specified foreign financial asset required to be reported on Form 8938. For example, a personal residence or a rental property does not have to be reported.

   ii. If the real estate is held through a foreign entity, such as a corporation, partnership, trust or estate, then the interest in the entity is a specified foreign financial asset that is reported on Form 8938, if the total value of all your specified foreign financial assets is greater than the reporting threshold that applies to you. The value of the real estate held by the entity is taken into account in determining the value of the interest in the entity to be reported on Form 8938, but the real estate itself is not separately reported on Form 8938.

b. Foreign currency – If you directly hold foreign currency, it is not a specified foreign financial asset and is not reportable on Form 8938.

c. A financial account maintained by a U.S. financial institution that holds foreign stocks and securities such as:

   i. U.S. mutual fund accounts

   ii. IRAs (traditional or Roth)

   iii. 401(k) retirement plans

   iv. Qualified U.S. retirement plans

   v. Brokerage accounts maintained by U.S. financial institutions

d. Payments or the rights to receive the foreign equivalent of social security, social insurance benefits or another similar program of a foreign government are not specified foreign financial assets and are not reportable.

e. Directly held tangible assets, such as art, antiques, jewelry, cars and other collectibles, are not specified foreign financial assets.

f. Directly held precious metals, such as gold, are not specified foreign financial assets. Note, however, that gold certificates issued by a foreign person may be a specified foreign financial asset that you would have to report on Form 8938, if

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the total value of all your specified foreign financial assets is greater than the reporting threshold that applies to you.

g. A safe deposit box is not a financial account.

iii. **<u>AND the aggregate value of your specified foreign financial assets is more than the reporting thresholds that applies to you</u>:**

1. *Reporting Thresholds – Living in the United States*

   a. <u>Unmarried taxpayers living in the US</u>: The total value of your specified foreign financial assets is more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year.

   b. <u>Married taxpayers filing a joint income tax return and living in the US</u>*:* The total value of your specified foreign financial assets is more than $100,000 on the last day of the tax year or more than $150,000 at any time during the tax year.

   c. <u>Married taxpayers filing separate income tax returns and living in the US</u>*:* The total value of your specified foreign financial assets is more than $50,000 on the last day of the tax year or more than $75,000 at any time during the tax year.

2. *Reporting Thresholds - Taxpayers living abroad.*

   a. You are a taxpayer living abroad if:

      i. You are a U.S. citizen whose tax home is in a foreign country and you are either a bona fide resident of a foreign country or countries for an uninterrupted period that includes the entire tax year; or

      ii. You are a U.S. citizen or resident, who during a period of 12 consecutive months ending in the tax year is physically present in a foreign country or countries at least 330 days.

   b. If you are a taxpayer living abroad you must file if:

      i. You are filing a return other than a joint return **and** the total value of your specified foreign assets is more than $200,000 on the last day of the tax

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year or more than $300,000 at any time during the year; or

ii. You are filing a joint return **and** the value of your specified foreign asset is more than $400,000 on the last day of the tax year or more than $600,000 at any time during the year.

iii. If you do not have to file an income tax return for the tax year, you do not need to file Form 8938, even if the value of your specified foreign assets is more than the appropriate reporting threshold.

iv. If you are required to file a Form 8938 and you have a specified foreign financial asset reported on one of the following forms, you do not need to report the asset on Form 8938. However, you must identify on Part IV of your Form 8938 which and how many of these form(s) report the specified foreign financial assets.

   1. Form 3520, “Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts” (in the case of a specified person who is the beneficiary of a foreign trust),

   2. Form 3520-A, “Annual Information Return of Foreign Trust With a U.S. Owner”

   3. Form 5471, “Information Return of U.S. Persons With Respect to Certain Foreign Corporations”

   4. Form 8621, “Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund”

   5. Form 8865, “Return of U.S. Persons With Respect to Certain Foreign Partnerships” or

   6. Form 8891, “U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans”

v. Even if a specified foreign financial asset is reported on a form listed above, you must still include the value of the asset in determining whether the aggregate value of your specified foreign financial assets is more than

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the reporting threshold that applies to you.

1. Form 8938 reporting applies for specified foreign financial assets in which the taxpayer has an interest in taxable years starting after March 18, 2010. For most individual taxpayers, this means they will start filing Form 8938 with their 2011 income tax return.

3. *How do you determine the value of a foreign financial asset*?

   a. In general. You may determine the *fair market value* of a foreign financial account for the purpose of reporting its maximum value based on periodic account statements unless you have reason to know that the statements do not reflect a reasonable estimate of the maximum value of the account during the tax year.

   b. For a specified foreign financial asset not held in a financial account, you may determine the fair market value of the asset for the purpose of reporting its maximum value based on information publicly available from reliable financial information sources or from other verifiable sources.

   c. Even if there is no information from a reliable financial information source or other verifiable source, you do not need to obtain an appraisal by a third party in order to reasonably estimate the asset's maximum value during the tax year.

   d. If you must translate the asset from foreign currency, you always use the exchange rate on the last day of the year (even if the asset was sold earlier in the year).

4. *Foreign Retirement Plans*

   a. In general, the value of your interest in the foreign pension plan or deferred compensation plan is the fair market value of your beneficial interest in the plan on the last day of the year.

   b. However, if you do not know or have reason to know based on readily accessible information the fair market value of your beneficial interest in the pension or deferred compensation plan on the last day of the year, the maximum value is the value of the cash and/or other property distributed to you during the year. This same value is used in determining whether you have met your reporting threshold.

c. If you do not know or have reason to know based on readily accessible information the fair market value of your beneficial interest in the pension plan or deferred compensation plan on the last day of the year and you did not receive any distributions from the plan, the value of your interest in the plan is zero. In this circumstance, you should also use a value of zero for the plan in determining whether you have met your reporting threshold. If you have met the reporting threshold and are required to file Form 8938, you should report the plan and indicate that its maximum is zero.

5. *Interest in a Foreign Trust*

a. Use the fair market value of your interest in the trust.

b. If you cannot determine the fair market value, use the maximum value of your interest in the foreign trust calculated as follows:

i. The value of all the cash or other property distributed during the tax year from the trust to you as a beneficiary, and

ii. The value using the valuation tables under section 7520 of your right as a beneficiary to receive mandatory distributions as of the last day of the tax year.

6. *Assets with no Positive Value* – If the maximum value of the specified foreign financial asset is less than zero, use zero as its value.

7. *Joint interests*

a. If the joint interest is with your spouse and you file a joint return, include the value only once.

b. If the joint interest is with your spouse, you are both specified individuals and you file separate income tax returns, it is unclear. The instructions are contradictory and tell you to include one half of the asset value on each return in one place and tells you to include the full value of the asset on each return in another place.

c. If you have joint ownership with someone who is not your spouse or if you have joint ownership with your spouse who is not a specified person, include the entire

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value of the jointly owned asset to determine the total value of that entire joint owner's specified foreign financial assets.

8. *Disregarded entities* – If you are the owner of a disregarded entity, you have an interest in any specified foreign assets owned by the entity.

9. *Foreign Grantor Trust*s – If you are considered the owner under the grantor trust rules of any part of a trust, you have an interest in any specified foreign financial asset held by that part of the trust that you are considered to own.

    a. A specified person that is treated as an owner of a foreign trust or any portion of a foreign trust under sections 671 through 679 is not required to report any specified foreign financial assets held by the foreign trust on Form 8938, provided—

        i. The specified person reports the trust on a Form 3520 timely filed with the Internal Revenue Service for the taxable year;

        ii. The trust timely files Form 3520-A, "Annual Information Return of Foreign Trust With a U.S. Owner," with the Internal Revenue Service for the taxable year; and

        iii. The Form 8938 filed by the specified person for the taxable year reports the filing of the Form 3520 and Form 3520-A.

10. *What information must be reported*

    a. In the case of a financial account maintained by a foreign financial institution, the name and address of the foreign financial institution and the account number of the account;

    b. In the case of stock or a security, the name and address of the issuer, and information that identifies the class or issue of which the stock or security is a part;

    c. In the case of a financial instrument or contract, information that identifies the financial instrument or contract, including the names and addresses of all issuers and counterparties;

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d. In the case of an interest in a foreign entity, information that identifies the interest, including the name and address of the entity;

e. The maximum value of the specified foreign financial asset during the portion of the taxable year in which the specified person has an interest in the asset;

f. In the case of a financial account that is a depository or custodial account under section 1471(d)(2), whether the account was opened or closed during the taxable year;

g. The date, if any, on which the specified foreign financial asset, other than a financial account that is a depository or custodial account under section 1471(d)(2), was either acquired or disposed of (or both) during the taxable year;

h. The amount of any income, gain, loss, deduction, or credit recognized for the taxable year with respect to the reported specified foreign financial asset, and the schedule, form, or return filed with the Internal Revenue Service on which the income, gain, loss, deduction, or credit, if any, is reported or included by the specified person;

i. The foreign currency exchange rate and, if the source of such rate is other than as described in §1.6038D-5T(c)(1), the source of the rate used to determine the specified foreign financial asset's U.S. dollar value, including maximum value; and

j. For any specified foreign financial asset excepted from reporting on Form 8938 under §1.6038D-7T(a), the specified person must report the number of Forms 3520, “Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts,” Forms 3520-A, “Annual Information Return of Foreign Trust With a U.S. Owner,” Forms 5471, “Information Return of U.S. Persons With Respect To Certain Foreign Corporations,” Forms 8621, “Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund,” Forms 8865, “Return of U.S. Persons With Respect To Certain Foreign Partnerships,” Forms 8891, “U.S. Information Return for Beneficiaries of Certain Canadian Registered Retirement Plans,” or such other form under Title 26 of the United States Code identified by the Secretary under §1.6038D-7T(a), timely filed with the Internal Revenue Service on which excepted foreign financial assets are reported or reflected for the taxable year.

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11. *When to file*

    a. Attach Form 8938 to the taxpayer's annual tax return

        i. Forms 1040 and 1040NR - for tax years beginning on or after March 18, 2010.

        ii. Forms 1120, 1120-S, 1065 & 1041 – for tax years beginning after December 31, 2011 (See Prop. Reg. 1.6038D-6)

    b. Notice 2011-55 suspended the filing requirement for taxpayers that filed their income tax return before Form 8938 was issued. These taxpayers must attach the form for the suspended year to the following year's tax return. The statute of limitations for this form will begin when the form is received by the IRS.

12. *Penalties*

    a. Failure to report foreign financial assets on Form 8938 will result in a penalty of $10,000 (and a penalty up to $50,000 for continued failure after IRS notification).

    b. There is a reasonable cause exception. But, the fact that a foreign jurisdiction would impose a civil or criminal penalty on you is NOT reasonable cause.

    c. A 40 percent penalty on any understatement of tax attributable to non-disclosed assets can also be imposed.

    d. If the underpayment is due to fraud, the penalty is 75% of the amount of the underpayment.

    e. Special statute of limitation rules apply to Form 8938.

        i. The statute is open for 3 years after the date on which you file Form 8938.

        ii. If you do not include an amount in income related to a specified foreign financial asset and the amount that you omit is greater than $5,000, the statute is extended to six years after the date you file your return. This applies to assets even if they are below the filing threshold or even if there is an exception from reporting a specified foreign financial asset on Form

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8938.

13. *Correlation with FBAR filing*

    a. The new Form 8938 filing requirement does not replace or otherwise affect a taxpayer's obligation to file an FBAR (Report of Foreign Bank and Financial Accounts).

14. *AICPA Comment Letters*

    a. Part II of form 8938 should permit the use of any reasonable method in determining fair market value of an SFFA including, but not limited to, tax basis where a published or external market value is not readily accessible to the taxpayer.

    b. IRS should provide guidance regarding how to value a financial instrument or contract that has a non-U.S. issuer or counterparty such as nonpublic, nontransferable stock options or rental contracts (mentioned by IRS on a joint IRS/AICPA webinar on March 20, 2012).

    c. Request to make the method for determining maximum account value consistent between FBARs and Form 8938.