Texas Tax Lawyer

A Tax Journal

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TAX SECTION
STATE BAR OF TEXAS

www.texastaxsection.org

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- Calendar (2015-2016)

THANK YOU TO OUR SPONSORS!:

- Interested in Becoming a Sponsor? Please Contact Tax Section Sponsorship Task Force Chair, Jim Roberts, at jvroberts@gpm-law.com

CHAIR'S MESSAGE

Dear Tax Section Members,

Greetings from Lubbock!

Thank you again for your membership in and support of the State Bar of Texas Tax Section.

Please mark your calendar for several upcoming deadlines and events:

- ***April 1, 2016 – Deadline to submit a nomination for the Outstanding Texas Tax Lawyer Award***
  - This award honors the contributions of our state's most prestigious tax lawyers. Please consider making a nomination today!
  - Click here to download an application: http://www.texastaxsection.org/DrawOnePage.aspx?PageID=244

- ***April 8, 2016 – Deadline to submit scholarship applications for "Law Students Pursuing Tax Law"***
  - Do you know a JD or LL.M student or are you a JD or LL.M student interested in pursuing tax law as a career in Texas?
  - Check out scholarships awarded by the Tax Section and consider applying: http://www.texastaxsection.org/DrawOnePage.aspx?PageID=245

- ***April 25, 2016 – Annual Property Tax Conference, Austin Texas***
  - Excellent conference to obtain current information on state property tax law and developing issues.
  - Check out more information here: http://www.texastaxsection.org/Registration/Events.aspx?EventID=16

- ***June 16-17 – Tax Section Annual Meeting, Fort Worth, Texas***
  - On **Thursday, June 16,** the Tax Section will be hosting a Section-wide networking reception from 5pm-6pm at the Omni Conference Hotel. Even in today's age of email and conference calls, we still need opportunities to meet each other face-to-face in order to develop relationships to help guide us through our careers. Hope to see you there!
  - **On Friday, June 17,** the Tax Section will host its Annual Meeting from 8:00am – 5:25pm with a fantastic line-up of speakers. A great venue to network and get CLE hours!

I'd also like to take this opportunity to highlight some of the benefits of being a Tax Section member:

CLE
Under the leadership of our CLE chair, Michael Threet (michael.threet@haynesboone.com), the Tax Section provides both live and web-based CLE. The web-based CLE on our website is called the 24/7 Free Online CLE Library, a place where you can get all of your CLE credit remotely on your laptop or other electronic device. Very exciting news – coming soon will be the completion of a priority this year, which is an updated version of the 24/7 Free Online CLE library! It will have a fantastic new look, contain many new audio and video programs, and will be extremely user friendly. We anticipate it being ready for you this Spring!

Texas Tax Lawyer
Under Michelle Spiegel's guidance, the *Texas Tax Lawyer* provides some of the best and most relevant tax articles, model forms, and updates on tax law. Interested in writing an article? Please join a committee online today to start participating and writing an article for the next edition of the Texas Tax Lawyer: http://www.texastaxsection.org. A great way to get involved!

Government Submissions
The Tax Section seeks volunteers to draft letters to the IRS, Treasury, Texas Comptroller, and other governmental entities recommending changes to proposed regulations and tax policies. So far this year, the Tax Section has completed six government submission projects and there are eleven pending. Any Tax Section member can get involved! Please contact Bob Probasco (robert.probasco@probascotaxlaw.com) or Henry Talavera (htalavera@polsinelli.com) for more information.

Pro Bono
Under the leadership of our Pro Bono Chair, Juan Vasquez (juan.vasquez@chamberlainlaw.com), the Tax Section assists individuals who cannot afford to pay for the services of a tax lawyer by advising pro se taxpayers who appear at calendar calls of the United States Tax Court held in various Texas cities. Through the VITA program, Section members help lower-income taxpayers in the preparation of their federal income tax returns, with a focus on helping qualified taxpayers take the earned income tax credit. In addition, under the leadership of Joe Perera

(joseph.perera@strasburger.com) we are involved with the VITA Adopt-a-Base program where the Tax Section works with the military and the IRS to help train services members to be volunteer return preparers. This helps members of our armed forces and their families have access to free tax preparation services. Lastly, under the leadership of Henry Talavera (htalavera@polsinelli.com) and Susan Wetzel (susan.wetzel@haynesboone.com), the Tax Section recently became involved with the Pension Rights Center, where Section members assist Texas residents in securing retirement benefits. This is important work. Please get involved today!

Law School Outreach

Under the leadership of Abbey Garber, we continue to expand our law school outreach program by hosting a "Tax Career Day" panel to educate students on the practice of tax law. This year our goal is to visit each law school in Texas! Please contact Abbey (abbey.b.garber@irscounsel.treas.gov) if you would like to get involved!

* * *

The above are just a few highlights of the activities of the Tax Section. Please check out our website to learn more: http://www.texastaxsection.org/

As always, please let me (alyson.outenreath@ttu.edu) or one of my fellow officers, David Colmenero/Chair-Elect (dcolmenero@meadowscollier.com), Stephanie Schroepfer/Secretary (stephanie.schroepfer@nortonrosefulbright.com), and Catherine Scheid/Treasurer (ccs@scheidlaw.com), know if you have any thoughts, ideas, or suggestions to enhance the Tax Section.

Thank you.

Get involved. Meet new people. It's fun!

Alyson Outenreath
Texas Tech University School of Law
Chair, Tax Section

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State Bar of Texas

Property Tax Committee Meeting & Legal Seminar

CLE: 5.75 Hrs (including 1.0 hr Ethics)

Course No. 901345521

Monday, April 25, 2016
Thompson Conference Center at the University of Texas,
2405 Robert Dedman Drive, Austin, Texas

8:00-8:30 **Registration & Welcome**

8:30-9:45 **Case Law Panel** .75 hr

Moderated by:	*Jason Marshall*	*The Marshall Firm, P.C.*
	Sharon Baxter	Travis Central Appraisal Dist.
	Rick Duncan	Blackwell & Duncan, PLLC
	Lorri Michel	Michel, Gray, Rogers & Brewer, LLP
	Matthew Tepper	McCreary, Veselka, Bragg & Allen, PC

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

10:00-10:30 **Delinquent Tax Issues From a Practical Perspective** .5 hr

James Bellevue	Law Offices of James Bellevue
Jason Bailey	Perdue, Brandon, Fielder, Collins & Mott, LLP
Lilia Gibson	Linebarger, Goggan, Blair & Sampson, LLP
Victoria Vonder Haar	Linebarger, Goggan, Blair & Sampson, LLP

10:30-10:50 **Delinquent Tax Case Law Panel** .25 hr

Moderated by:	*James Bellevue*	*Law Offices of James Bellevue*
	Ian Ghrist	Ghrist Law Firm
	Walt McColl	McColl Law Firm, P.C.

10:50-11:35 **Tax Collections: A View from the Bench** .75 hr/.25 ethics

Moderated by:	*James Bellevue*	*Law Offices of James Bellevue*
	Maureen Garrett	Harris County Tax Master
	Jose Lopez	Harris County Tax Master
	Thomas McQuage	Galveston Tax Master
	Hon. Kent Sims	Tax Court & Visiting Judge, Dallas County District Court

11:35-12:05 **1.111 Value Agreements and 25.25 Motions** .5 hr

Greg Hart	Popp Hutcheson, PLLC
Jenny Rodgers	Olson & Olson, LLP

12:05-1:35 **Lunch**

1:35-2:35 **Chief Appraiser's Panel** 1 hr

Moderated by:	*Windy Nash*	*Dallas Central Appraisal District*
	W.Kenneth Nolan	Chief Appraiser, Dallas Central Appraisal District
	Jeff Law	Chief Appraiser, Tarrant Appraisal District
	Sands Stiefer	Chief Appraiser, Harris County Appraisal District

2:35-3:00 **Discovery Issues** .5 hr

Melinda Blackwell	Blackwell & Duncan, PLLC
Tammy White-Chaffer	Olson & Olson, LLP

3:00-3:15 **Break**

3:15-4:00 **This is Jeopardy Ethics!** .75 ethics

Amy Sallusti	Geary, Porter & Donovan, P.C.

4:00-4:45 **Keeping it Weird-The City of Austin v. Travis CAD Case** .75 hr

Debbie Cartwright	Olson & Olson, LLP
Joe Harrison	Harrison and Duncan, PLLC

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PAYMENT BY CHECK: Make checks payable to: State Bar of Texas Tax Section

Name: ____

Bar Number: ____

Address: ____

City:________________________**State:**___________________**Zip:** ____________

Telephone:__________________ **Email:** ______________________

$55.00	**$75.00**	**$90.00**
Early Bird Registration*	**Regular Registration***	**Pay at the Door***
(Now until 2/29)	**(3/1-4/8)**	**(April 25)**

*Registration fee includes morning and afternoon snacks, materials sent electronically in advance, and access to the conference center's wireless Internet.

Send Registration and Payment to:

Chris Jackson
Perdue, Brandon, Fielder, Collins & Mott
3301 Northland Drive, #505
Austin, TX 78731

Feel free to contact the Course Director with any questions:
(512) 302-0190 or cjackson@pbfcm.com

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ADDITIONAL INFORMATION

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

Parking
Limited parking is available behind the center (Lot 40).

Directions

Heading north on IH-35, take the 32nd street exit and turn left at the light. Travel west 1 block on 32nd street to Red River. Turn left and travel south on Red River to the first light (Red River and26th/Dean Keeton St). Proceed through the intersection and turn right into the first parking lot (Lot 40).

Heading south on IH-35, take the 32nd street exit and turn right at the light. Travel west 1 block on 32nd street to Red River. Turn left and travel south on Red River to the first light (Red River and 26th/Dean Keeton street). Proceed through the intersection and turn right into the first parking lot (Lot 40).

Accessibility Information
If you need any special arrangements made, please contact Chris Jackson, **cjackson@pbfcm.com,** or call (512) 302- 0190 prior to April 15, 2016 to ensure your needs will be accommodated.

Refund Information
If you register and are unable to attend, full refunds will be provided for requests received on or before April 18, 2016. After that date, you will be e-mailed a copy of the course materials and no refund will be available.

To request a refund, please contact Sandra Carlson at the State Bar of Texas Section Accounting Department by phone at (512) 427-1408 or by email at sandra.carlson@texasbar.com.

Hotel Accommodations

Below is a list of hotels conveniently located within a 2.5 mile radius of the venue.

AT&T Conference Center	1900 University Ave.	(512) 404-3600
Austin Sheraton Hotel	701 East 11th Street	(512) 478-1111
Courtyard Central	5660 N IH 35	(512) 458-2340
Marriott Courtyard	300 E. 4th Street	(512) 691-9229
Days Inn Austin	3105 North IH 35	(512) 478-1631
Doubletree Hotel	1617 North IH 35	(512) 479-4000
The Driskill Hotel	604 Brazos	(512) 474-5911
The Hilton Austin	500 E. 4th Street	(512) 482-8000

We look forward to seeing you there!!!

2016 State Bar of Texas Tax Section Annual Meeting Agenda

June 16-17, 2016

Omni Fort Worth Hotel | 1300 Houston Street | Fort Worth, TX 76102

THURSDAY, JUNE 16

5:00pm – 6:00pm	**Complimentary Networking Reception** **Omni Fort Worth Hotel** **All Tax Section Members Welcome!** *Even in today's age of email and conference calls, we still need opportunities to meet each other face-to-dace in order to develop relationships to help guide us through our careers*	

FRIDAY, JUNE 17

8:00 – 8:45	**Tax Section Membership Meeting & Section Awards** *Alyson Outenreath, Chair* *Texas Tech University School of Law, Lubbock, TX* *David Colmenero, Chair-Elect* *Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP, Dallas, TX*	
8:45 – 9:45	**Recent Developments in International Tax** *Ben Vesely, BDO, Dallas, TX* *Joe Calianno, BDO, Washington, D.C.* *John Cohn, Thompson & Knight, LLP, Dallas, TX* *U.S. Treasury Department Representative, Washington, D.C*	**CLE 1 hr.**
9:45 – 10:45	**Update on Taxation of Damage Awards & Settlement Payments** *Robert Wood, Wood LLP, San Francisco, CA*	**CLE 1 hr.**
10:55 – 11:25	**Courage, Hope, Help – Texas Lawyers Assistance Program** *Ethics Video Program*	**CLE 0.5 hr.** **Ethics**

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11:30 – 11:50	**Break/Buffet Lunch Service** *(Ticket Required)*	
11:50 – 12:50	**Lunch Presentation: The State of State Taxation –** ***An Update from The Comptroller's Office*** *(Ticket Required)* *Keynote Address by Karey W. Barton, Associate Deputy Comptroller for Tax, Texas Comptroller of Public Accounts, Austin, TX*	**CLE 1 hr.**
1:00 – 1:15	**Outstanding Texas Tax Lawyer Award Presentation** *Award Presented by Alyson Outenreath, Chair* *Texas Tech University School of Law, Lubbock, TX*	
1:15 – 2:15	**IRS Enforcement Update** *Mary Wood, Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP, Dallas, TX* *Damon Rowe, Special Agent, Internal Revenue Service, Dallas, TX* *Revenue Agent from Internal Revenue Service, Dallas, TX*	**CLE 1 hr.**
2:25 – 3:25	**Texas Tax Legends Interview:** **Tax Section Former Chair, William D. Elliott, Continues His Texas Tax Legend Interviews With Stanley Blend About His Interesting Life and Exceptional Career** *Stanley Blend, Strasburger & Price, San Antonio, TX* *William D. Elliott, Elliott, Thomason & Gibson, LLP, Dallas, TX*	**CLE 1 hr.**
3:25 – 4:25	**Issues Every Tax Lawyer Needs to Know (But May Have Lost Track Of)** *Daniel J. Micciche, Akin, Gump, Strauss, Hauer & Feld, LLP, Dallas, TX*	**CLE 1 hr.**
4:25 – 5:25	**Property Tax 101: Understanding Ad Valorem Taxation in Texas** *Amy Stowe, Jeffrey L. Hooper PLLC, Dallas, TX* *Jeffery Law, Chief Appraiser, Tarrant Appraisal District, Fort Worth, TX*	**CLE 1 hr.**

TAX SECTION

STATE BAR OF TEXAS

2016
CALL FOR NOMINATIONS FOR OUTSTANDING TEXAS TAX LAWYER AWARD

The Council of the State Bar of Texas Tax Section is soliciting nominees for the Outstanding Texas Tax Lawyer Award. Please describe the nominee's qualifications using the form on the next page. Please attach additional sheets if needed.

Nominees must: (i) be a member in good standing of the State Bar of Texas or an inactive member thereof; (ii) a former full time professor of tax law who taught at an accredited Texas law school; or (iii) a full time professor of tax law who is currently teaching at an accredited Texas law school. In addition, nominees must have devoted at least 75% of his or her law practice to taxation law and been licensed to practice law in Texas or another jurisdiction for at least ten years.[1] The award may be granted posthumously.

In selecting a winner, the Council will consider a nominee's reputation for expertise and professionalism within the community of tax professionals specifically and the broader legal community; authorship of scholarly works relating to taxation law; significant participation in the State Bar of Texas, American Bar Association, local bar associations, or legal fraternities or organizations; significant contributions to the general welfare of the community; significant pro bono activities; reputation for ethics; mentorship of other tax professionals; experience on the bench relating to taxation law; experience in academia relating to taxation law; and other significant contributions or experience relating to taxation law.

Nominations should be submitted to Stephanie Schroepfer, Tax Section Secretary, by email to stephanie.schroepfer@nortonrosefulbright.com no later than April 1, 2016. The award will be presented at the 2016 Annual Meeting of the Tax Section in Fort Worth, Texas on June 17, 2016.

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[1] "Law practice" means work performed primarily for the purpose of rendering legal advice or providing legal representation, and also includes: service as a judge of any court of record; corporate or government service if the work performed was legal in nature and primarily for the purpose of providing legal advice to, or legal representation of, the corporation or government agency or individuals connected therewith; and the activity of teaching at an accredited law school; and "Taxation law" means "Tax Law" as defined by the Texas Board of Legal Specialization's standards for attorney certification in Tax Law; tax controversy; employee benefits and executive compensation practice; criminal defense or prosecution relating to taxation; taxation practice in the public and private sectors, including the nonprofit sector; and teaching taxation law or related subjects at an accredited law school.

NOMINATION FOR 2016 OUTSTANDING TEXAS TAX LAWYER AWARD

Nominee Name: ____

Nominee Mailing Address, Phone, and Email:

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Description of Nominee's Contributions/Experience Relating to Taxation Law (please attach additional sheets if needed):

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Nominator Name: ____

Nominator Mailing Address, Phone, and Email:

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TAX SECTION
State Bar of Texas

Law Students Pursuing Tax Law Scholarship Application

The Tax Section of the State Bar of Texas annually awards up to three $2,000 scholarships to students demonstrating academic excellence and commitment to the study and practice of tax law. Any student who is enrolled in an ABA accredited law school at the time the application is submitted, and who intends to practice tax law in Texas is eligible to apply. Thus, persons who have been accepted to law school but have not yet started classes at the time the application is filed are ineligible to apply. However, persons who have recently graduated at the time the scholarship is awarded are eligible to apply.

The purpose of this scholarship is to facilitate and encourage students to enter the practice of tax law in Texas, and to become active members of the State Bar Tax Section, by assisting these students with their financial needs. Selection criteria of the scholarships include: merit, scholarship performance, financial need, and demonstrated experience and interest in the field of tax law. Consideration is also given to extracurricular activities both inside and outside law school, including but not limited to legal externships or internships with state or federal taxing authorities such as the Internal Revenue Service, Office of the Texas Comptroller of Public Accounts or Texas-based legal aid societies and clinics.

A completed application must be returned either by: (1) mail to the State Bar of Texas Tax Section's Scholarship Selection Committee, c/o Robert C. Morris, Norton Rose Fulbright, 1301 McKinney, Suite 5100, Houston, Texas 77010; or (2) email to Robert C. Morris at robert.morris@nortonrosefulbright.com.

<u>All information, including supporting documentation such as letters of recommendation and transcripts, must be included in a single submission. Transcripts do not need to be in original or certified form. If documents are submitted via email, please scan all of the documents and attach the scan to an email as a single document in PDF form. Incomplete applications will not be accepted.</u>

Applications must be postmarked or time stamped by no later than April 8, 2016. The scholarships will be awarded at the State Bar Annual Meeting in June 2016. Winners need not be present to accept the award.

Please print or type.

I. GENERAL INFORMATION

NAME: ____

E-MAIL ADDRESS: ______________________

MAILING ADDRESS: ____
____

HOME PHONE: ____________________ ALTERNATE PHONE: ___________________

II. EDUCATIONAL INFORMATION

LAW SCHOOL NAME: ____

GPA (cumulative): _____________ EXPECTED GRADUATION DATE: __________

CLASS RANK: __________

UNDERGRADUATE COLLEGE NAME: ____

DEGREE: ____ MAJOR: ___________ GPA: ______ GRADUATION DATE: _______

GRADUATE DEGREES including LL.M. Programs (College, Degree, Date):

____

____

Please attach a copy of all college, graduate school (if any) and most recent law school transcripts. If your law school transcript does not include your grades for the most recent closed grading term, please separately provide information on all grades you have received to date and supplement your application with remaining grades as soon as possible after you receive them.

LAW SCHOOL ACTIVITIES AND/OR HONORS:

COMMUNITY ACTIVITIES:

Responses regarding law school activities and/or honors and community activities may be made in typewritten form of no more than one page in length.

III. RECOMMENDATIONS AND ESSAY

Please attach (1) one or more letters of recommendation and (2) a typewritten essay of no more than two pages in length (double spaced) addressing the following:

- Why you plan to pursue a career in tax law in Texas;
- What are your long-term career goals;
- List of the tax courses you have taken and grade received, and tax courses you are currently taking; and
- Any qualifications that you believe are relevant for your consideration for this scholarship. For example, students may describe relevant research, published articles, clubs, competitions, clinics, community service, job or internship or externship experience.

- (Optional) Any issues of financial need that you would like the Committee to consider.

AFFIRMATION OF APPLICANT: By signing below, I certify that all the information provided as part of this application is true and correct. I understand that the Tax Section's Scholarship Selection Committee reserves the right to investigate all information stated in this application.

Applicant's Signature: ___________________________________ Date: _______________

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The Tax Section Presents Its

TRIBUTE To A LEGEND

Stanley Blend of San Antonio

Stanley Blend of San Antonio is one of the preeminent tax lawyers in United States and Texas, and is one of five Texas tax lawyers to have served as Chair of the ABA Tax Section since 2007. Stanley also chaired the Texas State Bar Tax Section in 1987. At the Annual Meeting this year on June 17, 2016, in downtown Fort Worth at the Omni Conference Hotel, William D. Elliott will continue his Texas Tax Legend interviews with an interview with Stanley Blend, about his interesting life and exceptional career.

Hope to see you at the Tax Section Annual Meeting
CLE Event on Friday, June 17, 2016!

7.5 CLE Hours

Also join us for a Complimentary Networking Reception
on Thursday, June 16, from 5-6pm

http://www.texastaxsection.org

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Congratulations

to the following attorneys who have been selected to participate in the 2016-2017 Tax Section Leadership Academy

Jeffrey Benson	PricewaterhouseCoopers, LLP	Dallas
Christopher Blackwell	Texas Comptroller of Public Accounts	Austin
David Boudreaux, Jr.	Carr, Riggs, and Ingram	Houston
Thomas "Bucky" Brannen	Baker Botts LLP	Dallas
Michael Cannon	Gibson Dunn & Crutcher	Dallas
Austin Carlson	Gray Reed & McGraw, PC	Houston
Kacie Czapla	Gardner Firm PLLC	Tyler
William LeDoux	K&L Gates LLP	Dallas
James Dossey	Dossey & Jones, PLLC	The Woodlands
Preston "Trip" Dyer, Jr.	Winstead PC	Dallas
Kathleen Gerber	Thompson & Knight LLP	Houston
Jeffrey Glassman	McDermott Will & Emery LLP	Dallas
Sally Hartman	Hartman & Moore	Austin
Kelly Latta	Jones Day	Dallas
Leonora "Lee" Meyercord	Thompson & Knight LLP	Dallas
Michael Overstreet	Lee & Desenberg, PLLC	Houston
Alex Pilawski	Meadows, Collier, Reed, Cousins, Crouch, & Ungerman, LLP	Dallas
Mishkin Santa	Five Stone Tax Advisers	Austin
John Strohmeyer	Crady, Jewett & McCulley, LLP	Houston
Tracy Turner	Brusniak Law, PLLC	Dallas
Joy Williamson	Baker & McKenzie, LLP	Dallas

TAX SECTION
STATE BAR OF TEXAS

To Learn More About the Tax Section's Leadership Academy, visit http://www.texastaxsection.org

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New Partnership Tax Audit Rules

By Michael J. Donohue[1]

I. Introduction

A. Existing Rules. Currently, federal tax audits of partnerships (and their partners) for tax years after 1982 are subject to one of the following procedural rules: (i) partnerships with more than 100 partners that elect the large partnership audit rules of Sections[2] 6240 through 6255 and Sections 771 through 777 of the Internal Revenue Code of 1986, as amended ("IRC"), are subject to electing large partnership tax rules, (ii) partnerships that are not electing large partnerships and have more than ten partners are subject to IRC Sections 6221 through 6234, which were enacted as part of the Tax Equity and Fiscal Responsibility Tax Act of 1982 ("TEFRA") (the "TEFRA Audit Rules"), and (iii) all other partnerships (those with 10 or fewer partners[3] that have not elected the TEFRA Audit Rules) are subject to the general audit rules, whereby the tax treatment of an adjustment to partnership items of income, gain, loss, deduction, or credit is determined for each partner in separate administrative and judicial proceedings.[4]

B. New Rules. The enactment of Section 1101 of the Bipartisan Budget Act of 2015[5] (the "2015 Act") on November 2, 2015 drastically changed the rules relating to federal tax audits of partnership.[6] The new audit rules, which are effective for partnership tax years beginning after December 31, 2017 and apply to all partnerships, completely overhaul the partnership tax audit procedures and raise numerous difficult questions regarding application of the provisions of the 2015 Act. Effective for partnership returns for tax years beginning after December 31, 2017, these sweeping new rules (i) repeal the TEFRA Audit Rules and the electing large partnership rules, (ii) replace the "tax matters partner" provisions of IRC Section 6231(a)(7) with different "partnership representative" rules, and (iii) provide new procedures for determining and collecting partnership tax assessments. The 2015 Act seeks to streamline the procedures relating to IRS audits of entities taxed as partnerships, thus increasing the number of

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[1] © Partner, Gardere Wynne Sewell LLP mdonohue@gardere.com.
[2] Unless other stated, references to "Section" refer to the Internal Revenue Code of 1986, as amended.
[3] IRC Section 6231(a)(1)(B)(i). Each partner must be an individual (other than a nonresident alien), a C corporation, or a deceased partner's estate. Certain partnerships may elect to apply the TEFRA procedures. IRC Section 6231(a)(1)(B)(ii).
[4] Under the first two sets of rules, partnership items generally are determined at the partnership level under unified audit procedures.
[5] H.R. 1314, 114th Cong. (P.L. 114-74 2015). Section 1101 of the 2015 Act amends IRC Sections 6221 through 6223; 6225 through 6227; 6231 through 6235; and 6241.
[6] Unless the context indicates otherwise, the term "partnership" also refers to a limited liability company that is taxed as a partnership.

partnership audits, which historically had been very low due in part to the cost and complexity of dealing with numerous partners.[7]

For simplicity and administrative convenience, the 2015 Act introduces a radically new mechanism that imposes the collection of tax, interest, and penalties resulting from the audit adjustments directly on the partnership.[8] Under the new audit rules, tax from partnership audits is assessed and collected at the partnership level at the highest individual[9] income tax rate,[10] unless the partnership qualifies for and elects special procedures that either reduce such tax rate or shift the payment of tax to its partners. Significantly, such tax is imposed on the partnership during the year the audit is resolved, rather than for the year being audited, thus indirectly burdening those persons who are partners for the year the audit is resolved (even though the adjustments relate to partners for the year being audited).

A partnership can reduce the partnership tax to the extent it demonstrates that all or part of the tax adjustment is attributable to a tax-exempt partner or subject to a capital gain or C corporate tax rate.[11] As an alternative to the partnership's payment of the underpayment, the partnership may elect to furnish a special Schedule K-1 statement to each partner of the partnership for the year being audited, who is then required to pay tax attributable to such partner's shares of the partnership adjustment.[12] Certain so-called "small" partnerships are permitted to elect out of the partnership audit rules.[13] Under the new audit rules, partners no longer have the right to be notified of or participate in partnership audits.

As noted, the new partnership audit rule generally apply after 2017, but a partnership generally is permitted to elect to apply the new audit rules to partnership returns filed for

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[7] A government report issued in 2014 stated that, according to IRS data for fiscal year 2012, IRS closed only 84 large partnership field audits - an 0.8% audit rate that is well below the 27.1% audit rate of C corporations with $100 million or more in assets for the same period. *See* U.S. Government Accountability Office, GAO-14-732, "*Large Partnerships: With Growing Number of Partnership, IRS Needs to Improve Audit Efficiency*" (9/18/2014). The report determined that TEFRA's requirement to shift audit adjustments to the partners (unless the partnership makes a election to the contrary, which generally is rare) sharply limits the number of IRS audits due to the significant time incurred in, and cost of, adjusting returns of a large number of partners IRS. The Joint Committee on Taxation estimated the net revenue effect of the partnership audit provisions to produce $9.325 billion in additional revenue over the period 2016 through 2025. *See Staff of the Joint Committee on Taxation, Estimated Revenue Effects of the Tax Provisions Contained in H.R. 1314, the Bipartisan Budget Act of 2015, JCX-135-15 (10/28/2015).*

[8] The 2015 Act breaks new ground since previously IRS generally collected tax underpayments attributable to partnership audit adjustments from the partners.

[9] The partnership-level tax is calculated based on the higher of the maximum individual income tax rate (currently 39.6%) and the maximum corporate income tax rate (currently 35%).

[10] IRC Revised Section 6221(a). References to "IRC Revised Section" and "IRC Amended Section" refer to the Sections of the IRC, as amended by the 2015 Act.

[11] IRC Revised Section 6225(c)(3), (4).

[12] IRC Revised Section 6226.

[13] IRC Revised Section 6221(b).

partnership tax years beginning after November 2, 2015 and before January 1, 2018 in the manner prescribed by IRS.[14]

Although not effective until 2018, the new audit provisions will force most partnerships to closely review their partnership agreement and likely make conforming amendments thereto.

II. Pre-2015 Act: Summary of TEFRA Partnership and Electing Large Partnership Audit Rules[15]

A. TEFRA Partnership Unified Audit Rules.

(1) TEFRA Overview. In 1982, TEFRA established unified audit rules, requiring the tax treatment of all "partnership items" to be determined at the partnership, rather than the partner, level. Partnership items are those items that are appropriately determined at the partnership level, rather than at the partner level, as provided by regulations.[16] Under TEFRA, IRS audits a partnership by conducting a single administrative proceeding to resolve issues with respect to all partners. Upon completing the audit, IRS calculates each partner's tax liability for the year being audited.

The TEFRA Audit Rules were enacted because the "[d]etermination of the tax liability of partners resulted in administrative problems under prior law due to the fragmented nature of such determinations. These problems became excessively burdensome as partnership syndications have developed and grown in recent years. Large partnerships with partners in many audit jurisdictions result in the statute of limitations expiring with respect to some partners while other partners are required to pay additional taxes. Where there are tiered partnerships, identifying the taxpayer is difficult."[17]

The TEFRA Audit Rules provide that collection of tax deficiencies occurs at the partner (rather than the partnership) level, although a settlement agreement with respect to partnership items generally binds all parties to the settlement.[18]

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[14] Section 1101(g)(4) of the 2015 Act. It is not expected that many partnerships will elect to adopt the new partnership audit rules for this period.
[15] *See generally*, Joint Committee on Taxation, Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Dec. 18, 2015) (the "2015 Technical Explanation").
[16] IRC Section 6231(a)(3).
[17] *See* Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 at 268 (JCS-38-82) (December 31, 1982). Additional reasons for the 1982 change include problems of duplication of administrative and judicial effort, inconsistent results, difficulty of reaching settlement, and inadequacy of prior-law filing and recordkeeping requirements for foreign partnerships with U.S. partners.
[18] IRC Section 6224(c).

(2) TEFRA Tax Matters Partner. The primary representative of a partnership in TEFRA proceedings is the "tax matters partner", who is a general partner[19] designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year.[20] If no tax matters partner is designated, and it is impractical to apply the largest profits interest rule, IRS may select any partner as the tax matters partner.[21] The tax matters partner generally is required to keep the other partners informed of all administrative and judicial proceedings relating to adjustment of partnership items at the partnership level.

(3) Partner TEFRA Audit Rules. Partners are required to report partnership items consistently with the partnership's reporting, unless the partner notifies IRS of inconsistent treatment. Tax attributable to an adjustment of a partnership item is assessed against each of the partners in the year in which the understatement of tax liability arose. A partner has the right to participate in administrative proceedings relating to the determination of partnership items at the partnership level, and can request an administrative adjustment (or refund) for the partner's separate individual tax liability. If a settlement is reached as to partnership items, all partners are entitled to consistent treatment.[22]

The TEFRA Audit Rules apply to partnership tax items, which are categorized as partnership items, non-partnership items, and affected items.[23] IRS adjustments of partnership items and affected items are resolved at the partnership level in a unified proceeding, while adjustments to non-partnership items are determined and resolved in separate proceedings with the individual partners. Tax deficiencies, penalties, and interest are assessed at the partner level.

Any partner, including an indirect partner, has the right to participate in any partnership-level administrative proceeding relating to the determination of the partnership items. IRS is required to send notice of the beginning of an administrative proceeding relating to partnership items to the tax matters partner and each the "notice partners."[24] IRS is required to issue a notice of final

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[19] With respect to a limited liability company taxed as a partnership for federal tax purposes, Treasury Regulation ("Reg.") §301.6231(a)(7)-2(a) provides that each "member-manager" is treated as a general partner, and all other members are considered non-general partners. A member-manager is one "who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization was formed." Reg. §301.6231(a)(7)-2(b)(3). If there are no elected or designated member-managers of the limited liability company, each member is treated as a member-manager for purposes of these rules.
[20] IRC Section 6231(a)(7).
[21] IRC Section 6231(a)(7).
[22] IRC Section 6224.
[23] A partnership item is any item that must be taken into account for the partnership's tax year, if regulations provide the item is more appropriately determined at the partnership level than at the partner level. IRC Section 6231(a)(3). A non-partnership item is an item that is not a partnership item. IRC Section 6231(a)(4). The term "affected item" means any item to the extent that item is affected by or dependent on a partnership item. IRC Section 6231(a)(5).
[24] All partners in a partnership with 100 or fewer partners are notice partners. In a partnership with more than 100 partners, partners with a 1% or greater interest in the partnership are notice partners. IRC Sections 6231(a)(8) and 6223(b).

partnership administrative adjustment, which sets forth the partnership adjustments, to the tax matters partner and all notice partners. [25]

(4) TEFRA Settlements. IRS may enter into a settlement agreement with the tax matters partner of a partnership or with one or more other partners of the partnership. The tax matters partner may execute a settlement agreement with IRS with respect to partnership items, including partnership-level penalties, additions to tax, or additional amounts relating to adjustments to partnership items. All partners are bound by the agreement to the extent the agreement so provides, except for notice partners, members of a five percent notice group, and partners who have filed a statement not to be bound by settlement agreements between IRS and the tax matters partner.[26] If IRS settles with any partner with respect to partnership items for any partnership tax year, IRS generally must offer consistent settlement terms for that partnership tax year to all other partners.

B. Electing Large Partnerships.[27]

A partnership with at least 100 partners is permitted to elect simplified audit procedures that apply to electing large partnerships. These audit procedures, which differ significantly from the TEFRA Audit Rules, generally are intended to ease the partnership's reporting responsibilities of tax items allocated to its partners. Similar to the TEFRA Audit Rules, disputes relating to the tax treatment of partnership items and affected items are determined at the partnership level and tax is assessed at the partner level. But, a partner in an electing large partnership must treat all partnership items on its return consistently with the partnership return, even if it notifies IRS of the inconsistency.[28] Further, under the electing large partnership rules, IRS is not required to furnish notice to individual partners of the commencement of an administrative proceeding or the issuance of a final administrative adjustment. Also unlike the TEFRA Audit Rules, the electing large partnerships rules allocate partnership adjustments to partners for the year the adjustment become final.

An electing large partnership is permitted to challenge IRS's administrative adjustment in the Tax Court, the federal district court for the district in which the partnership's principal place of business is located, or the Court of Federal Claims.[29] The electing large partnership is permitted to elect to pay the imputed tax on the adjustment instead of passing the adjustment through to its partners.[30] The electing large partnership is generally liable for any interest and penalties that result from a partnership adjustment.

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[25] The final partnership administrative adjustment is the partnership's equivalent of a statutory notice of deficiency (90-day letter).
[26] Such settlement agreement binds non-notice partners only with respect to partnership level determinations.
[27] It has been reported that very few partnerships have elected to apply these rules.
[28] IRC Section 6241(a).
[29] IRC Section 6247(a).
[30] IRC Section 6242(a)(2)(A).

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III. New Partnership Audit Rules Under Bipartisan Budget Act

A. Overview. Effective for partnership returns for tax years beginning after 2017, the 2015 Act replaces the TEFRA Audit Rules (including the tax matters partner provisions) and the electing large partnership provisions with a system that generally requires the partnership (rather than the partners) to pay income tax attributable to partnership audit adjustments. Tax imposed at the partnership level is calculated on at the highest rate of income tax pursuant to §1 (applicable to individual taxpayers) or §11 (applicable to corporate taxpayers) for the year in which the tax adjustments are finalized. Thus, partners during the year the audit is resolved (including through judicial proceedings) indirectly bear the partnership tax liability, even though the tax adjustments are attributable to tax items allocated to partners for the prior year being audited. Because of this potential unfairness, partnerships are permitted to shift the obligation to pay the tax those who were partners for the year being audited (i) by issuing revised Schedule K-1s to its partners for the year being audited, or (ii) to the extent that a partner files an amended return (for the year being audited) reflecting the partner's share of the partnership tax adjustment and pays the additional tax. Further, a partnership with no more than 100 partners (none of whom are trusts or taxed as partnerships) can elect out of the new audit rules altogether on a year-by-year basis, thus shifting the resolution and collection of the tax to its partners.[31]

The 2015 Act also amends the procedural rules relating to partnership audits and related judicial proceedings, including limitation periods applicable to partnership adjustments and tax assessments, IRS notice rules, administrative adjustments requested by partnerships, interest and penalty provisions, and judicial review. As noted, the 2015 Act provides the partnership representative, who is not required to be a partner, with the sole right to control partnership tax audits and judicial proceedings and bind the partners. Thus, commencing in 2018, partners will no longer have the right pursuant to the IRC to receive notice of, or to participate in, tax exams and proceedings at the partnership level.

B. Exemption for Electing Small Partnerships

(1) General Requirements. IRC Amended Section 6221(b) allows certain so-called "small partnerships" to elect out of the new partnership audit rules. Pursuant to this election, the partnership and its partners become subject to the pre -TEFRA Audit Rules that require IRS to deal separately with the partnership and each partner. This election is available on an annual basis if the following requirements are met for each specific election year (i) the partnership affirmatively elects out of the new audit rules[32] on a timely filed partnership return for such year and discloses to IRS the name and taxpayer identification numbers of each partner,[33] (ii) each partner is an individual, a C corporation, a foreign entity that would be treated

[31] If a purported partnership is later determined not be a partnership for tax purposes, the new provisions nevertheless apply to the entity and its owners as provided in future regulations. IRC Amended Section 6241(8).
[32] A separate election is required by the partnership for each year the election is to be effective.
[33] Pursuant to IRC Revised Section 6221(b)(2)(B), IRS may provide for alternative methods of identifying foreign partners.

as a C corporation if it were domestic, an S corporation, or an estate of a deceased partner,[34] (iii) the partnership has one hundred or fewer partners for such tax year,[35] and (iv) the partnership notifies each partner of the election (in a manner prescribed by IRS).[36] Thus, absent guidance, a partnership having a partner that is a trust[37] or an entity taxed as a partnership may not elect out of the new audit rules.

(2) S Corporation Partners. For purposes of the small partnership election, special rules apply to a partnership that has an S corporation partner.[38] First, the partnership must disclose to IRS the name and taxpayer identification number of each shareholder to whom the S corporation is required to furnish an S corporation K-1 for the tax year of the S corporation ending with or within the partnership election year. Second, in determining if the partnership has more than 100 partners, the shareholders of the S corporation partner are treated as partners of the partnership.[39] IRC Revised Section 6221(b)(2)(C) authorizes IRS to issue appropriate guidance similar to these S corporation rules for partners that otherwise cause the partnership to be ineligible to make the election.

C. Tax Matters Partner Replaced with Partnership Representative. The 2015 Act provides that each partnership is responsible for designating a person to be the "partnership representative."[40] The designation must occur in a manner determined by IRS. If the designation is either not made or not effective, IRS is permitted to name the partnership representative.[41] The partnership representative must be a person with a substantial presence in the U.S. but, unlike the tax matters partner designated under the TEFRA Audit Rules, the partnership representative is

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[34] Partnerships intending to make this election should consider (i) prohibiting the issuance or other transfer of partnership equity to an ineligible partner and (ii) requiring all partners (including S corporation partners discussed below) to furnish the requisite information to the partnership to qualify for the election.
[35] This rule is satisfied if the partnership is required to issue 100 or less Schedule K-1s to its partners pursuant to IRC Section 6031(b).
[36] IRC Revised Section 6221(b)(1)(C).
[37] Apparently, a grantor trust is not an eligible partner for purposes of the election-out provision. It is not clear if the election is available to a partnership with a partner that is a disregarded entity under Reg. §301.7701-2 or a qualified subchapter S subsidiary (QSub) within the meaning of IRC Section 1361(b)(3)(B). IRS apparently intends to adopt a narrow view of the type of partner (other than those listed in IRC Amended Section 6221(b)(1)(C)) that should be eligible to permit the partnership to elect out of the new audit rules. *See Leniency Not IRS's Goal in Partnership Audit Elect-Out Option*, 48 Daily Tax Report at G-5 (Mar. 11, 2016) (quoting Clifford Warren, special counsel in IRS's Office of Chief Counsel (Pass-through and Special Industries) as stating that, although a final decision has not yet been reached, it is likely that IRS will not be overly accommodating to expand the type of partners for purposes of electing out of the 2015 Act beyond those set forth in IRC Amended Section 6221(b)(1)(C)).
[38] IRC Revised Section 6221(b)(2)(A).
[39] It is not clear if an S corporation partner with an eligible S corporation shareholder that is a trust disqualifies the partnership from electing out of the new partnership audit rules. Although an S corporation shareholder that is a trust is counted for purposes of the 100 partner limit, the 2015 Act does not otherwise have "look-through" rules.
[40] IRC Revised Section 6223(a).
[41] Questions surround the partnership representative rules, including how a person terminates its designation, how successor partnership representatives are named, and whether the bankruptcy or other events impacting a partnership (or impacting the partnership representative) cause loss of partnership representative status.

not required to be a partner of the partnership.[42] Interestingly, the partnership representative may be a person who is not authorized to sign the partnership's tax return.[43] The 2015 Act grants the partnership representative significant rights in connection with a tax audit of the partnership and related judicial proceedings, including broad power to bind the partnership and its partners.[44] Accordingly, a partner who is not the partnership representative (or affiliated with the partnership representative) should strongly consider seeking (in the partnership agreement or otherwise) notification, participation, approval, veto and similar rights with respect to a partnership audit and partnership tax adjustments.[45] Likewise, the partnership representative should seek indemnification by the partnership and partners for expenses and losses arising from fulfilling its role as the partnership representative.[46]

D. Calculation and Collection of Partnership Imputed Underpayment.

(1) Default Rule - Tax Underpayment Collected at Partnership Level.

(a) Net Unfavorable Partnership Adjustments. IRC Amended Section 6221 generally provides that partnership tax adjustments, and a partner's distributive share thereof, is determined at the partnership level. To the extent the net adjustments increase partnership income (i.e., unfavorable adjustments), any underpayment of tax (referred to as an "imputed underpayment")[47] resulting therefrom generally is assessed and collected at the partnership level (the "default rule").[48] Interest accrues at the applicable underpayment rate from the day after the due date of the partnership return for the audit year.

Under the default rule, partnership tax assessments generally are made for the year in which the audit is resolved, rather than the year being audited. Significantly, because the partnership is responsible (subject to various exceptions) for payment of the tax liability, the liability is indirectly borne by those who are partners during the year in which the adjustment

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[42] If a partnership representative is an entity, it is unclear who can act on behalf of such entity and fulfill the partnership representative responsibilities.

[43] Presumably, the partnership representative will need access to sensitive partnership information, including the partnership tax return and Schedule K-1 information of the partners.

[44] In this regard, judicial review of a partnership adjustment must be filed solely by the partnership. IRC Amended Section 6223.

[45] Such provisions may lead to conflicts and lawsuits between the partnership representative (who the 2015 Act grants absolute power to deal with partnership tax matters) and partners who may disagree with the decisions of the partnership representative.

[46] Any rights provided to, and restrictions placed on, the partnership representative in the partnership agreement (or otherwise) should be carefully considered and potentially will result in heated negotiations between the partnership representative and the partners. Similarly, to the extent that the partnership agreement requires (or permits) the partnership representative to elect one or more alternative audit procedures or modifications under the 2015 Act, the partners should be required to furnish any requisite information to the partnership, and otherwise cooperate with the partnership representative.

[47] IRC Revised Section 6225(a)(1).

[48] Likewise, under the default rule, imposition and collection of penalties, additions to tax or additional amounts relating to such adjustments occurs at the partnership level.

becomes final (referred as the "adjustment year"),[49] rather than those who were partners during the year being audited (referred to as the "reviewed year").[50] This represents a significant and drastic change from the TEFRA Audit Rules. Importantly, a person acquiring an interest in a partnership (whether from the partnership or a partner) should seek to obtain indemnity protection through the partnership agreement (or otherwise) from understatements of partnership tax attributable to pre-acquisition periods of the partnership for which the new partner may indirectly become liable.

(b) Net Favorable Partnership Adjustments. If the net partnership adjustment reduces partnership income or otherwise does not result in an imputed underpayment tax (i.e., constitutes a net favorable adjustment), the partnership treats such favorable adjustment in the year the audit is resolved as a reduction in the partnership's non-separately stated income (or an increase in any non-separately stated loss) pursuant to IRC Section 702(a)(8).[51] Importantly, under the default rule, the partners for the year the audit becomes final are allocated the benefit of the net favorable adjustments, rather than the partners for the year being audited who initially suffered the detriment that gave rise to the favorable adjustments. Thus, the default rule does not permit the prior year partners to claim a refund with respect to favorable tax adjustments arising from the year being audited.

(c) Maximum Tax Rate Imposed on Net Unfavorable Partnership Adjustments. Generally, an imputed underpayment of a partnership is calculated by netting all adjustments of items of income, gain, loss, or deduction for the audit year. Any resulting net income or gain of the partnership (i.e., an unfavorable adjustment) is multiplied by the highest tax rate in effect for the year being audited pursuant to IRC Section 1 or 11.[52] Currently, the highest tax rate for IRC Section 1 is 39.6% (applicable to individual taxpayers) and for IRC Section 11 is 35% (for corporate taxpayers). Thus, the highest rate presently is 39.6%. A net adjustment amount that results in an increase (or decrease) in a partnership loss is treated as a decrease (or increase, respectively) in partnership income.[53] Although the partnership is assessed tax only on a net unfavorable adjustment, under the default rule the partnership is not entitled to a tax refund with respect to a net favorable adjustment. The legislative history states that netting

[49] IRC Amended Section 6225(d)(2). The "adjustment year" is defined as: (i) if the adjustment is pursuant to a court decision in a proceeding brought under the rules, the partnership tax year in which the decision becomes final (IRC Revised Section 6225(d)(2)(A)); (ii) when the adjustment is under an administrative adjustment request, the partnership tax year in which the administrative adjustment request is made (IRC Revised Section 6225(d)(2)(B)); or (iii) otherwise, the partnership tax year in which notice of the final partnership adjustment is mailed (IRC Revised Section 6225(d)(2)(C)). With respect to the 2015 Act, references herein to the year the audit is resolved or the year in which the adjustments become final refer to the "adjustment year."

[50] IRC Amended Section 6225(d)(1).

[51] IRC Revised Section 6225(a)(2)(A). An adjustment to a partnership credit is treated as a separately stated item. IRC Revised Section 6225(a)(2)(B).

[52] IRC Amended Section 6225(b)(1)(A). Adjustments to credits are treated as an increase or decrease, as applicable, to the tax imposed on the imputed underpayment. IRC Amended Section 6225(b)(1)(C).

[53] IRC Amended Section 6225(b)(1)(B).

of the adjustments is applied based on applicable limitations, restrictions, and special rules under present law.[54]

(d) Reallocation Adjustments Among Partners. The default rule provides that when an adjustment merely reallocates the distributive share of a partnership tax item from one partner to another partner (resulting in no net aggregate adjustment for all affected partners), the partnership determines the imputed underpayment by disregarding the favorable adjustments (i.e., ignoring (i) any decrease in any item of income or gain, [55] and (ii) any increase in any item of deduction, loss, or credit).[56] Thus, in that event, the amount on which the partnership must pay tax is determined solely with respect to each partner's share of the unfavorable adjustments, rather than the aggregate net adjustments of the affected partners.[57]

(e) Partner Liability for Partnership Tax. Imposing liability to fund the imputed underpayment tax on the partnership for the year the audit is resolved may causes significant issues as to how the partnership pays the tax, especially if it does not have the funds.[58] Importantly, legislative history to the 2015 Act provides that partners are not subject to joint and several liability for any tax liability determined at the partnership level.[59]

(2) Modifications. IRC Amended Section 6225(c)(1) directs IRS to establish procedures permitting the partnership to modify (i.e., reduce) the amount of the imputed underpayment tax.[60] In addition to the imputed underpayment modifications described below, IRS is authorized to permit additional adjustments to the calculation of imputed underpayment amounts through regulations or other guidance consistent with the purpose of the new audit rules.[61] All modifications to a partnership's imputed underpayment must be approved by IRS.[62]

(a) Partner Amended Returns. If a person, who was a partner during the year under audit, files an amended return for that year that reflects the partner's share of partnership adjustments and the partner pays the resulting tax, the partnership is permitted to

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54 *See* 2015 Technical Explanation. It is not clear how such limitations, restrictions, and special rules under present law apply in this context. Presumably this rule requires for example that, prior to netting, partnership items be separately categorized based on the character of the tax item (e.g., capital loss and ordinary income).
55 IRC Amended Section 6225(b)(2)(A).
56 IRC Amended Section 6225(b)(2)(B).
57 Presumably, the partnership would reduce non-separately stated partnership income (or increase partnership loss, as appropriate) pursuant to IRC Section 702(a)(8) with respect to the favorable adjustments. The partnership agreement should address how to specially allocate those favorable adjustments to the partner(s) whose allocation caused the favorable adjustment.
58 The partnership agreement should consider requiring current partners to make capital call contributions or loans to the partnership to fund the partnership tax (and also consider requiring prior year partners to indemnify the partnership for their share of this partnership liability attributable to the audit year during which they were partners).
59 Bipartisan Budget Act of 2015: Section-by-Section Summary, U.S. House of Representatives (2015), at 13-14, http://docs.house.gov/meetings/RU/RU00/CPRT-114-RU00-D001.pdf.
60 IRC Amended Section 6225(c).
61 IRC Amended Section 6225(c)(6).
62 IRC Amended Section 6225(c)(8).

reduce the imputed underpayment by the corresponding portion reported by the partner.[63] For this purpose, a partner may file an amended return even if the IRC Section 6511 statute of limitation period for the amended return has expired.[64] This alternative[65] not only transfers the tax obligation from the partnership to the partners filing amended returns, but effectively shifts the tax responsibility from those who are partners for the year the audit is resolved to the audit year amending partners.[66]

As noted, however, under the default rule, a person who was a partner during the year under audit, but is not a partner when the audit become final, does not bear (directly or indirectly) the burden of a partnership-level tax payment. Accordingly, a partner who departs the partnership prior to the year in which the partnership tax assessment is finalized may not have an incentive to file an amended return.[67] For that reason, partnerships should consider including language in their partnership agreement requiring (if requested by the partnership) persons who terminate their partner status (i) to promptly file (upon request by partnership representative) amended returns for the partnership years being examined, and (ii) to reasonably cooperate with the partnership representative to comply with the amended return requirements and furnish adequate information and documentation to the partnership.[68]

(b) Reductions of Partnership Tax Based on Character of Income or Tax Status of Partner. A partnership is permitted to reduce the imputed underpayment by the portion of the partnership adjustment that the partnership establishes is not subject to tax due to a partner's status as a tax-exempt entity.[69] Further, to calculate the imputed underpayment tax, a

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[63] IRC Amended Section 6225(c)(2). With respect to a partnership adjustment resulting from a reallocation of a partnership tax item from one partner to another, this provision applies only if all affected partners file such amended returns reflecting their distributive share of the adjustment. IRC Amended Section 6225(c)(2)(B).
[64] IRC Amended Section 6225(c)(2)(A)(i). The amended return extends the statute of limitations for all items on the partner's tax return for the year being audited.
[65] Apparently, this alternative is available only with respect to partnership audit adjustments that result in a tax liability to the audit year partner who files an amended return (i.e., unfavorable adjustments). Thus, it appears that if an amending partner's share of the partnership tax adjustment decreases the amending partner's tax, such partner apparently is not permitted to claim that benefit on the partner's individual return. Rather, this benefit presumably is treated as a current partnership deduction that is allocated to those who are partners for the year the audit is finalized. A partner that leaves the partnership should seek to be compensated by the partnership for this lost benefit to the extent it arises.
[66] If less than all of the partners file amended returns for the year being audited, complexities may arise as how the allocations of the amount of the modification should be made to the current partners (e.g., should such benefit be allocated solely to any successor of the amending partner?).
[67] If an amending partner owns equity in the partnership during both the audit year and the subsequent year in which the audit is resolved, and the partnership pays the reduced imputed underpayment, the share of the partnership tax expense allocated to the amending partner should be reduced. This should be addressed in the partnership agreement.
[68] Such a partnership agreement provision presumably would require partners to furnish their amended returns to the partnership, which may raise confidentiality issues.
[69] IRC Amended Section 6225(c)(3). For this purpose, a "tax-exempt entity" is defined in IRC Section 168(h)(2) and includes a foreign partner (other than a partner that is a foreign partnership).

partnership is permitted to use the lower tax rate[70] applicable to the portion of the imputed underpayment attributable (i) to a partner that is a C corporation (since the maximum corporate tax rate is less than the maximum individual rate)[71] or (ii) to capital gain or an IRC Section 1(h)(11)(B) qualified dividend.[72] The partnership has the burden to establish facts supporting the lower rate applicable to (i) tax exempt and C corporate partners and (ii) capital gain and qualified dividend income allocated to individual partners.[73] Accordingly, the partnership agreement should require partners to provide the partnership with the requisite supporting information relating to such lower tax rates.

The portion of the imputed underpayment to which a lower rate applies[74] will be calculated by reference to the partners' distributive share of items to which the imputed underpayment relates.[75] If a lower rate applies, the partnership agreement should address how the expense[76] allocation attributable to the reduced partnership tax payment will be made to the partner who causes the reduction of the imputed underpayment. If the imputed underpayment is attributable to the adjustment of more than one partnership item, and any partner's distributive share of the items is not the same for all the items, the portion of the imputed underpayment to which the lower rate applies is determined based on the amount that would have been the partner's distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the partnership's year being audited.[77]

(c) <u>Passive Losses of Publicly Traded Partnership</u>. IRS modifications will permit a publicly traded partnership to reduce an imputed underpayment by the portion it demonstrates is attributable to "specified passive activity losses"[78] that are attributable to a "specified partner." The amount of the specified passive activity loss is correspondingly decreased, and the partnership accounts for the decrease in the year the audit becomes final with respect to the specified partners to which the decrease relates.

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[70] This lower tax rate cannot be less than the highest rate applicable to the relevant income for the relevant taxpayer. IRC Section 6225(c)(4)(A).
[71] IRC Amended Section 6225(c)(4)(A)(i). Currently, the highest corporate tax rate is less than the highest individual tax rate.
[72] IRC Amended Section 6225(c)(4)(A)(ii). Such income and gain currently is subject a maximum income tax rate lower than both the IRC Section 1 and Section 11 rates. For this purpose, an S corporation is treated as an individual. IRC Amended Section 6225(c)(4)(A).
[73] Based on the statutory language, it is unclear if these modifications apply to partners for the audit year or the year in which the audit is resolved (although IRC Amended Section 6225(c)(4)(B)(ii) refers to the year being audited).
[74] It is unclear if a partnership, which has a partner that is a partnership, will be allowed to establish that the equity owners of the pass-through partner are tax exempt, C corporations and individuals eligible for favorable federal income tax rates on allocable partnership capital gain and qualified dividend income. IRC Amended Section 6225(c)(4) limits these special rules to a "partner" (rather than a partner of a partner).
[75] IRC Amended Section 6225(c)(4)(B)(i).
[76] The amount of a partnership's imputed underpayment should be treated as a nondeductible partnership expense in the year when the tax audit is resolved.
[77] IRC Amended Section 6225(c)(4)(B)(ii).
[78] For this purpose, a passive activity loss is defined in IRC Section 469(k).

A specified passive activity loss for any specified partner of a publicly traded partnership is the lesser of the passive activity loss of such partner for the partner's taxable year (i) during which the audit year of the partnership ends, or (ii) during which partnership year in which the audit becomes final. A specified partner is one who, for the period commencing with the partner's taxable year relating to the partnership year being audited and ending with such partner's taxable year relating to the partnership year when the audit becomes final (i) is a partner of the publicly traded partnership; (ii) is an individual, estate, trust, closely held C corporation, or personal service corporation; and (iii) has a specified passive activity loss with respect to the publicly traded partnership.

(d) <u>Time to Submit Supporting Information to IRS</u>. IRC Amended Section 6225(c)(7) requires that information required to support an imputed underpayment modification (discussed above) must be submitted to IRS no later than 270 days after the notice of the proposed partnership adjustment is mailed pursuant to IRC Amended Section 6231 (unless IRS consents to an extension).[79]

E. <u>Partnership Election to Shifting Tax Responsibility to Partners</u>.

(1) <u>General</u>. Pursuant to the 2015 Act, a partnership has another alternative to transfer the obligation of paying tax on partnership tax deficiencies to those who were partners of the partnership during the year being audited.[80] This important procedure, which is expected to be widely used, allows a partnership to elect to furnish, to IRS and to each person who was a partner for the year under audit, a statement (a special Schedule K-1 statement) of the partner's share of the partnership tax adjustment, as determined in the notice of final partnership adjustment.[81] The statements must be prepared and issued in the manner determined by IRS.

(2) <u>Election</u>. The election, which is irrevocable and is available to all partnerships,[82] must be made by the partnership within 45 days of receipt of the final partnership adjustment.[83] This alternative procedure (i) relieves the partnership from liability to pay the imputed underpayment and (ii) precludes IRS from collecting the tax imposed on a partner’s share of the partnership tax adjustments from other partners. The election, which apparently is

[79] The 270-day period may expire prior to a decision by the partnership to pursue judicial review of any proposed partnership adjustment.
[80] If the partnership makes this election, query if the partnership agreement should require those who were partners during the audit year to reimburse the partnership for the cost the partnership and partnership representative incur to resolve the audit and related judicial proceedings.
[81] IRC Amended Section 6226(a)(2). It may become typical for a partnership’s lender to require the partnership to elect this alternative (or, alternatively, to require the partnership to elect out of the provisions of the 2015 Act under the small partnership exemption discussed above) to the extent the partnership is eligible.
[82] IRC Amended Section 6226(a).
[83] IRC Amended Section 6226(a)(1). Of course, the short 45-day period in which to make the election may place significant time constraints on the partnership and partnership representative to properly weigh the pros and cons of such election. Also, although the election is unilaterally made by the partnership representative, if the partners have contractual rights to approve whether such election is made, prompt coordination with such partners will be critical.

available only to the extent the partnership audit increases partners' tax liability (i.e., only applies to the partnership's net unfavorable partnership adjustments),[84] subjects each person (who was a partner during the audit year) to tax liability for the year during which the partnership issues the statement.[85]

Thus, under this alternative the partner does not file an amended return for the year being audited, but rather pays its increased tax for the year in which the audit is finalized. But, the partner's tax is calculated as if the tax adjustments occurred for the year under audit.[86] The partner also must compute and pay any tax increase for years subsequent to the year being audited that results from adjustments to tax items and attributes that would have been affected if the partnership adjustments occurred during the audit year.[87]

(3) Increased Partner Interest Rate. Significantly, interest on the partner's additional tax is determined at the partner level and calculated from the due date of the return for the year under audit at the underpayment rate pursuant to IRC Section 6621(a)(2) based on the applicable federal short-term rate plus by five percentage points (instead of normal three percentage point increase set forth in IRC Section 6621(a)(2)(B)).[88] Thus, a disadvantage of the alternative of the issuing special K-1 statements is the partners are exposed to a higher interest cost.[89] This election also requires the audit year partner to become liable for any penalties, additions to tax, or additional amounts imposed on the partner's share of the partnership tax assessment. [90]

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[84] Partners whose tax liability from the partnership tax adjustment would decrease for the audit year generally obtain no benefit, rather the partnership apparently would claim a net deduction for the year the audit is resolved and such deduction would be allocated to those who are partners for that year.

[85] IRC Amended Section 6226(b)(1). The ramifications are unclear if a partner receives a statement from the partnership but does not file an amended return or pay the corresponding tax.

[86] IRC Revised Section 6226(b)(2)(A). In essence, a partner's increased tax is calculated by increasing the income for the year being audited as if the partner's share of the tax adjustment had been properly reflected on the original Schedule K-1 for the year being audited, but tax is reported and paid on the partner's return for the year the special K-1 is issued. The partner is liable for the additional tax even if the statute of limitation has expired for the partner's return for the year being audited.

[87] IRC Revised Section 6226(b)(2)(B). Tax items and attributes of the partner must be adjusted for tax years after the year being audited and before the year the audit becomes final, and thereafter for later tax years. IRC Revised Section 6226(b)(3)(A) and (B). Note that if a partner experiences a post-audit year reduction in tax as a result of reporting the special K-1 adjustments for the audit year, such benefit is not taken into account.

[88] IRC Amended Section 6226(c)(2).

[89] The special K-1 statement election may also put pressure on the partnership representative to resolve the audit promptly to minimize the increased interest cost. Other possible disadvantages of the special K-1 statement alternative (that would not occur absent the special K-1 statement election) include (i) subjecting the partner to taxes (and interest and penalties) for post-audit years resulting from the special K-1 adjustments for the audit year, and (ii) possibly imposing the 3.8% Medicare tax under IRC Section 1411 on the special K-1 adjustments of partners who are not C corporations.

[90] IRC Amended Section 6226(c)(1). Those tax items continue to be determined at the partnership level.

(4) Tiered Partnerships. Numerous partnerships have tiered partnership structures whereby the partnership (the "lower-tier partnership") has one or more partners that are taxed as a partnership (an "upper-tier partnership"). It is not clear how the special K-1 statement election, if made at the lower-tier partnership level, affects an upper-tier partnership. Tiered structures will likely raise complex issues as to how the lower tier partnership's imputed underpayment tax flows up to (and through the upper-tier partnership to the owners of the upper-tier partnership) as a result of the upper-tier partnership receiving a special K-1 statement from the lower tier partnership. In this regard, if the lower-tier partnership makes the election and issues a special K-1 statement to the upper-tier partnership, it is unclear if the upper-tier partnership has the discretion to either pay the tax attributable to the special K-1 statement or instead shift that payment obligation to the partners of the upper-tier partnership by itself issuing special K-1 statements to its partners. Moreover if, upon receiving a special K-1 statement from a lower-tier partnership, the upper-tier partnership is permitted in turn to issue special K-1 statements to the partners of the upper-tier partnership, does the upper-tier partnership obtain an additional 45 days to elect the special K-1 alternative. Also if, under IRC Amended Section 6221(b)(1), the upper-tier partnership has elected out of the provisions of the 2015 Act for the year being audited, what impact (if any) does such election have on the upper-tier partnership issuing special K-1 statements in this context. Answers to many issues arising from tiered partnership structures likely will not be answered until IRS issues future guidance.

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F. Termination of the Partnership. IRC Amended Section 6241(7) provides that if a partnership ceases to exist before the partnership adjustments are finalized (or even prior to a partnership audit commencing), the adjustments are taken into account by the "former" partners as determined under future regulations.[91] Because the new audit rules generally do not impose joint and several liability for partnership tax on the partners, it is not entirely clear what rights IRS has to collect partnership tax directly from the partners if the terminated partnership has insufficient funds and one or more "former" partners do not pay their share of tax.

G. New Partnership Tax Assessment and Collection Procedures. Unlike the TEFRA Audit Rules permitting a "notice" partner to settle its share of partnership adjustment (regardless of whether the other partners did so),[92] the 2015 Act generally eliminates a partner's ability to settle partnership adjustments with IRS. Further, the new audit rules do not distinguish among TEFRA partnership items, non-partnership items, and affected items. The new regime is intended to reduce administrative challenges. Likewise, in contrast to the TEFRA Audit Rules, which under certain circumstances permit a partner to file a petition in the U.S. Tax Court,[93] the new audit rules only permit the partnership to petition the U.S. Tax Court to challenge an IRS

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[91] It is unclear how broadly the term "former" partner will be interpreted in this context and whether this provision only applies to current partners of the partnership existing when the partnership terminates (or applies to all persons who were former partners of the partnership). In this situation, it may be prudent for the partnership agreement to address how post-termination partnership tax audits will be handled and whether the partnership representative is permitted to elect to issue special K-1s to former partners of the partnership.
[92] IRC Section 6224(c).
[93] IRC Section 6226(b).

adjustment at the partnership level.[94] Under IRC Amended Section 6223(b), a partnership and its partners are bound (i) by actions taken by the partnership representative and (ii) by any final decision in a proceeding brought with respect to the partnership.

(1) Consistent Partner Reporting. Similar to the TEFRA Audit Rules, the new audit rules require that a partner generally report partnership tax items consistently with the partnership.[95] But, as with the TEFRA Audit Rules, the 2015 Act permits a partner to file a tax return that is inconsistent with the partnership's return, provided the partner notifies IRS.[96] If a partner fails to report in a manner consistent with the partnership and does not qualify for an exception, IRS is allowed to assess and collect the underpayment as if the underpayment were a mathematical or clerical error on the partner's return.[97]

(2) Limitation Period for IRS to Make Partnership Adjustments. Pursuant to IRC Amended Section 6235, the general limitations period for asserting partnership adjustments is three years[98] after the latest of (i) the date the partnership return is filed, (ii) the partnership return due date for such year, or (iii) the date on which the partnership filed an administrative adjustment request relating to such year pursuant to IRC Amended Section 6227.[99] This limitation period is extended (x) 270 days after any permitted partnership submission to IRS of information supporting an imputed underpayment modification pursuant to IRC Amended Section 6225, and (y) 330 days after the date of a notice of a proposed partnership adjustment under IRC Amended Section 6231(a)(2).[100]

(3) Administrative Adjustment Requests. IRC Amended Section 6227 sets forth procedures for a partnership to file a request for an administrative adjustment to partnership tax adjustments. The request must be filed not more than 3 years after the later of (i) the date on which the partnership return for such year is filed, or (ii) the last day for filing the partnership return for such year (determined without regard to extensions).[101] IRC Amended Section 6227(c) provides that a request may not be filed after a notice of an administrative proceeding with respect to the taxable year is mailed pursuant IRC Amended Section 6231. If the request reflects an imputed underpayment amount, the partnership must either (i) pay the amount of any imputed

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[94] IRC Amended Section 6234(a).
[95] IRC Amended Section 6222(a).
[96] IRC Amended Section 6222(c). The partner must also comply with IRS notice requirements when the partnership fails to file a return. IRC Amended Section 6222(c)(1)(A)(ii).
[97] IRC Amended Section 6222(b).
[98] IRC Amended Section 6235(b) provides the partnership and IRS may extend the general limitations period by agreement entered before the expiration of such period. The period of limitations is extended to six years in the case of a substantial omission from gross income, and no period of limitation applies in cases of a fraudulent partnership return or where the partnership fails to file a return for any tax year. IRC Amended Section 6235(c).
[99] Under the new audit rules, the statute of limitations is based solely on the partnership return; the expiration of a partner's statute of limitations is no longer relevant.
[100] These periods are further extended for any additional periods consented to by IRS pursuant to IRC Amended Section 6225(c)(7).
[101] IRC Amended Section 6227(c)(1) and (2).

underpayment when filing the request, or (ii) issue amended K-1s to the partnership similar to the rules set forth in IRC Amended Section 6226.

(4) Notice of Adjustments; Assessments Periods. IRC Amended Section 6231 requires IRS to mail to the partnership and partnership representative (i) notice of an administrative proceeding initiated at the partnership level, (ii) notice of any proposed partnership adjustment resulting from such proceeding, and (iii) notice of any final partnership adjustment resulting from such proceeding. The notice of any final partnership adjustment may not be mailed earlier than 270 days after the date on which the notice of any proposed partnership adjustment is mailed.[102] Pursuant to IRC Amended Section 6232, generally no assessment of a tax deficiency may be made (and no collection action related to such adjustments commenced) before the 90th day after the date the notice of final partnership adjustment was mailed or, if a petition is filed for judicial review of the adjustment, before the decision of the court has become final.[103]

(5) Judicial Review. A partnership[104] may seek judicial review of the adjustments in a notice of final partnership adjustments with the Tax Court, the U.S. district court,[105] or the Court of Federal Claims by filing a petition for readjustment within the 90-day period after the date on which a notice of final partnership adjustment is mailed pursuant to IRC Amended Section 6231.[106] However, to sue in the district court or the Court of Federal Claims, the partnership must deposit, on or before the petition is filing date, the amount of the imputed underpayment.[107] Pursuant to IRC Amended Section 6234, the court has jurisdiction to determine (i) all items of income, gain, loss, deduction, or credit of the partnership for the taxable year to which the final partnership adjustments relates, (ii) the proper allocation of items among partners, and (iii) penalties, additions to tax, and other amounts for which the partnership may be liable.

IV. Practical Application.

Although the new audit rules do not yet apply, partnerships and their partners (in consultation with their advisors) should become familiar with the provisions of the 2015 Act and determine whether to amend their partnership agreements in advance of the 2018 effective date. Partners should identify who will bear the burden or enjoy the benefit of partnership adjustments for a specific audit year by including appropriate indemnification and other provisions in their partnership agreement. Likewise, partners forming a new partnership, along with purchasers of

[102] During the 270-day period (as extended by IRS) that the partnership is permitted to seek a modification of the imputed underpayment, IRS may not issue a notice of final partnership adjustment.
[103] The 2015 Act addresses interest and penalties related to a partnership adjustment in IRC Amended Section 6233.
[104] A partner is not permitted to seek judicial review of the partnership tax adjustment.
[105] The applicable district court is the district in which the partnership's principal place of business is located.
[106] IRC Amended Section 6234(a).
[107] IRC Amended Section 6234(b)(1).

interests of an existing partnership, should consider the effect of the 2015 Act in their agreements.

Among the many issues to consider are:[108]

(i) is the partnership eligible to elect out of the new audit rules and, if so, will the annual election be made to do so,

(ii) if the partnership intends to elect out, should the partnership agreement prohibit (a) transfers (including issuances by the partnership) of partnership interests to ineligible persons (e.g., trusts and entities taxed as partnerships), (b) transfers of partnership interests (including to an S corporation having more than one S corporation shareholder) that cause the partnership to have more than 100 partners within the meaning of IRC Amended Section 6221(b), and (c) S corporation partners from increasing the number of their shareholders in violation the 100-partner threshold.

(iii) who will be designated the partnership representative, what procedures will apply for a successor partnership representative, and what restrictions (if any) will be imposed by the partners on the partnership representative's broad statutory rights,[109]

(iv) what contractual rights (if any) will partners acquire from the partnership and the partnership representative with respect to (a) notice of and participation in partnership audits and related judicial proceedings, (b) approval of various partnership elections under the 2015 Act, and (c) approval of resolution of partnership audit adjustments,

(v) should the partnership and partners indemnify the partnership representative for acting as the partnership representative,

(vi) will the partnership elect to transfer the payment obligation for any partnership imputed underpayment tax to its partners by issuing special K-1s to the partners, thus subjecting such partners to the increased interest rate on their portion of the tax deficiency,

(vii) how will a partnership that is an upper-tier partnership handle receipt of a special K-1 from the lower-tier partnership,

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[108] A partnership and its partners likely will not be in a position to properly address many of these issues until future guidance is issued.

[109] In fulfilling its responsibilities as the partnership representative, a related issue is what duty (if any) does the partnership representative owe to those persons who were partners during the year being audited.

(viii) will partners (including former partners) be required to file amended returns and pay tax for the audit year reflecting their share of partnership tax adjustments in order to reduce the partnership imputed underpayment tax and, if so, such partners should be required to (a) promptly furnish such amended returns to the partnership representative, and (b) reasonably cooperate with the partnership representative,

(ix) if the partnership decides to pay the imputed underpayment tax, will the current partners be required to contribute or loan cash to the partnership to fund such tax if the partnership has insufficient cash.

(x) will the partnership agreement require a partner who leaves the partnership (and who thus becomes a former partner) to indemnify the partnership and its current partners for the partnership tax cost relating to partnership adjustments for audit years during which the former partner was a partner,

(xi) will lenders of the partnership require the partnership to shift the payment obligation for any partnership imputed underpayment tax from the partnership to its partners by issuing special K-1s to its partners or by electing out of the new audit rules, thus eliminating IRS as a creditor of the partnership,

(xii) what information must a partner provide to the partnership representative (for example, (a) a corporate partner's status as a C corporation, permitting the partnership to calculate a portion of the imputed underpayment tax at the corporate tax rate, and (b) information relating to an S corporation partner and its owners and relating to an upper tier partnership and its owners),

(xiii) how will the partnership allocate partnership tax items attributable to partnership audit adjustments (and partnership tax payments) to its partners,

(xiv) what provisions should be addressed in the partnership agreement relating to the partnership audit adjustments that are made after the partnership terminates, and

(xv) what consequences occur to a partner who fails to comply with partnership provision related to the new partnership audit rules?

As noted, if the partnership does not statutorily shift liability to pay taxes to its partners, a person becoming a partner after the audit year (but before the year the audit become final) may become indirectly liable for partnership taxes for pre-acquisition periods of the partnership. A person who acquires an interest in an existing partnership should perform detailed tax due diligence on the partnership's prior tax positions and seek an indemnity from the partnership and

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its partners for any partnership tax liability that may arise for pre-acquisition tax periods. Also, the new partner should clearly understand what partner rights exist under the partnership agreement relating to tax audits of the partnership (and related judicial proceedings) and confirm that the new partner is adequately protected with respect to partnership audits (and related judicial proceedings). Likewise, if a partnership is acquired, the 2015 Act now strongly encourages the acquirer to focus on potential partnership tax liability for pre-acquisition periods and obtain tax indemnities from the partners of the partnership for such potential partnership-level federal taxes.[110]

V. IRS Notice 2016-23 – IRS Request for Comments on New Partnership Audit Rules.

On March 4, 2016, IRS issued Notice 2016-23, which requests comments on the new audit rules by April 15, 2016. The Notice implicitly acknowledges that the current general federal income tax system applicable to pass-through entities is not consistent with the 2015 Act default rule that imposes and collects tax at the partnership level. The Notice specifically lists 12 issues on which comments are specifically invited, including the following:

(1) Election Out of 2015 Act. What type of partner, in addition to those described in IRC Amended Section 6221(b)(1)(C) (i.e., individuals, C corporations, foreign entities treated as C corporations if they were domestic, S corporations, and estates of a deceased partners), should permit the partnership to elect out of the provisions of the 2015 Act (similar to the special rules applicable to S corporations);

(2) Designation of Partnership Representative. What limitations (if any) should be placed on the partnership representative designation; and how should "substantial presence in the United States" be defined for purposes of that designation;

(3) Determination of the Imputed Underpayment. How should the netting of partnership audit adjustments be calculated; and how should the general IRC provisions relating to character changes, restrictions, and limitations be applied to calculate the imputed underpayment;

(4) Modification of the Imputed Underpayment. How should the mechanics and timing requirements apply for requesting modification to the imputed underpayment and providing supporting documentation; what effect should a tax-exempt partner's unrelated business taxable income have on the modification procedure; and what other criteria should be considered in applying the modification procedures;

[110] Disclosure provided to a prospective new partner likewise should address the consequences of the new partnership audit rules to the new partner.

(5) Favorable Audit Adjustments. How should a partnership account for IRS adjustments that do not result in an imputed underpayment (e.g., net favorable adjustments that do not increase income or do not decrease loss);

(6) Special K-1 Statements. How should the partnership election to issue special K-1 statements to partners be made (and what information should be included with the election); when should the related information be sent to IRS and the partners; how should changes by a court proceeding to the final notice of partnership adjustment be taken into account; and what consequences (if any) occur if a partner fails to account for adjustments on the special K-1 statement (including how IRS collects the tax resulting from the special K-1);

(7) Effect on Basis. What effect does partnership audit adjustments have on the bases of (i) the partners' partnership interests; and (ii) the partnership's assets; and

(8) Effect of Partnership Bankruptcy or Termination. What effect does bankruptcy or termination of the partnership have on application of the new audit rules.

Conclusion. The 2015 Act will have a significant impact on virtually all partnerships and their current and future partners. However, many significant questions surrounding the 2015 Act will remain unanswered until the issuance of detailed regulations and other guidance by IRS. Although the 2015 Act is not yet effective, partnerships, partners and their tax advisors are well-advised to promptly commence reviewing the new audit rules, and amending their partnership agreements to address the impact of the new rules, including the various alternatives and elections provided therein.

S Corporation Opportunities and Pitfalls

(Originally Presented at the 2015 UT-CLE Taxation Conference)

Christina A. Mondrik, Mondrik & Associates

I. Disclaimer

This paper provides information on general tax issues and is not intended to provide advice on any specific legal matter or factual situation. This information is not intended to create, and receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this information without seeking professional counsel.[1]

II. Introduction

S corporations derive their name from Subchapter S of Chapter 1 of the Internal Revenue Code, which sets forth their general requirements and treatment. S corporations are defined as "small business corporations."[2] S corporation elections are popular, especially among small business owners. In many ways, since the S corporation allows for flow-through entity treatment, it may simplify reporting by requiring payment of tax only at the shareholder level. However, it may complicate reporting as well. Many business owners who have made the election to have their corporations treated as S corporations are unaware of the requirements to qualify for and maintain the S corporation election, and face potential risks related to assignment of income, reasonable compensation requirements, and other lurking issues. This paper discusses common audit issues related to S Corporations, how businesses may avoid them, and considerations to discuss with taxpayers related to their choice of entity and whether it continues to make sense as time progresses.

III. S Corporation Prerequisites

In order to qualify to make an S corporation election, and to maintain S corporation status, an entity must be formed as a domestic corporation and must meet the following requirements:

1. 100 or fewer shareholders.
2. Shareholders must be individuals.
3. Shareholders must not be nonresident aliens.
4. Only one class of stock.

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[1] In accordance with IRS Circular 230, this communication does not reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant Federal tax issues discussed herein, and with respect to such tax issues, this communication was not written, and cannot be used by you, for the purpose of avoiding Federal tax penalties that could be asserted against you.

[2] IRC § 1361(a)(1).

While this may seem simple, the details of these requirements are not as straightforward. Issues arise in connection with each of these categories, potentially causing the S corporation to fail its qualifications and default to "C corporation" status. Unlike the flow-through nature of S corporations, if an S corporation loses its status and is treated as a C corporation, it will be required to pay income tax twice, once at the entity level and a second time at the individual level when the shareholders receive corporate payments as dividends.

A. Number of Shareholders

The shareholder limitation presents interesting issues. Members of a family are treated as one shareholder. This includes a husband and wife (and their estates).[3] This also includes all members of a family (and their estates). Members of a family are defined to include a common ancestor, any lineal descendent of the common ancestor, any spouse or former spouse of a common ancestor or any such lineal descendent. A common ancestor includes individuals not more than six generations removed from the youngest generation of shareholders who would be considered family members. For these purposes, spouses (and former spouses) are treated as being part of the same individual to whom the spouse is (or was) married. Family members also include legally adopted children and eligible foster children.[4] This means it's not as straightforward as it seems to count to 100.

B. Individuals Only

IRC § 1361(b)(1)(B) provides an exception for an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6). For these purposes an individual's estate includes not only the estate of a deceased person, but also the bankruptcy estate of an individual who files for bankruptcy protection under Title 11 of the US Code.

IRC § 1361(c)(2) allows for certain domestic trusts to be treated as individual shareholders. These include (i) domestic individual grantor trusts, (ii) grantor trusts surviving a decedent for a two-year period beginning on the day of the deemed owner's death, (iii) trusts to which stock is transferred pursuant to the terms of a will, for the two-year period following the day the stock is transferred to the trust, (iv) a trust created primarily to exercise the voting power of the stock transferred to it, (v) an electing small business trust, and (vi) an IRA, including a Roth IRA, held by a bank or depository institution, subject to IRC §1351(c)(2)(A)(vi). Foreign trusts may not be treated as S corporation shareholders.

IRC § 1361(c)(6) allows certain exempt organizations to be treated as S corporation shareholders.

C. No Non-Resident Aliens

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[3] IRC § 1361(c)(1).
[4] Further defined under IRC §152(f)(1)(C).

Non-resident aliens may not be shareholders of an S corporation. If a US shareholder's spouse is a nonresident alien with a current ownership interest under community property law or the law of a foreign country, or some other provision, the corporation cannot qualify as an S corporation from the time the nonresident alien spouse acquires an interest.[5] However, a nonresident alien married to a US citizen or resident may elect to be treated as a US resident under IRC § 6013(g).

D. One Class of Stock

An S corporation may only have one class of stock. For example, if an S corporation were to establish a second class of stock, such as preferred stock, it may lose its eligibility. For the purpose of determining whether there is more than one class of stock, the IRS considers only stock issued and outstanding, regardless of whether it is authorized.[6] Treasury stock, if unissued, would not necessarilydefault this requirement.

E. Ineligible Business Types

Certain types of businesses are precluded from making an S corporation election.[7] These include:

1. Financial institutions using the reserve method of accounting for bad debts under IRC § 585,
2. Insurance companies subject to tax under subchapter L,
3. Corporations that have made an election under IRC § 936 for Puerto Rico and possession tax credits, or
4. DISCs or former DISCs.

IV. Effects of S Corporation Election

Two primary reasons for making an S corporation election are to avoid double taxation on distributions and allow flow through of corporate losses to shareholder. The S corporation itself is not a taxpayer but only files an information report.

A. No Double Tax on Distributions

Unlike traditional C corporations, which file Form 1120 and are taxed at the entity level, S corporations file Form 1120S, which distributes income and loss items to shareholders for reporting on their individual Form 1040 tax returns.

[5] Regs. § 1.1361-1(g)(1)(i).
[6] *See e.g.*, PLR 9027007 and PLR 200145026.
[7] IRC § 1361(b).

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B. Corporate Losses Flow through to Owners, With Limitations

S corporation owners can offset taxable income by distributed S corporation losses. S corporation losses are subject to three limitations.

1. Stock and Debt Basis Limits

S corporation shareholders must track both their stock and debt basis, which increases or decreases based upon the S corporation's operations. The S corporation issue shareholders Schedules K-1, which report the S corporation's items of income, loss and deduction allocated to each shareholder for the year. The K-1 reports the amount of non-dividend distribution the shareholder receives but does not state the taxable amount of a distribution. The taxable amount is contingent on the shareholder's stock basis, which each individual shareholder is responsible for tracking.

A shareholder receiving a non-dividend distribution from an S corporation receives the distribution tax-free to the extent it does not exceed the shareholder's stock basis. Debt basis is not considered when determining the taxability of a distribution.

Basis is increased by ordinary income, separately stated items, tax exempt income and excess depletion. Basis is decreased by ordinary losses, separately stated losses, nondeductible expenses, non-dividend distributions, and oil and gas depletion, but may not be decreased below zero. Non-dividend distributions in excess of basis are treated as capital gains, and are treated as long term capital gains if held for longer than a year. Nondeductible expenses reduce stock and/or debt basis before loss and deduction items and are not suspended and carried forward. Different types of loss and deduction items in excess of basis must be allocated pro rata. There is loss suspension for items in excess of basis. They can be carried forward indefinitely.

One common issue is whether an S corporation shareholder had sufficient resources to make a contribution or loan. Current year losses and deductions are combined with suspended items from prior years. The current and prior year items should be separately reported on the shareholder's Form 1040, Schedule E. Debt basis is allowed only to the extent shareholders personally loan funds to the S corporation. Guarantees are insufficient to establish basis.

Part or all of a repayment of reduced basis debt is taxable to the shareholder. If the shareholder sells the S corporation stock, suspended losses are lost due to basis limitations. Gains on sales of S corporation stock, however, don't increase the shareholder's stock basis.

2. At Risk Test

For a shareholder to claim a loss and/or deduction reported from an S corporation K-1, the shareholder must first have adequate stock and/or debt basis. Even when the shareholder has adequate stock and/or debt basis to claim the S corporation loss or deduction, the shareholder must also consider the at-risk and passive activity loss limitations and therefore may or may not be able to claim the loss and/or deduction item.

3. Passive Activity Losses

IRC Sec. 469 sets forth rules for identifying passive activities, for which losses are suspended until related income is generated. A passive activity is one in which the taxpayer does not materially participate.

The Internal Revenue Code states:

> A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is—
>
> (A) regular,
> (B) continuous, and
> (C) substantial.[8]

The Regulations provide seven tests a taxpayer can use to prove that he or she meets these three factors.[9] The first of these tests states that, barring certain limitations, an individual who "participates in [an] activity for more than 500 hours during [a] year" has materially participated in that activity.[10] Therefore, if a taxpayer participates in a business activity for more than 500 hours during a calendar year, the activity is not passive.[11] Even if the 500 hour threshold is not met, a taxpayer can still prove material participation if he spends at least 500 hours participating in all "significant participation activities."[12] A "significant participation activity" is an activity that a taxpayer participated in for more than 100 hours, but did not pass any of the other material participation tests.[13] A taxpayer can prove he materially participated in several activities if he spent at least 100 hours participating in each activity alone, and over 500 hours participating in all significant participation activities in aggregate.

In general, any work done in connection with an activity a taxpayer owns counts as participation in that activity.[14] There are exceptions, however. The most relevant exception is that work done as an "investor" does not count as participation unless the taxpayer is also involved in day-to-day management or operations of the activity.[15] Work done as an investor includes reviewing financial statements and operational reports, analyzing the business's finances or operations for the taxpayer's own use, and monitoring the finances or operations of the business in a non-managerial capacity.[16]

As a general rule, a "real property trade or business" means "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. A real estate business is considered an active trade or business if more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in

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8 IRC § 469(h)(1).
9 Treas. Reg. § 1.469-5T(a).
10 Treas. Reg. § 1.469-5T(a)(1).
11 IRC § 469(c)(1).
12 Treas. Reg. § 1.469-5T(a)(4).
13 Treas. Reg. § 1.469-5T(c).
14 Treas. Reg. § 1.469-5(f)(1).
15 Treas. Reg. § 1.469-5T(f)(2)(ii)(A).
16 Treas. Reg. § 1.469-5T(f)(2)(ii)(B).

which the taxpayer materially participates." In the case of a joint return, these requirements are satisfied if either spouse separately satisfies such requirements.

Courts have held that taxpayers may appropriately group related business activities to determine material participation. In *Schumacher v. Commissioner*, the court considered whether the taxpayers could group rental activities with an S corporation's activities.[17] The S corporation operated a flight training, aircraft rental and aircraft charter service. The rental operation involved additional equipment that the taxpayers purchased and rented to the S corporation. The court determined that the rental activity and the S corporation constituted an appropriate economic unit and that the equipment rental was insubstantial to the S corporation's operations. Therefore, the taxpayers were entitled to group the activities for the purpose of determining material participation.

V. Making an S Corporation Election

An S Corporation election is made by filing Form 2553. The form must be signed by all shareholders, It may be filed at any time during the tax year preceding the filing of the initial Form 1120 S or at least no more than two months plus fifteen days after the beginning of the tax year when the election is to take effect.

In community property states the shareholder's spouse must also sign the Form 2553. Revenue Procedure 2004-35 provides automatic relief for late shareholder consents. Automatic relief is available if the election is invalid solely because the spouse didn't sign, the spouse must be a shareholder solely due to community property laws and must not hold an outright interest in the S corporation, and all income must be reported by both spouses on affected returns. A written signed statement is required to trigger the automatic relief.

VI. Withdrawing an S Corporation Election

Sometimes S corporation elections are made hastily without full knowledge or understanding of the effect of the election. In those cases, especially where tax returns have been filed that are inconsistent with the S election (e.g. a taxpayer reporting an LLC S corporation's income and expenses on Form 1040, Schedule C), a taxpayer may wish to withdraw the S election.

Voluntarily withdrawing an S corporation election requires a written request specifically seeking withdrawal or revocation of the election. The request must include the name(s) and social security numbers of all owners and explain the reason for the erroneous election.

An S corporation election may also be involuntarily withdrawn, or defaulted if at any time there are too many shareholders, non-resident alien owners, invalid entities as shareholders, too many classes of stock, or ineligible shareholders.

VII. Reasonable Wage Requirement

[17] TCM 2003-96.

S corporations owners are required to pay themselves a “reasonable wage,” which is subject to withholding and payroll taxes. Many business owners elect S corporation status in order to save self-employment taxes, but it is important to analyze what a “reasonable wage” might be for the profession before advising clients to enter into the complexity of additional tax returns, flow-through reporting, and corporate formalities that are also necessary when establishing S corporations.

IRC § 162(a)(1) allows a deduction for a reasonable allowance for salaries or other compensation for personal services actually rendered. Treas. Reg. § 1.162-7 evaluates intent and reasonableness. A taxpayer must have intended for the payment to be compensation for personal services and must have treated the payment accordingly at the time of payment.[18] The reasonableness of the amount of compensation is fact question.[19] Courts determine reasonableness by comparing the amount of compensation paid with the value of the services the employee performed.[20] The courts apply the test to individual employees, not in the aggregate.[21]

The IRS doesn’t treat a shareholder’s share of S corporation earnings as self-employment income, unlike other types of pass-through entities.[22] Rather, compensation S corporations pay to shareholders is subject to payroll tax. Thus, the IRS requires S corporation owners to pay themselves a reasonable wage, subject to payroll tax.

When an S corporation pays no compensation to its shareholder/employees the IRS is likely to allege all dividends and distributions were paid in lieu of salaries for services they performed, assessing payroll tax on all payments received. Dividends paid in lieu of the shareholder/employee’s entire salary are wages subject to payroll taxes.[23]

Particularly in situations where the sole shareholder of an S corporation is its only full-time employee and devotes all of his working time to performing services for the business “[a]n employer should not be permitted to evade FICA and FUTA by characterizing *all* of an employee's remuneration as something other than ‘wages.’ . . . This is simply the flip side of those instances in which corporations attempt to disguise profit distributions as salaries for whatever tax benefits that may produce.”[24]

Where an S corporation shareholder/employee is paid at least some amount as wages subject to withholding and payroll taxes, the dispute is more likely to revolve around whether the compensation paid to the individual was reasonable. IRS Fact Sheet 2008-25 sets forth the following factors to consider in determining reasonable compensation:

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[18] *Paula Construction Co. v. Comm’r*, 58 T.C. 1055, 1058 (1972), *aff’d* 474 F.2d 1345 (5th Cir. 1973).
[19] *Owensby & Kritikos, Inc. v. Comm’r*, 819 F.2d 1315, 1323 (5th Cir. 1987).
[20] *Mad Auto Wrecking, Inc. v. Comm’r,* T.C. Memo 1995-153; *Haffner’s Service Stations, Inc. v. Comm’r,* T.C. Memo 2002-38.
[21] *Id.*
[22] *See* Rev. Rul. 59-221, 1959-1 C.B. 225.
[23] Rev. Rul. 74-44, 1974-1 C.B. 287. (citing that “Sections 3121(a) and 3306(b) of the Federal Insurance Contributions Act and the Federal Unemployment Tax Act, respectively, define the term ‘wages,’ with certain specific exceptions not material here, as ‘all remuneration for employment.’”)
[24] *Joseph Radke, S.C. v. U.S.*, 712 F. Supp. 143 (E.D. Wis. 1989), *aff’d* 895 F.2d 1196 (7th Cir. 1990).

1. training and experience;
2. duties and responsibilities;
3. time and effort devoted to the business;
4. dividend history;
5. payments to non-shareholder employees;
6. timing and manner of paying bonuses to key people;
7. what comparable businesses pay for similar services;
8. compensation agreements; and
9. the use of a formula to determine compensation.

The IRS and the courts may consider other factors as well, such as company conditions.[25] The IRS is more likely to allow a business within its first few years of development to wait until it has sufficient funds to pay its owners. However, once the business is established and operating, the IRS will expect to see shareholders being paid wages as compensation for the services they perform on the entity's behalf. Dividends, on the other hand, constitute payments in respect of a shareholder's ownership of stock, which may be justified as a return on investment in the case of an S corporation with substantial assets or a high fair market value. The analysis of whether a payment constitutes a dividend or salary should consider the S corporation's goodwill and going concern value. If an S corporation has written off assets under IRC § 179 deduction, the analysis should include those assets as well, since they constitute part of the value of the business itself.

The IRS and the courts may also consider how much the business pays other workers, or how my the business owner may have been paid in a prior job, in comparison to the current salary.[26] If non-employee shareholders received similar distributions relative to their stock ownership a shareholder/employee's has a stronger position in arguing that an S corporation properly characterized payments to the shareholder/employee as dividends rather than salary. Dividend treatment is appropriate where the relationship between the amount of the payment and the stock value is closer than the relationship between the value of the payment and the services performed.

Timing of payments may also be relevant. If the S corporation paid dividends on a quarterly, semi-annual, or annual basis, rather than on a periodic basis as corporations typically pay salaries, that may help an S corporation shareholder to distinguish those payments from wages. However, paying a single lump sum payment at the end of the year, or periodically through the year will still likely be deemed compensation if it's the only payment made.

If the IRS re-characterizes an S corporation's dividend payments as salary, the IRS will assess Code § 6656's failure to deposit penalty and interest on its additional payroll tax assessment. In case of an audit, the IRS can apply the reduced rates under Internal Revenue Code Section 3509(a) rather than the higher rates of Section 3509(b). Tax assessed under IRC § 3509, for an employer's treatment of an employee as not being an employee for withholding purposes

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[25] *Trucks, Inc. v. U.S.*, 588 F. Supp. 638, 643 (D. Neb. 1984).
[26] *See Owensby & Kritikos, Inc.*, 819 F.2d at 1323; *Rutter v. Comm'r*, 853 F.2d 1267, 1271 (5th Cir. 1988); *Mad Auto Wrecking, Inc. v. Comm'r*, T.C. Memo 1995-153.

cannot be abated through the procedures normally available under § 3402 in other circumstances.[27] Therefore, the backup withholding must be paid.

For state tax purposes, wages of an owner of an S corporation, along with the wages of many other people who are not eligible for unemployment benefits, are still subject to unemployment tax. If a taxpayer reports and pays unemployment tax to the Texas Workforce Commission, it will reduce the unemployment tax assessed by the federal government because there is a state unemployment tax offset.[28]

VIII. Reclassification of Distributions

It's common for the IRS to reclassify shareholder distributions as wages, dividends, or some other non-flow-through status during audits of S corporations and their shareholders. Common pitfalls include failure to maintain corporate formalities, making payments of personal expenses from the business account, etc. These events frequently result in additions to the individual shareholder's taxable income and/or disallowed deductions at the S corporation level. The statute of limitations is generally three years from the due date of the return, with certain exceptions for criminal investigations, fraud acts, etc. No statute of limitations begins to run if no tax return is filed.

IX. Assignment of Income

Income generated by the efforts of a shareholder-employee and assigned to a controlled corporation (such as an S corporation, Inc.) is generally includible in a shareholder-employee's individual gross income if he retains ultimate control over the manner and extent of the services, bears the risks associated with the service, and only permits the corporation to do little more than own bank accounts and make bookkeeping entries.

Under the great weight of existing legal authority, the Service is likely to conclude that a taxpayer earned the income listed on uncorrected Forms 1099-MISC and then transferred it to an S corporation. The Service may even go on to apply the agency exception to find that the income on the corrected Forms 1099-MISC was earned by the taxpayer, individually.

If the IRS determines a taxpayer has earned income from personal services (as opposed to finding that an S corporation earned the income), it may be possible for him to deduct the business expenses that an S corporation paid and deducted in connection with the income-generating activities. The Service could possibly seek to limit the deduction to unreimbursed employee business expenses, which are subject to Schedule A limitations.

If the Service disallows the assignment of the income to an S corporation and moves it to a taxpayer's personal return on his Schedule C, there is no guarantee the IRS would also move the income-related expense deductions to Schedule C to properly calculate a taxpayer's net taxable self-employment income.

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[27] S*ee* IRM Procedural Update, WI-21-0115-0113, 01/14/2014.
[28] Additional information is available online at: http://twc.state.tx.us/ui/bnfts/employer6.html#covered

A. Legal Authority

Generally, gross income includes all income from whatever source derived, including compensation for services, fees, commissions, or gains from dealings in property.[29] Fundamental to this principle is that income is taxed to the person who earns it.[30] For federal tax purposes, the term "person" includes individuals and separate legal entities. The IRS generally treats each separate legal entity as a separate "person" for tax purposes.

B. Assignment of Income Doctrine

The assignment of income doctrine applies when determining <u>which taxpayer</u> must include an item in gross income, not whether an item is generally includable in gross income.[31] The assignment of income doctrine has been developed by the courts. It adds to IRC §61 an implicit requirement that an item of gross income be included in the gross income of the taxpayer who earned it.

In determining which taxpayer earned the income, courts review income-generating contracts to see if the other parties to the contract are in privity of contract with the transferee. Privity of contract occurs only between the parties to the contract; only the parties to the contract have rights and obligations under the contract. The assignment of income doctrine applies if the other parties to the contract generating the income are not in privity of contract with the alleged transferee.[32]

Where the transferee is an S corporation, such as when a taxpayer transfers to an S corporation income he received in his own name, the inquiry would be whether an S corporation was in privity of contract with each entity that issued a Form 1099-MISC. In the absence of privity of contract between an S corporation and the issuer, the Service could seek to apply the assignment of income doctrine to determine that the income is taxable to a taxpayer individually.

In *Truxal v. Comm'r*,[33] the Tax Court held that a taxpayer's business income was includable in the taxpayer's gross income and not in the gross income of a family trust. The trust allegedly operated three businesses. The opinion provides little details regarding the business activities. However, the court considered the relationship between the business and the trust in determining the income was taxable to the individual instead of to the trust. The customers had no dealings with the trust, they probably knew nothing about the trust, and no trust property was used in the business. Therefore the court held that the trust did not actually operate the businesses.

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[29] IRC § 61(a).
[30] Lucas v. Earl, 281 US 111, 114 (1930).
[31] Lucas v. Earl, 281 US 111 (1930).
[32] *See, e.g.*, Worthley v. Comm'r, TC Memo 1988-262; REP Sales, Inc. v. US, 86-1 USTC ¶ 9387 (S.D. W.Va. 1986).
[33] T.C. Memo 1982-616.

The courts look to the agreements between the parties and how the payments are made in determining which taxpayer must report the income. In *Brooks v. Comm'r*,[34] the Tax Court held that insurance commissions the taxpayer earned were includable in his, and not his corporation's, gross income, because the contract was between the taxpayer and the payor and the checks were made payable to the taxpayer. In *Isom v. Comm'r*,[35] the Tax Court reached the same result because only the taxpayer was authorized to write and deliver insurance policies, to represent the insurer, and to collect premiums and monies due. The Tax Court also based its decision on the fact that the insurer issued the commission checks to the taxpayer, in accordance with the agreement between the insurer and the taxpayer, because the taxpayer's corporation was not a party to the agreement, and only the taxpayer had the right to terminate the agreement with the insurer.[36] In *Zaal v. Comm'r*,[37] the Tax Court held that it does not matter that the taxpayer sold the commissions to the corporation, even if doing so constituted a state law property transfer, because for federal income tax purposes, the taxpayer earned the commissions. The key is that the taxpayer controls the earning of the commissions.[38]

In *McIver v. Comm'r*,[39] the Tax Court found that a real estate commission was earned by the individual real estate agent-shareholder instead of by the corporation to which he assigned the commission. The Tax Court relied on the following determinative facts: (1) the individual real estate agent-shareholder, not the corporation, signed the closing statement; (2) the individual real estate agent-shareholder, not the corporation, held a real estate license; and (3) Florida law made it illegal for an unlicensed entity (i.e., the corporation) to collect a real estate commission.

The *McIver* court found that the parties could not have intended for the corporation to receive the commission since that would have been illegal under state law and would have subjected them to disciplinary action by the Florida Real Estate Commission for participating in an illegal real estate transaction.

C. Income from Personal Services

A taxpayer's gross income includes income the taxpayer earned for services rendered, even if the taxpayer delivers the payor's check to a third party before cashing it.[40] Similarly, if the taxpayer causes the check to be issued directly to the third party or payment to be made directly to the third party in some other way, the taxpayer must include the compensation in gross income.[41] The same result is reached if the payor applies the amount to a debt owed by the taxpayer.[42]

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[34] T.C. Memo 1982-690.
[35] T.C. Memo 1995-383.
[36] *Id*.
[37] T.C. Memo 1998-222.
[38] *See* Hagy v. Comm'r, 778 F.Supp 897 (W.D. Va. 1991).
[39] T.C. Memo 1977-174.
[40] US v. Allen, 551 F.2d 208 (8th Cir. 1977) (taxpayer had commission income on sale of parents' home; fact that after he sold house he turned commission check over to them was immaterial; taxpayer accepted payment of commission and made gift to parents).
[41] Hall v. Comm'r, T.C. Memo 1976-311, *aff'd*, 595 F.2d 1059 (5th Cir. 1979) (interest income from joint savings account was taxable to taxpayer who deposited and controlled funds, not to co-tenant).
[42] Hunt v. Comm'r, T.C. Memo 1991-566.

In *Johnson v. Comm'r*,[43] the Tax Court held that a basketball player was required to include his earnings in gross income even though they were paid to his wholly owned corporation because the contract for services was between the team and the player.

In determining whether amounts paid with respect to services are income to the individual taxpayer or a personal service corporation, the *Johnson* court held that the following two elements were necessary in order for the corporation to be considered the controller of the income and, therefore, the appropriate taxpayer with respect to that income:

(1) the service-performer must be an employee of the corporation whom the corporation has the right to direct or control; and
(2) there must exist between the corporation and the person or entity using the services a contract or similar recognition of the corporation's controlling position.[44]

Most courts applying the "*Johnson* control test" have found against the employee-shareholder in cases involving assignment of income between employee-shareholders and their personal service corporations.[45] For example, if the corporation does not control the shareholder's activities or there is no agreement between the payor and the corporation acknowledging the corporation's controlling position, then the fact that some of the payments are deposited into the corporation's accounts does not change the conclusion that the shareholder is the taxpayer with respect to the income earned through the taxpayer's efforts.[46]

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[43] 78 T.C. 882 (1982) (although contract gave corporation right to control player's services, assignment of income to corporation didn't shift tax burden because club had no contract with corporation and club refused to sign contract with anyone but player), *aff'd by unpub. opin.*, 734 F.2d 20 (9th Cir. 1984), *cert. denied*, 469 US 857 (1984).
[44] *Id*.
[45] *See, e.g.*, Owen v. Comm'r, T.C. Memo 2012-21 (assignment of income to personal service corporation was generally improper; in most circumstances, relationship between taxpayer and personal service corporation did not meet test set forth in *Johnson v. Comm'r*). *Cf.* Sargent v. Comm'r, 929 F.2d 1252 (8th Cir. 1991), *rev'g* 93 T.C. 572 (1989) (no improper assignment of income; both employment contract between employee-shareholder and personal service corporation and corporation's contract with third party to provide shareholder's services respected).
[46] *See* Zadan v. Comm'r, 65 T.C.M. 2059 (1993) (commission checks payable either to taxpayer or his wholly owned corporation were income to taxpayer in his individual capacity even though deposited into corporation's bank account; no evidence that employee-employer relationship existed between taxpayer and corporation or that corporation had contractual relationship with payor; Forms 1099 issued by payor reported commission paid to taxpayer as individual).

D. The Agency Exception

The assignment of income doctrine does not apply if the taxpayer receives income as an agent of another person or entity and remits the income to that person or entity.[47] To be an agent, the taxpayer must lack ultimate control over the funds, must not benefit from their use, and must remit them to the principal.[48]

Whether the taxpayer is an agent of another person or entity is a fact question.[49] Agency is demonstrated by a taxpayer's performance of services in connection with the business of the taxpayer's employer, and the remission of any amounts received to the employer.[50] However, the absence of a principal for whom the taxpayer is acting is a strong indication that there is no agency. For example, if the alleged principal is a shell corporation that the taxpayer cannot prove exists, the agency exception will not apply.[51] In *List v. Comm'r*,[52] the Tax Court held that payments made to a psychotherapist were includable in his gross income because they were made to him in his name and were not payments to the institute's name under which he operated his office. Further, if an employee voluntarily enters into an agreement to remit income to his employer and can terminate the agreement at will, the income is included in the employee's gross income.[53]

The question of whether a corporation is acting as the agent of its shareholders is a fact question. If payment is made to the corporation for services rendered by the shareholder, the payment is taxable to the shareholder unless the shareholder proves that the corporation is not merely an agent to which the income has been assigned.[54] In *Griffiths v. Helvering*,[55] the Supreme Court held that a corporation formed by the taxpayer solely to receive the taxpayer's gross income and pay it to the taxpayer over a 40-year period was acting as the taxpayer's agent, requiring inclusion of the income in the taxpayer's gross income when received by the corporation.

On the other hand, in *Moline Properties, Inc. v. Comm'r*,[56] the Supreme Court held that income received by a corporation formed by the taxpayer to hold and manage real property to be used as collateral (in a manner the creditor suggested) should be included in the corporation's gross income, and not the individual's, because the corporation received income while acting in the capacity for which it was formed. In addition, forming a corporation to provide insulation

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[47] *See, e.g.*, Brittingham v. Comm'r, 57 T.C. 91 (1971), *acq.*, 1971-2 C.B. 2; Hessing v. Comm'r, T.C. Memo 2013-179.
[48] *See* Perry v. Comm'r, T.C. Memo 1988-280; Owens v. Comm'r, T.C. Memo 1985-98; Guardianship of Fink v. Comm'r, T.C. Memo 1984-505.
[49] Alexander v. Comm'r, 56 T.C. 710 (1971), *aff'd*, 476 F.2d 974 (5th Cir. 1973).
[50] *See* Rev. Rul. 58-515, 1958-2 C.B. 28.
[51] Olken v. Comm'r, T.C. Memo 1987-589.
[52] T.C. Memo 1967-148 (no indication that taxpayer received checks other than in his individual capacity; none of taxpayer's tax returns indicate that he was employed by an institute or by anyone else).
[53] Rev. Rul. 69-275, 1969-1 C.B. 36, *amplified by* Rev. Rul. 70-161, 1970-1 C.B. 15.
[54] *See* Cherokee Motor Coach Co. v. Comm'r, 135 F.2d 840 (6th Cir. 1943).
[55] 308 US 355 (1939).
[56] 319 US 436, 440 (1943).

from tort liability does not make the corporation an agent of the shareholder.[57] It did not matter that the corporation was formed to assume responsibility for managing a business formerly managed by the taxpayer.[58]

If a corporation is formed solely to exploit services rendered by its sole shareholder to third parties, the question of whether the corporation is merely the taxpayer's agent is a fact question.[59] Generally, if the sole purpose of forming the corporation is tax avoidance, the corporation is disregarded or, at best, treated as the taxpayer's agent.[60] In *Roggin v. Comm'r*,[61] however, the Tax Court held that the corporation is not treated as an agent if it was not a sham and was recognized by third parties, even though the reason for its formation was to take advantage of tax savings available through the use of corporate pension plans.

If a shareholder retains ultimate control over the manner and extent of his services and permits the corporation to do little but own bank accounts and make bookkeeping entries, the corporation may be deemed to be an agent of the shareholder. Under these circumstances, the shareholder's assignment of income to the corporation will not be respected and the shareholder will be required to recognize the income.[62] If the corporation assumes the risks and expenses of providing the services, and pays a fixed amount to the taxpayer regardless of the corporation's revenues, it is less likely to be treated as an agent.[63] An important factor in reaching the conclusion that the corporation is not the taxpayer's agent is whether third parties treat the corporation as engaging in business activities on its own behalf.[64] Another factor is whether services are performed by employees over whom the corporation has control.[65]

In *Shaw v. Comm'r*,[66] the court held that commissions generated by the taxpayer's efforts and paid to the taxpayer's corporation were includible in the individual taxpayer's gross income because the taxpayer, and not the corporation, bore the risks associated with the transactions, and thus was not acting as the corporation's agent.

E. Statutory Incorporation of the Assignment of Income Doctrine

With few exceptions, Congress has left application and development of the assignment of income doctrine to the courts, where it originated. Where Congress has enacted statutory provisions that implicate assignment of income, it has been either to provide additional substantive rules or to bestow specific discretionary powers on the IRS with respect to the issue. The Service has provided additional substantive rules for trusts, partnerships, and S corporations.

[57] Given v. Comm'r, 238 F.2d 579 (8th Cir. 1956).
[58] Spencer v. Comm'r, 19 T.C. 727 (1953).
[59] Comm'r v. Laughton, 113 F.2d 103 (9th Cir. 1940).
[60] Leeder v. Comm'r, T.C. Memo 1960-69.
[61] T.C. Memo 1985-307.
[62] Roubik v. Comm'r, 53 T.C. 365 (1969).
[63] Cole Est. v. Comm'r, T.C. Memo 1973-74.
[64] Keller v. Comm'r, 723 F.2d 58 (10th Cir. 1983), *aff'g* 77 T.C. 1014 (1981).
[65] *See* Keller, 723 F.2d at 62.
[66] 59 T.C. 375 (1972).

S Corporations

Under IRC § 1366(e), if a family member of one or more of an S corporation's shareholders renders services for the corporation without receiving adequate compensation, the IRS may adjust the items taken into account by the individual and the shareholders to reflect the value of services.[67] For purposes of this rule, family members include only spouses, ancestors, lineal descendants, and trusts created for the primary benefit of such persons.[68]

Personal Service Corporations

In addition, IRC § 269A(a) allows the IRS to allocate the income and other items of a personal service corporation ("PSC") to its employee-owners if it is necessary to prevent avoidance or evasion of federal income tax or clearly to reflect the income of the PSC or any of its employee-owners. A PSC is a corporation, the principal activity of which is the performance of personal services that are substantially performed by employee-owners.[69] Generally, employee-owners are employees who, on any day during the taxable year, own more than 10% of the PSC's outstanding stock.[70]

Three conditions must be satisfied in order for the IRS to allocate the income and other items of a PSC to its employee-owners: First, substantially all of the PSC's services must be performed for or on behalf of one other corporation, partnership, or other entity.[71] Second, the principal purpose for forming or using the PSC must be the avoidance or evasion of federal income tax by reducing the income of the employee-owner, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for any employee-owner, which would not otherwise be available.[72] Third, the allocation must be necessary to prevent avoidance or evasion of federal income tax or to clearly reflect the income of the PSC or any of its employee-owners.[73]

Related Party Reallocation

Under IRC §482, the IRS also has the power to distribute, apportion, or allocate gross income and other items between or among any two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, if it determines that distribution, apportionment, or allocation is necessary to prevent evasion of taxes or clearly to reflect the income of any of those organizations, trades, or businesses.[74] It does not matter whether the organizations, trades, or businesses are incorporated, organized in the US, or whether they are affiliated.[75]

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[67] I.R.C § 1366(e).
[68] *Id*.
[69] IRC § 269A(b)(1); Prop. Regs. § 1.269A-1(b)(1).
[70] IRC § 269A(b)(2); Prop. Regs. §1.269A-1(b)(2).
[71] IRC § 269A(a)(1); Prop. Regs. § 1.269A-1(a)(1).
[72] IRC § 269A(a)(2); Prop. Regs. § 1.269A-1(a)(2).
[73] IRC § 269A(a) (flush language); Prop. Regs. § 1.269A-1(a).
[74] IRC § 482.
[75] *Id*.

F. Deductibility of Expenses

Generally, deductions are a matter of legislative grace and are allowable only as specifically provided by statute.[76] The taxpayer bears the burden of clearly showing the right to a claimed deduction.[77]

The determination of which taxpayer is entitled to claim a deduction has also been discussed in numerous cases, yet it has never evolved into an "assignment of deductions" doctrine analogous to the assignment of income doctrine.[78] Generally, deductions attributable to expenditures are allowable to the taxpayer that bears the economic burdens and receives the benefits of the expenditures.[79]

Nonstatutory Assignment of Deductions

Only a few published opinions address the issue of which taxpayer may claim a deduction, and those opinions cover a wide range of deductions. Taking into consideration the numerous opinions discussing the assignment of income doctrine, several basic principles have emerged that provide some guidance with respect to assigning deductions.

Generally, no deduction is allowed for the voluntary payment of another person's expenses even if the expense would be allowable as a deduction had it been the taxpayer's own obligation.[80] The taxpayer must be legally obligated to pay or incur the other person's expense.[81] However, just as a taxpayer can be considered to have received under the assignment of income doctrine amounts received by another person, a deduction that is disallowed to one person under the assignment of deduction doctrine ought to be allowable to the taxpayer that actually incurred the expense. The US Tax Court has followed this position at least once, holding that if the assignment of income doctrine requires a taxpayer to include amounts in gross income that are received by another person, the taxpayer should be allowed to deduct the otherwise deductible expenses of earning that income that are paid by the other person.[82] This is a voluntary provision, however, that the IRS has discretion to apply and the taxpayer has no right to invoke.

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[76] INDOPCO, Inc. v. Comm'r, 503 US 79, 84 (1992).
[77] *Id*.
[78] *See* Blair v. Comr., 300 US 5, 12 (1937); Lucas v. Earl, 281 US 111, 114-15 (1930).
[79] *See, e.g.*, Case v. Comr., 50 T.C.M. 1291, 1295 (1985); Bordo Prods. Co. v. US, 476 F.2d 1312, 1327 (Ct. Cl. 1973).
[80] Williams v. Comm'r, 19 T.C.M. 106, 112 (1960).
[81] Sharon Herald Co. v. Granger, 195 F.2d 890, 895 (3d Cir. 1952), *aff'g* 97 F.Supp. 295 (W.D. Pa. 1951); Shoholm v. Comm'r, 30 T.C.M. 1070, 1071 (1971).
[82] *See e.g.*, McEnaney v. Comm'r, 3 T.C. 552, 559 (1944).

Statutory Assignment of Deductions

Many statutory provisions have been enacted to resolve the question of which taxpayer is entitled to claim the deductions arising from a specific transaction. Under IRC §§ 269, 269A, 482, and 845, the IRS has the power to disallow a deduction to one taxpayer and allow it to another taxpayer if the IRS determines the reallocation to be necessary to prevent the evasion or avoidance of federal income tax by securing the benefit of the deduction.[83] However, these statutes do not grant rights to taxpayers to apply the provisions at will or to compel the IRS to apply such provisions.[84] In other words, the IRS is not required to reallocate deductions under the above-referenced statutes, and is not likely to do so, unless it will prevent the evasion or avoidance of federal income tax.

G. Payroll and Self Employment Taxes

Generally, self-employed individuals must pay self-employment tax in addition to income tax. A person is considered to be self-employed if he operates a business as a sole proprietor or independent contractor, is a member of a partnership that carries on a trade or business, or is otherwise in business for himself. Self-employment tax is a Social Security and Medicare tax primarily imposed on individuals who work for themselves.

Self-employment taxes are imposed on the net earnings from self-employment, which is the gross income derived by an individual from any trade or business carried on by the individual, reduced by certain deductions attributable to the individual's trade or business. In the context of self-employment tax, trade or business expenses generally must satisfy the requirements of IRC § 162 in order to offset self-employment income.

Owners of S corporations are required to pay themselves a reasonable wage, subject to payroll taxes. Taxpayers who operate Schedule C businesses, on the other hand, pay self-employment tax, which approximates payroll taxes, on their entire net income. It would only be beneficial to operate as an S corporation if a taxpayer earns more than a reasonable wage. The IRS generally considers a reasonable wages based upon wage comparison information that is publicly available. In the absence of proof regarding a reasonable wage, the IRS may recharacterize all distributions as wages. If an S corporation owner earns more than a reasonable wage, then the taxpayer can draw a reasonable salary, and also take distributions, reducing the overall amount that is subject to self-employment or payroll taxes. However, the law does not allow taxpayers to avoid payroll taxes by paying themselves an artificially low salary and then taking distributions.

[83] IRC § 404(k)(5)(a).
[84] *See, e.g.*, Treas. Reg. § 1.482-1(a)(3).

H. Penalties

IRC § 6662 imposes a 20% accuracy-related penalty if a substantial understatement of income tax on the tax return results in a taxpayer underpaying the true income tax due for the taxable year.[85] For substantial understatement penalty purposes, an "understatement" means the excess of the amount of tax required to be shown on the return for the taxable year over the amount of tax actually shown on the return, reduced by any rebate.[86] An individual or an entity has a "substantial" understatement if the amount of the understatement for the taxable year exceeds the greater of: (i) 10% of the tax required to be shown on the return for the taxable year, or (ii) $5,000.[87] The amount of the accuracy-related penalty for a substantial understatement is 20% of the underpayment of tax attributable to the understatement.[88]

Reasonable Cause Exception

In many cases, the accuracy-related penalty will not be imposed for a substantial understatement where the taxpayer can show "reasonable cause" for the underpayment and that the taxpayer acted in good faith.[89]

Reliance on an information return or the advice of a professional constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all the facts and circumstances, including the experience, knowledge, and education of the taxpayer.[90]

A special reasonable cause standard applies to the accuracy-related penalty. This higher standard generally requires the taxpayer to show a reasonable basis for the position taken on the return. In addition, there must be economic substance behind how the transactions were reported for federal tax purposes.

IRS regulations provide that all facts and circumstances are taken into account in determining whether a taxpayer has reasonably relied in good faith on professional advice regarding the treatment of the taxpayer, entity, plan, or arrangement, under federal tax law. The IRS will take into account a taxpayer's education, sophistication and business experience in determining whether the taxpayer's reliance on the advice was reasonable and made in good faith.[91] In general, the advice must be based on all pertinent facts and circumstances. Thus, for

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[85] IRC § 6662(a) and (b)(2); Treas. Reg. § 1.6662-4(a).
[86] IRC § 6662(d)(2)(A).
[87] IRC § 6662(d)(1)(A).
[88] IRC § 6662(a), (i), (j). Under certain circumstances the IRS can increase the penalty to 40% where there are gross understatements.
[89] IRC § 6664(c)(1); Treas. Reg. § 1.6664-4.
[90] Treas. Reg. § 1.6664-4(b); *See, e.g.*, Williams v. Comm'r, 123 T.C. 144 (2004) (because the case was one of first impression, there was no clear authority to guide the taxpayer; consequently, the taxpayer had an honest misunderstanding of the law), Klamath Strategic Investment Fund, LLC v. US, 472 F. Supp.2d 885 (E.D. Tex. 2007), *aff'd*, No. 07-40861 (5th Cir. 5/15/09) (court upheld taxpayers' reasonable cause and good faith defense on the basis of the quality of the legal opinions obtained).
[91] Treas. Reg. § 1.6664-4(c)(1).

example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. a taxpayer may establish reasonable cause and good faith by showing that the taxpayer: (i) reasonably believed that the professional was a competent tax advisor with sufficient expertise; (ii) provided necessary and accurate information to the advisor; and (iii) actually relied on the advisor in good faith.[92]

I. Audit Initiative

The IRS is conducting audits of Forms 1040 as part of a special tax return Compliance Initiative Project (CIP) under Part 4, Chapter 17 of the Internal Revenue Manual. The CIP was intended to correct what the IRS perceived as widespread improper assignment of income between shareholders and their personal service corporations. Indeed, in our anecdotal experience, it has been widespread common practice for CPAs and other tax professionals to advise clients to submit tax returns that effectively move income from Forms 1040 to Forms 1120 and 1120S when the taxpayers receive Forms 1099 addressed to them individually. The CIP expressly targets this practice, selecting for audit the returns of taxpayers claiming a Schedule C Return and Allowance deduction of $75,000 or more with a service specific NAICS[93] code.

X. S Corporation ESOP Abuse

The IRS has identified in Rev. Rul. 2003-6 and Rev. Rul. 2004-4 listed transactions related to S corporation employee stock ownership plans, which resulted in prohibited allocations of securities under IRC § 409(p). In the situations described by the revenue rulings, the employees are identified as eligible to participate but there is no reasonable expectation they will accrue more than insubstantial benefits. Effectively, the IRS’s requirements under § 409(p) result in ESOP treatment only if rank-and-file employees are given a meaningful stake in the S corporation. Tax benefits purportedly generated by these transactions are not allowable for federal income tax purposes. These transactions are reportable transactions which must be registered under IRC §§ 6011 and 6112 and are subject to penalty under IRC §§6707(a) and 6708(a).

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[92] *See, e.g.*, Lee Est. v. Comm’r, T.C. Memo 2009-84 (executor of estate, a judge without estate tax experience, relied reasonably on an estate tax attorney with 30 years of experience).
[93] The North American Industry Classification System (NAICS) is the standard used by Federal statistical agencies in classifying business establishments for the purpose of collecting, analyzing, and publishing statistical data related to the US business economy.

Where is my Secret Decoder Ring? Decoding and Applying Local Tax Rates

TSCPA Expo
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by

Christi Mondrik, CPA, Esq.
Board Certified – Tax Law
Texas Board of Legal Specialization
cmondrik@mondriklaw.com

Mondrik & Associates
11044 Research Blvd
Suite B-400
Austin, Texas 78759
(512) 542-9300
www.mondriklaw.com

Christina A. Mondrik

Christi Mondrik, attorney, dedicates her practice to resolving state and federal tax controversies and litigation. She is board certified in Tax Law by the Texas Board of Legal Specialization. Ms. Mondrik has handled IRS cases involving substantial corporate, individual and estate taxes. Her state tax experience includes disputes arising under Texas franchise tax, sales and use tax, fuel taxes, severance taxes, motor vehicle sales tax, and other state taxes. Ms. Mondrik is also a CPA.

Ms. Mondrik and her associates represent the firm's state tax clients in administrative and legal proceedings before the Comptroller's office, the State Office of Administrative Hearings and the Texas state courts. They also represent federal tax clients in audits, at the administrative appeals level and in proceedings before the US Tax Court and US District Courts. Ms. Mondrik is licensed to practice in the United States Tax Court, the United States District Court, Western District of Texas, and all of the Texas state courts.

Ms. Mondrik and members of her firm are frequent authors and lecturers on federal tax controversies and state taxation.

Ms. Mondrik has served on the State Bar of Texas Tax Section's governing council and has served as chair and vice-chair of its Tax Controversy, CLE and Solo and Small Firms Committee Committees. After completing her 2010-13 SBOT Tax Section council member term, Ms. Mondrik served as annual meeting committee chair for 2013-14. She is also Tax Section Leadership Academy chair for 2016-17. The State Bar Tax Section Awarded Ms. Mondrik the Outstanding Volunteer award for 2014-15.

The TSCPA awarded Ms. Mondrik the Young CPA of the Year Award for 2009-10 and the 2012 TSCPA Rising Star Award. The Austin Chapter of CPAs awarded Ms. Mondrik the Distinguished Service Award in 2015.

Ms. Mondrik currently serves on Texas Society of Certified Public Accountants (TSCPA) Executive Board, the State Bar of Texas and TSCPA State Taxation Committees, and the TSCPA Federal Tax Policy Committee. Ms. Mondrik was the 2009-10 President of the Austin Chapter of CPAs. She has also served as manager of education and leadership and chair and vice-chair of its Oversight Council. Ms. Mondrik was the 2009-10 chair of the State Tax Conference Committee and the 2009-13 chair of the TSCPA state taxation committee. As chair of the state taxation committee, she was a principal drafter of comments submitted by the TSCPA in response to legislation implementing the Texas margin tax and various administrative rules. She currently serves as commenting subcommittee chair for the TSCPA Federal Tax Policy Committee.

Ms. Mondrik earned her B.B.A. in Accounting and her J.D., with honors, both from the University of Texas at Austin. She has been licensed as an attorney by the State of Texas since 2001.

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I. Introduction

Local tax rates have historically been the source of significant controversy and confusion among local taxing authorities and taxpayers alike. The Comptroller of Public Accounts and the Texas legislature have established a system whereby local sales and use taxes are primarily based upon the seller's place of business, which differs from many other states.[1] The local taxes are reported, along with the state taxes, and remitted to the Comptroller's office. The Comptroller's auditors review local tax rates along with their comprehensive Texas sales and use tax audits, and local taxing authorities also retain jurisdiction to perform their own review.

Politically, Texas and its municipalities generally favor the seller's place of business as the primary local tax rate because it allows the localities to enter into agreements with businesses that choose to locate within their jurisdictions. Municipalities are able to leverage anticipated local tax revenues from a business's sales to negotiate benefits for those businesses in the area of reduced property taxes or other incentives.

II. Sales and Use Tax

As with the state taxes, local taxes may be either sales or use taxes. Sales tax generally applies to any sale of a taxable item in Texas. Use tax applies to the storage, use or consumption of a taxable item in Texas. The two taxes are complimentary. Together, the State may impose the sales and use tax up to a state tax rate of 6.25% plus local tax rates not to exceed an additional 2.0%.

Taxable items include sales of tangible personal property and certain listed services. Sales of tangible personal property are presumed to be taxable, unless an exemption applies. There is no such presumption for services. The list of taxable services is enumerated in Texas Tax Code Sec. 151.0101. The Comptroller bears the initial burden of proving that a particular service falls within a category of taxable services.

III. Place of Business

A sales and use tax permit is required for each place of business in Texas.[2] Certain out of state retailers with sufficient nexus with Texas are also required to hold Texas sales and use tax permits. A person desiring to be a seller in Texas shall file a sales and use tax permit application with the Comptroller's office.[3] As a general matter, a "business" is defined as "the activity of or caused by a person for the purpose of direct or indirect gain, benefit or advantage."

For purposes of determining whether a sales and use tax permit is required, the term "place of business" means an established outlet, office, or location that the seller, his agent, or

[1] For example, states that are members of the Streamlined Sales Tax Project are required to collect local taxes based on destination only.
[2] Texas Tax Code § 151.201.
[3] Texas Tax Code § 151.202.

employee operates for the purpose of receiving orders for taxable items. The following locations may or may not be considered "places of business" for Texas sales and use tax purposes:

a. Storefront – A location where a seller receives three or more orders in a calendar year for sales of taxable items.

   Examples: call centers, showrooms, and clearance centers

   Example: a home office where three or more items are sold over a 12-month period through an online auction website.

b. Warehouse – A warehouse, storage yard, or manufacturing plant is not a "place of business of the seller" for tax permit requirement purposes unless the seller receives three or more orders in a calendar year at the warehouse, storage yard, or manufacturing plant.

c. Kiosk – A place of business does not include a kiosk.[4] A "kiosk" is defined as a small stand-alone area or structure located within another place of business, such as a department store or shopping mall, that is used solely to display merchandise and/or to submit orders through a data entry device and that does not have inventory ready for immediate delivery or transfer to a customer.

d. Booths – Booths, stalls or similar structures or data entry devices that are not located within a place of business of another retailer are not kiosks. A booth set up in a shopping mall to sell cosmetics is not considered a "kiosk" if customers can receive the items purchased at the time of the sale. Local sales tax is due based on the location of the booth, stall or cart at the time of the sale.

e. Mobile Vendors – Mobile food vendors who sell prepared foods at street fairs or carnivals are operating places of business and local sales tax is due based on the location of the booth, stall or cart at the time of the sale.

f. Contractors – The Comptroller has proposed revisions to Rule 3.334 to explain that a contractor is a natural person contracted to perform work or services for another, as opposed to an entity performing contracts for construction or other services.

g. Bartering Clubs and Exchanges – Barter exchanges which maintain show or sales rooms for the purpose of bartering taxable items are sellers.[5]

h. Traveling salespersons – A travelling salesperson is a seller, or an agent or employee of a seller, who visits potential purchasers in person to solicit sales, and who does not carry inventory ready for immediate sale, but who may carry samples or perform demonstrations of items for sale. If a salesperson who receives three or more orders for taxable items within a calendar year is assigned

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[4] Texas Tax Code § 321.002 (amended by 81st Legislature, R.S., S.B. 636, effective 9/1/2009).
[5] Comptroller Rule 3.283.

to work from, or to work at, a distribution center, manufacturing plant, storage yard, warehouse, or similar facility operated by a seller, then the facility is a place of business. Any outlet, office, or location operated by a seller that serves as a base of operations for a traveling salesperson or that provides administrative support to a traveling salesperson is a place of business.

i. Temporary place of business – A location operated by a seller for a limited duration for the purpose of selling and receiving orders for sales of taxable items, where the seller has inventory available for immediate delivery to a purchaser.

   Example: a person who rents a booth at a weekend craft fair or art show to sell and take orders for jewelry.

   Example: a person who maintains a facility at a job site to rent tools and equipment to a contractor during the construction of real property.

   When a seller operates a temporary place of business, and items purchased are transferred to the purchasers at the time of sale, the sales are consummated at, and local sales tax is due based upon, the location of the temporary place of business.

   When a seller receives an order at a temporary place of business and the order is fulfilled at another location, the sale is consummated at, and local sales taxes are due based upon, the location of the temporary place of business where the order was received.[6]

A distribution center, manufacturing plant, storage yard, warehouse, or similar facility operated by a seller where the seller receives three or more orders for taxable items during the calendar year is a place of business. If a location that is a place of business of the seller, such as a sales office, is in the same building as a distribution center, manufacturing plant, storage yard, warehouse, or similar facility operated by a seller, then the entire facility is a place of business of the seller.

A purchasing office is not a place of business if the purchasing office exists solely to rebate a portion of the local sales and use tax imposed by Chapter 321 or 323 of the Tax Code to a business with which it contracts; or if the purchasing office functions or exists to avoid the tax legally due under Chapter 321 or 323 of the Tax Code. A purchasing office does not exist solely to rebate a portion of the local sales and use tax or to avoid the tax legally due under Chapter 321 or 323 of the Tax Code if the purchasing office provides significant business services, beyond processing invoices, to the contracting business, including logistics management, purchasing, inventory control, or other vital business services.

[6] If a seller received an order at a temporary place of business prior to June 19, 2009, and the order was fulfilled at another place of business of the seller in this state, the sale was consummated at, and local sales taxes are due based upon, the location of the place of business where the order was fulfilled and not the temporary location where the order was received.

When the Comptroller determines a purchasing office is not a place of business, the sale of any taxable item is deemed to be consummated at the seller's place of business where the purchasing office purchased the taxable item for resale and local sales and use taxes are due according to the following rules:

(i) When taxable items are purchased from a Texas seller, local sales taxes are due based on the location of the seller's place of business where the sale is deemed to be consummated.

(ii) When the sale of a taxable item is deemed to be consummated at a location outside Texas, local use tax is due based on the location where the items are first stored, used or consumed by the entity that contracted with the purchasing office.

In making a determination as to whether a purchasing office provides significant business services to the contracting business, the Comptroller will review the books and records of the purchasing office to determine whether the total value of the business services provided to the contracting business equals or exceeds the total value of processing invoices. If the total value of the business services provided, including logistics management, purchasing, inventory control, or other vital business services, is less than the total value of the service to process invoices, then the Comptroller will presume the purchasing office to not be a place of business of the seller.

In 2013, the Texas legislature revised the definition of "place of business" for local tax purposes to clarify that "[a]n outlet, office, facility, or location does not exist to avoid the tax legally due under this chapter or solely to rebate a portion of the tax imposed by this chapter if the outlet, office, facility, or location provides significant business services, beyond processing invoices, to the contracting business, including logistics management, purchasing, inventory control, or other vital business services."

IV. Local Tax Nexus

A seller that has nexus in Texas and is engaged in business in Texas must collect and remit local sales and use tax even if no sales and use tax permit is required at the location where taxable items are sold. A seller is only required to collect local sales or use taxes imposed by a local taxing jurisdiction in which the seller is engaged in business. Purchasers are still responsible for accruing and remitting local taxes if the seller fails to collect them.

V. Taxing Authorities

Local sales and use taxes include the city tax, the county tax, the special purpose district tax, and the various transit authority (MTA & ATD) taxes. These taxes are imposed by various local jurisdictions, generally upon a vote of the citizens in the affected area.

A city is defined to include incorporated cities, municipalities, towns, or villages. City tax rates are authorized under Tax Code §321.101. They may include the additional municipal sales and use tax,[7] the municipal sales and use tax for street maintenance,[8] the Type A Development

[7] Tax Code §321.101(b).

Corporation sales and use tax,[9] the Type B Development Corporation sales and use tax,[10] a sports and community venue project sales and use tax,[11] or a municipal development corporation sales and use tax.[12] City sales and use tax does not apply to taxable sales that are consummated outside the boundaries of the city, including sales made in a city's extraterritorial jurisdiction, except for certain strategic partnership agreements, the City of El Paso and Fort Bliss.[13] However, an extraterritorial jurisdiction may lie within the boundaries of a special purpose district, transit authority, county, or any combination of the three, and the sales and use taxes for those jurisdictions would apply to those sales. Cities may impose local tax rates of up to 2.0%.

Counties are defined by state law. There are 254 counties in Texas. County sales and use taxes are authorized under Tax Code §323.101, and include a sports and community venue project sales and use tax.[14] Some local tax jurisdictions, such as the county health services sales and use tax,[15] the county landfill and criminal detention center sales and use tax,[16] and the crime control and prevention district sales and use tax,[17] may sound like county taxes, but are actually considered special purpose district taxes instead. Counties may impose sales and use tax at rates ranging from 0.5% to 1.5%.

A special purpose district is a local governmental entity authorized by the Texas legislature for a specific purpose, such as crime control, a local library, emergency services, county health services, or a county landfill and criminal detention center. Special purpose districts are created under the Special District Local Laws Code or other provisions of Texas law. Special purpose districts are authorized to impose sales and use tax by are governed by the provisions of Chapters 321 or 323 of the Tax Code and other provisions of Texas law. Special purpose districts may impose sales and use tax at rates ranging from 0.125% to 2.0%.

The term "transit authority" includes a metropolitan rapid transit authority (MTA), advanced transportation district (ATD), regional or subregional transportation authority (RTA), city transit department (CTD), county transit authority (CTA), regional mobility authority (RMA) or coordinated county transportation authority.[18] Texas has six metropolitan transit authorities (MTAs), two city transit departments (CTDs), one county transit authority (CTA) and one advanced transportation district (ATD) that impose a sales and use tax. Transit authorities are authorized to impose sales and use tax by Chapters, 451, 452, 453, 457, or 460 of the Transportation Code as governed by Chapter, 322 of the Tax Code. Transit authorities may impose sales and use tax at rates ranging from 0.25% to 1.0%.

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8 Tax Code §327.003.
9 Local Government Code, §504.251.
10 Local Government Code, §505.251.
11 Local Government Code, §334.081.
12 Local Government Code, §379A.081.
13 Local Government Code, §42.021.
14 Local Government Code, §334.081.
15 Tax Code §324.021.
16 Tax Code §325.021.
17 Tax Code §323.105.
18 Transportation Code, Chapters 370, 451, 452, 453, 457, or 460.

Jurisdictional boundaries, combined areas, and city tax imposed through strategic partnership agreements. City taxing jurisdictional boundaries cannot overlap one another and a city cannot impose a sales and use tax in an area that is already within the jurisdiction of another city. County tax applies to all locations within the county imposing the tax. Special purpose districts and transit authorities may cross or share boundaries with other local taxing jurisdictions and may encompass, in whole or in part, other local taxing jurisdictions, including cities and counties. A geographic location or address in this state may lie within the boundaries of more than one special purpose district or more than one transit authority.

A combined area is an area where the boundaries of a city overlap the boundaries of one or more other local taxing jurisdictions as a result of an annexation of additional territory by the city, and where, as the result of the imposition of the city tax in the area in addition to the local taxes imposed by the existing taxing jurisdictions, the combined local tax rate would exceed 2.0%. The comptroller shall make accommodations to maintain a 2.0% rate in any combined area. Sellers engaged in transactions on which local sales or use taxes are due in a combined area, or persons who must self-accrue and remit tax directly to the comptroller, must use the combined area local code when reporting the tax rather than the codes for the individual city, county, special purpose districts, or transit authorities that make up the combined area. The comptroller shall distribute the tax revenue generated in these combined areas to the local taxing jurisdictions located in the combined areas as provided in Tax Code §321.102 or Health and Safety Code, §775.0754. Combined areas are identified on the Comptroller's website at http://comptroller.texas.gov/taxinfo/local/.

VI. General Local Tax Rules

As a general rule, the tax applies when the sale originates from a place of business in the taxing jurisdiction. A place of business is any location that takes orders for sales of taxable products more than three times a year. "A warehouse, storage yard, or other location not operated for the purpose of receiving orders for taxable items is not a place of business unless three or more sales are made or three or more orders are taken there during a calendar year." Sellers generally hold sales tax permits for each place of business location.

The Comptroller's rules reference order fulfillment as the process of completing an order by transferring a taxable item directly to a purchaser at a Texas location, or shipping or delivering a taxable item to a Texas location designated by the purchaser. Local tax rates are determined based on a combination of the place of business and the location where order fulfillment occurs.

Texas imposes the local taxes, up to 2%, using a formula. The formula assesses the taxes in a specific order, starting with the city tax, then the county tax, then the special purpose district taxes and finally the transit authority taxes. If a local taxing jurisdiction does not impose a certain level (type) of sales tax at the origin, the destination's use tax rate will apply.

Before September 1, 2007, the transit authority taxes were always assessed based upon the destination. Legislation effective September 1, 2007 (HB 142, 80th Legislative Session, 2007) repealed Section 322.107, eliminating that difference.

The order of assessment is important because a tax will not be imposed if it would cause the local taxes to exceed 2%. It's an "all or nothing" approach. Once you reach a point where a local tax level (type) would cause the local tax rate to exceed 2%, no additional local taxes will be imposed.

The Comptroller offers four basic rules to help taxpayers remember how to assess local taxes:[19]

a. Sales tax precedes use tax. A seller must collect the applicable local sales taxes before collecting local use taxes. When local use taxes are due in addition to local sales taxes all applicable use taxes must be collected or accrued in the following order until the two percent cap is reached: city, county, special purpose district, and transit authority. If more than one special purpose district use tax is due, all such taxes are to be collected or accrued before any transit authority use tax is collected or accrued.

b. No more than 2%. ("Don't Spill the Beans") A seller can collect no more than two percent in total local sales and use tax for all applicable jurisdictions.

c. Don't assess the same tax level (type) twice. ("No Double Dipping") If a seller collects a sales tax for a city, county, special purpose district or transit authority, the seller cannot collect a use tax for another local taxing jurisdiction of the same type. A seller may, however, collect more than one transit or special purpose district sales tax or multiple transit or special purpose district use taxes in relation to the same sales transaction.

   If a seller collects a local sales tax on an item, or a purchaser accrues a local sales tax on an item, a use tax for the same type of jurisdiction is not due on the same item. For example, once a city sales tax has been collected or accrued for an item, no use tax is due to that same or a different city on that item, but use tax may be due to a county, special purpose district, or transit authority. Similarly, if one or more special purpose district sales taxes have been collected or accrued for an item, no special purpose district use tax is due on that item, and if one or more transit authority sales taxes have been collected or accrued for an item, no transit authority use tax is due on that item.

   Collection or accrual of use tax for multiple special purpose districts. If more than one special purpose district use tax is in effect at the location where use of an item occurs, the special purpose district taxes are due in the order of their effective dates, beginning with the earliest effective date, until the two percent cap is met. The effective dates of all special purpose district taxes are available on the comptroller's website. However, if the collection or accrual of use tax for the district with the earliest effective date would exceed the two percent cap, the tax for that district is not due and the seller or purchaser should determine

[19] Comptroller Letter No. 200803162L.

whether use tax is due for the district that next became effective.[20]

Collection or accrual of use tax for multiple transit authorities. If more than one transit authority use tax is in effect at the location where use of an item occurs, and the two percent cap has not been met, the transit authority taxes are due in the order of their effective dates, beginning with the earliest effective date, until the two percent cap is met. The effective dates of all transit authority taxes are available on the comptroller's website. However, if the collection or accrual of use tax for the authority with the earliest effective date would exceed the two percent cap, the tax for that authority is not due and the seller or purchaser should determine whether use tax is due for the authority that next became effective.[21]

d. All or nothing. ("All-In or Fold") If the seller cannot collect the total tax rate percentage of a local jurisdiction's use tax without exceeding the 2% cap, then the seller should not collect any of it. If a local use tax cannot be collected or accrued at its full rate without exceeding the two percent cap, the seller cannot collect it, or any portion of it, and the purchaser is not responsible for accruing it.

The following rules apply to all sellers engaged in business in this state, regardless of whether they have a place of business in Texas or multiple places of business in the state.[22]

Example 1. Order placed in person at a seller's place of business in Texas. When a purchaser places an order for a taxable item in person at a seller's place of business in Texas, the sale of that item is consummated at that place of business, regardless of the location where the order is fulfilled. There is an exception for qualifying economic development agreements.

Example 2. Order received at a place of business in Texas, fulfilled at a location that is not a place of business. When an order that is placed over the telephone, through the Internet, or by any means other than in person is received by the seller at a place of business in Texas, and the seller fulfills the order at a location that is not a place of business of the seller in Texas, such as a warehouse or distribution center, the sale is consummated at the place of business where the order for the taxable item is received.

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[20] If the competing special purpose districts became effective on the same date, the special purpose district taxes are due in the order of the earliest date for which the election in which the district residents authorized the imposition of sales and use tax by the district was held. If the elections to impose the local taxes were held on the same date, the special purpose district taxes are due in the order of the earliest date for which the enabling legislation under which each district was created became effective.

[21] If the competing transit authorities became effective on the same date, the transit authority taxes are due in the order of the earliest date for which the election in which the authority residents authorized the imposition of sales and use tax by the authority was held. If the elections to impose local taxes were held on the same date, the transit authority use taxes are due in the order of the earliest date for which the enabling legislation under which each authority was created became effective.

[22] Tax Code §§321.203 and 323.203.

Example 3. Order fulfilled at a place of business in Texas. When an order is placed in person at a location that is not a place of business of the seller in this state, such as a kiosk, or when an order is placed over the telephone, through the Internet, or by any means other than in person, and the seller fulfills the order at a location that is a place of business in Texas, the sale is consummated at the place of business where the order is fulfilled.

Example 4. Order fulfilled within the state at a location that is not a place of business. When an order is received by a seller at any location other than a place of business of the seller in this state, and the seller fulfills the order at a location in Texas that is not a place of business of the seller, then the sale is consummated at the location in Texas to which the order is shipped or delivered, or the location where it is transferred to the purchaser.

Example 5. Order received outside of the state, fulfilled outside of the state. When an order is received by a seller at a location outside of Texas, and the order is shipped or delivered into a local taxing jurisdiction from a location outside of the state, the sale is not consummated at a location in Texas. However, local use tax is due based upon the location in this state to which the item is shipped or delivered or at which possession of the item is taken by the purchaser.

Example 6. Exception for qualifying economic development agreements entered into before January 1, 2009.[23] If applicable, the local sales tax due on the sale of a taxable item is based on the location of the qualifying warehouse, which is a place of business of the seller, from which the item is shipped or delivered or at which the purchaser takes possession of the item.

Example 7. Orders received by traveling salespersons. Orders taken by traveling salespersons are received by the seller at the administrative office or other place of business from which the traveling salesperson operates.

Example: a traveling salesperson who operates out of a seller's place of business in Texas takes an order for a taxable item, and the order is fulfilled at a location that is not a place of business of the seller in this state, the sale is consummated at the place of business from which the salesperson operates

Example: a traveling salesperson takes an order for a taxable item, and the order is fulfilled at a place of business of the seller in Texas, the sale is consummated at the location of the place of business where the order is fulfilled.

In addition to local sales tax, local use tax may be due. All taxable items that are shipped or delivered to a location in this state that is within the boundaries of a local taxing jurisdiction are presumed to have been purchased for use in that local taxing jurisdiction as well as presumed to have been purchased for use in the state. The following examples explain how local use tax is to be collected or accrued and remitted to the Comptroller:

[23] Tax Code §§321.203(c-4) - (c-5) or 323.203(c-4) - (c-5). Effective until September 1, 2024.

Example 8. Sale consummated outside the state, item delivered from outside the state or from a location in Texas that is not operated by the seller - local use tax due. A seller receives an order for a taxable item at a location outside of Texas, and the order is shipped to the purchaser from a location outside Texas. Local use tax is due based upon the location to which the order is shipped or delivered. If a sale is consummated outside Texas and the item purchased is either shipped or delivered to a location in Texas as designated by the purchaser from a location outside Texas, or if the order is drop shipped directly to the purchaser from a third-party supplier, local use tax is owed based upon the location in Texas to where the order is shipped or delivered. If the seller is engaged in business in the local taxing jurisdiction where the order is shipped or delivered, the seller is responsible for collecting the local use tax due on the sale. If the seller does not collect the local use taxes due on the sale, the purchaser is responsible for accruing such taxes and remitting them directly to the Comptroller.

Example 9. Sale consummated in Texas outside a local taxing jurisdiction, item delivered into one or more local taxing jurisdictions - local use tax due. A seller uses its own delivery vehicle to transport a taxable item from a place of business that is outside the boundaries of a local taxing jurisdiction to a delivery location designated by a purchaser that is inside the boundaries of a local taxing jurisdiction. The seller is responsible for collecting the local use taxes due based on the location to where the items are delivered. If a sale is consummated at a location in Texas that is outside of the boundaries of any local taxing jurisdiction, and the order is shipped or delivered to the purchaser at a location in Texas that is within the boundaries of one or more local taxing jurisdictions, local use tax is due based on the location to where the items are shipped or delivered. If the seller is engaged in business in the local taxing jurisdiction where the items are shipped or delivered, the seller is responsible for collecting the local use taxes due. If the seller fails to collect any local use taxes due, the purchaser is responsible for accruing such taxes and remitting them directly to the Comptroller.

Example 10. Sale consummated in any local taxing jurisdictions imposing less than 2.0% in total local taxes - local sales taxes, and possibly use taxes, due. If a sale is consummated at a location in Texas where the total local sales tax rate imposed by the taxing jurisdictions in effect at that location does not equal or exceed 2.0%, and the item is shipped or delivered to the purchaser at a location in Texas that is inside the boundaries of a different local taxing jurisdiction, additional local use tax may be due based on the location to where the order is shipped or delivered, subject to the two percent cap. If the seller is engaged in business in the local taxing jurisdiction into which the order is shipped or delivered, the seller is responsible for collecting any additional local use taxes due. If the seller fails to collect the additional local use taxes due, the purchaser is responsible for accruing such taxes and remitting them directly to the comptroller.

Example: An order is received in person at a seller’s place of business of the seller. The sale is consummated at the location where the order is received. If the local sales tax due on the sale does not meet the two percent cap, additional local use taxes may be due based on the location to where the order is shipped or delivered.

Example: If a purchaser places an order for a taxable item at a seller’s place of business in Texas, and the seller ships or delivers the item from an out-of-state location to a location in Texas as designated by the purchaser, local sales tax is due based upon the location of the place of business where the order is received. If the local sales tax due on the item does not meet the two percent cap, use tax is due based upon the location where the items are shipped or delivered.

VII. Retailers Operating Multiple Places of Business

Legislative changes from 2009 specify that each sale of a taxable item is consummated at the retailer's place of business in Texas where the retailer first accepts the order, provided that the order is placed in person by the purchaser or lessee of the taxable item. Now, when a purchaser places an order in person, retailers should collect local sales tax based on the location of the place of business where the order is received rather than the place of business from which the item is shipped.[24]

Retailers should continue to collect local sales tax based on the "ship from" location on all delivery sales of taxable items that are shipped from a place of business in Texas when the order is not placed in person by the purchaser or lessee. Orders placed over the Internet, by telephone or through the mail are still consummated at the retailer's place of business in this state from which the items are shipped if the items are shipped from a place of business of the seller in Texas.

When the taxpayer orders an item at one place of business and then the item is shipped from another business location special rules apply. If the taxpayer physically enters a place of business to order the item, that place of business is treated as the origin of the goods for local tax purposes, rather than the place of business from where the goods are shipped. For example, if a taxpayer were to enter The Abode Furniture Store in Houston to order a couch and the couch was then shipped from The Abode location in Austin, the Houston rate would be used to calculate the applicable local tax rate based upon the location where the customer was physically present to take the order.[25]

VIII. Drop Shipments.

A drop shipment is a transaction in which an order is received by a seller at one location, but the seller ships the item purchased from another location, or directs the seller's third-party supplier to ship it directly to a location designated by the purchaser.

When an order for a taxable item is received at a seller's place of business in Texas, or by a traveling salesperson operating out of a place of business in this state, and the item is drop-shipped directly to the purchaser from a third-party supplier, the sale is consummated at, and

[24] Texas Tax Code §§ 321.203 and 323.203 (amended by 81st Legislature, R.S., Senate S.B. 636 (Effective June 19, 2009)).
[25] August 2009 Tax Policy News, available online at: http://www.window.state.tx.us/taxinfo/taxpnw/tpn2009/tpn908.html#issue5.

local sales tax is due based upon, the location of the place of business where the order is received.

When an order for a taxable item is received by a seller at one location, but shipped by the seller to the purchaser from a different location, the sale is consummated at, and local sales tax is due based upon, the location designated under the general rules for determining local sales tax rates.

If the local sales taxes due based on the location of the seller's place of business at which the sale is consummated equal less than 2.0%, additional local use tax may be due based upon the location in this state to which the purchased item is shipped or delivered or at which possession of the item is taken by the purchaser.

When an order for a taxable item is received by the seller at a location outside of Texas, or by a traveling salesperson operating from a location outside of this state, and the item is drop-shipped directly to the purchaser from a third-party supplier, the item is subject to use tax.

IX. Itinerant Vendors and Vending Machines

An itinerant vendor is a person who travels to various locations for the purpose of receiving orders and making sales of taxable items and who does not operate a fixed place of business. A traveling salesperson who operates out of an office, place of business, or other location that provides administrative support to the salesperson is not an itinerant vendor.

Example: a person who sells rugs from the back of a truck that the person drives to a different location each day is an itinerant vendor.

Sales made by itinerant vendors are consummated at, and itinerant vendors must collect sales tax based upon, the location where the item is delivered or where the purchaser takes possession of the item. Itinerant vendors do not have any responsibility to collect use tax; only sales tax.

A person who sells items through vending machines is also an itinerant vendor. Sales of taxable items made from a vending machine are consummated at the location of the vending machine.

X. Construction Contracts and Job Sites

Nonresidential real property repair and remodeling services. Local taxes are due on services to remodel, repair, or restore nonresidential real property based on the location of the job site where the remodeling, repair, or restoration is performed.[26]

Nonresidential real property repair and improvement. When taxable services are performed to repair, remodel, or restore nonresidential real property, including a pipeline, transmission line, or parking lot, that is crossed by the boundaries of one or more local taxing jurisdictions, the local taxes due on the taxable services, including materials and any other charges connected to the services performed, must be allocated among the local taxing jurisdictions based upon the total mileage or square footage, as appropriate, of the repair, remodeling, or restoration project located in each jurisdiction.[27]

Residential real property repair and remodeling and new construction of a real property improvement performed under a separated contract. When a contractor constructs a new improvement to realty pursuant to a separated contract or improves residential real property pursuant to a separated contract, the sale is consummated at the job site where the contractor incorporates taxable items into the customer's real property.

Residential repair and remodeling; new construction of an improvement to realty. When a contractor is improving real property under a separated contract, and the job site is crossed by the boundaries of one or more local taxing jurisdictions, the local taxes due on any separately stated charges for taxable items incorporated into the real property must be allocated to the local taxing jurisdictions based on the total square footage of the real property improvement located within each jurisdiction, including the square footage of any standalone structures that are part of the construction, repair, or remodeling project.[28]

If a job site is crossed by one or more local taxing jurisdiction boundaries so that a portion of the job site is located within a taxing jurisdiction and the remainder of the place of business lies outside of the taxing jurisdiction, tax is due to the local taxing jurisdictions in which the sales office is located. If there is no sales office, sales tax is due to the local taxing jurisdictions in which any cash registers are located.

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[26] See Rules 3.291(f)(2)(B) and 3.357.

[27] For more information about tax due on materials used at nonresidential real property repair and remodeling job sites, see Rule 3.357 (relating to Nonresidential Real Property Repair, Remodeling, and Restoration; Real Property Maintenance).

[28] For more information about tax due on materials used at residential and new construction job sites, refer to Rule 3.291 (relating to Contractors).

XI. Local Tax on Residential Gas and Electricity

Residential use of natural gas and electricity is exempt from most local sales and use taxes. Counties, transit authorities, and most special purpose districts are not authorized to impose sales and use tax on the residential use of natural gas and electricity.[29]

Certain authorized local tax jurisdictions, including certain special purpose districts may tax residential use of utilities.[30] Effective January 1, 2010, Texas Tax Code Chapter 321 allows certain special purpose districts to impose local sales and use tax on the residential use of gas and electricity.[31] Local tax may apply even though state sales and use tax exempts the residential use. The board of directors of a fire control, prevention and emergency medical services district, or a crime control and prevention district located in all or part of a municipality that imposes a tax on the residential use of gas and electricity, may take actions necessary to impose the tax throughout the district.

Tax Code Section 321.102, provides that a tax becomes effective on the first day of the calendar quarter following the expiration of the first complete calendar quarter occurring after the date on which the Comptroller receives a copy of the order or resolution. This means that if a board votes to impose the tax and notifies the Comptroller during the first calendar quarter of 2014, the tax cannot become effective until after the second quarter of 2014 has passed.[32]

Any local city and special purpose taxes due are based upon the location where the natural gas or electricity is delivered to the purchaser. Residential use of natural gas and electricity is exempt from all county sales and use taxes and all transit authority sales and use taxes, most special purpose district sales and use taxes, and many city sales and use taxes. A list of the cities and special purpose districts that do impose, and those that are eligible to impose, local sales and use tax on residential use of natural gas and electricity is available on the Comptroller's website.

Cities that adopted local sales tax prior to October 1, 1979, may, in accordance with the provisions in Tax Code §321.105, choose to repeal the exemption for residential use of natural gas and electricity. The comptroller's website provides a list of cities that impose tax on the

[29] Pursuant to Tax Code §321.105, any city that adopted a local sales and use tax effective October 1, 1979, or later is prohibited from imposing tax on the residential use of natural gas and electricity.
[30] 81st Legislature, R.S., S.B. 575 (2009) (effective January 1, 2010). Effective January 1, 2010, a fire control, prevention, and emergency medical services district organized under Local Government Code, Chapter 344 that imposes sales tax under Tax Code §321.106, or a crime control and prevention district organized under Local Government Code, Chapter 363 that imposes sales tax under Tax Code §321.108, that is located in all or part of a municipality that imposes a tax on the residential use of natural gas and electricity as provided under Tax Code §321.105 may impose tax on residential use of natural gas and electricity at locations within the district. A list of the special purpose districts that impose tax on residential use of natural gas and electricity and those districts eligible to impose the tax that do not currently do so is available on the comptroller's website
[31] 81st Legislative Session, 2009 Senate Bill 575.
[32] October 2009 Tax Policy News.

residential use of natural gas and electricity, as well as a list of those cities that do not currently impose the tax, but are eligible to do so.

XII. Local Tax on Cable Television Services

The Comptroller defines a cable system as the system through which a cable service provider delivers cable television or bundled cable service.[33] One of the primary changes to the Comptroller's rule on cable television services is the change to how local taxes are collected:

a. Direct-to-home satellite. Sales of cable television or bundled cable services by means of direct-to-home satellite are exempt from local tax.[34] Direct-to-home satellite refers to cable television or bundled cable services transmitted directly to a purchaser's premises, including a residence, hotel, or motel, without use of ground receiving or distribution equipment, except at the purchaser's premises or in the uplink process to the satellite.

   Tangible personal property transferred to the care, custody, and control of the purchaser as an integral part of the cable television or bundled cable service is considered to be part of the service and is also exempt from local tax.

   Equipment a cable service provider uses to provide direct-to-home satellite cable television or bundled cable service is subject to local sales and use taxes, unless otherwise exempt.

b. Fixed physical connection. If a cable service provider delivers, or under its contract with the purchaser is able to deliver, cable television or bundled cable service, or any portion or element thereof, to the purchaser by means of a fixed physical connection, then the address of that fixed physical connection is the point of delivery, even if the purchaser can access the service both through a fixed physical connection and by means of nomadic access.

c. Two or more fixed physical connections. If fixed physical connections at two or more locations are associated with a single account, then the service provider must collect local taxes for each separately stated charge for cable television or bundled cable services based upon the location of the fixed physical connection to which the charge is allocable.

   Example. If a purchaser's account is associated with coaxial cable connections in City A and in City B, and the purchaser incurs a separately stated charge for a pay-per-view movie that is provided through the coaxial cable connection in City B, then the service provider should collect local taxes on the pay-per-view charge using the City B location as the point of delivery.

   If the service provider cannot determine the location of the fixed physical

[33] See Comptroller Rule 3.313.
[34] Under the Telecommunications Act of 1996, §602.

connection to which a charge is allocable, then the point of delivery is the location of the fixed physical connection designated by the purchaser prior to or at the time of purchase. The seller must maintain information about a purchaser's designated point of delivery in its books and records.

Example. If http://info.sos.state.tx.us/pls/pub/readtac$ext.TacPage?sl=T&app=9&p_dir=F&p_rloc=165933&p_tloc=15001&p_ploc=1&pg=2&p_tac=&ti=34&pt=1&ch=3&rl=313 a purchaser's account is associated with fixed physical connections at two or more locations, and the purchaser incurs a separately stated charge for video programming that is provided by means of nomadic access, then the point of delivery is the location of the fixed physical connection designated by the purchaser prior to or at the time of purchase.

d. Mobile telecommunications service provider. If the purchaser's account does not have a fixed physical connection, and if the cable service provider is also a mobile telecommunications service provider, then the point of delivery to the purchaser is the purchaser's place of primary use of the mobile telecommunications service under the rules set forth in Comptroller Rule 3.344.

e. No fixed physical connection. If the purchaser has no fixed physical connection, and the cable service provider is not a mobile telecommunications service provider, then the point of delivery shall be:

    i. The purchaser's mailing address in this state.

    Example. If there is no fixed physical connection, but the cable service provider sends invoices to the purchaser at a mailing address in this state, or has a mailing address in this state on file for the purchaser in its books and records, then the purchaser's Texas mailing address is the point of delivery.

    ii. **Good Faith Reliance.** A cable service provider acting in good faith may rely upon a statement from a purchaser regarding the purchaser's mailing address, in which case the provider will not be held liable for any additional tax, penalty, or interest if the Comptroller subsequently determines that the statement is invalid.

    iii. The Texas address associated with the payment instrument the purchaser used to pay for the service. The payment address can only be used if the cable service provider cannot otherwise determine, or the purchaser has not provided, a mailing address in this state.

When a service provider uses a satellite system to provide cable services to customers, no local tax is due on the service in accordance with the Telecommunications Act of 1996, §602.

XIII. Special Rules for Certain Types of Services

Real Property Services. With the exception of garbage or other solid waste removal services, local sales and use taxes apply to services in the same way as they apply to tangible personal property. Generally, service providers must collect local sales taxes if their place of business is within a local taxing jurisdiction, even if the service is actually provided at a location outside that jurisdiction. However, transit sales taxes do not apply to services provided outside the boundaries of the transit area. If the service provider's place of business is outside a local taxing jurisdiction but the service is provided to a customer within a local taxing jurisdiction, local use taxes apply and the service provider is required to collect them. Local taxes for garbage or other solid waste removal services are allocated to the local taxing jurisdiction in which the garbage or other solid waste is located when its collection or removal begins.[35]

Amusement services. Local tax is due based upon the location where the performance or event occurs.

Florists. Local sales tax is due on all taxable items sold by a florist based upon the location where the order is received, regardless of where or by whom delivery is made. Local use tax is not due on deliveries of taxable items sold by florists. For example, if the place of business of the florist where an order is taken is not within the boundaries of any local taxing jurisdiction, no local sales tax is due on the item and no local use tax is due regardless of the location of delivery. If a Texas florist delivers an order in a local taxing jurisdiction at the instruction of an unrelated florist, and if the unrelated florist did not take the order within the boundaries of a local taxing jurisdiction, local use tax is not due on the delivery.

Telecommunication services. Telecommunications services are exempt from all local sales taxes unless the governing body of a city, county, transit authority, or special purpose district votes to impose sales tax on these services. However, since 1999, under Tax Code §322.109(d), transit authorities created under Chapter 451 of the Transportation Code cannot repeal the exemption unless the repeal is first approved by the governing body of each city that created the local taxing jurisdiction. The local sales tax is limited to telecommunications services occurring between locations within Texas. The Comptroller's website provides a list of local taxing jurisdictions that impose tax on telecommunications services.

Landline telecommunications services. Local taxes due on landline telecommunications services are based upon the location of the device from which the call or other transmission originates. If the seller cannot determine where the call or transmission originates, local taxes due are based on the address to which the service is billed.

Mobile telecommunications services. Local taxes are due on mobile telecommunications services based upon the location of the customer's place of primary use.

Motor vehicle parking and storage. Local taxes are due based on the location of the space or facility where the vehicle is parked.

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[35] Rule § 3.356(k) Real Property Services.

Waste collection services. Local taxes are due on garbage or other solid waste collection or removal services based on the location at which the waste is collected or from which the waste is removed.

XIV. Direct Pay Permit Holders

Direct pay permit holders accrue and remit tax on their own purchases. A direct pay permit holder may issue a special form of an exemption certificate to its vendor, shifting the sales tax accrual and remittance burden from the vendor to its customer. The customer is then responsible for accruing and remitting tax on purchases when it files its monthly sales and use tax report.

A taxpayer may apply for a direct pay permit if its annual purchases meet or exceed $800,000 of taxable items for the taxpayer's own use.[36] The direct pay permit applicant agrees to maintain a separate accounting of taxable and nontaxable purchases, and to submit its records at any time, upon request, to the Comptroller's office for review. The advantage of the direct pay permit is that it allows a taxpayer to make an election regarding the timing of payment – when an item is first purchased and stored, or when it is removed for use. The direct pay permit holder may also have some control over the local tax rate that applies. However, effective November 11, 2012, local use tax "is due to the jurisdictions where the item is first stored regardless of which election is chosen."[37]

When taxable items are purchased under a direct payment permit, local use tax is due based upon the location where the permit holder first stores the taxable items, except that if the taxable items are not stored, then local use tax is due based upon the location where the taxable items are first used or otherwise consumed by the permit holder.

If, in a local taxing jurisdiction, storage facilities contain taxable items purchased under a direct payment exemption certificate and at the time of storage it is not known whether the taxable items will be used in Texas, then the taxpayer may elect to report the use tax either when the taxable items are first stored in Texas or are first removed from inventory for use in Texas, as long as use tax is reported in a consistent manner.

If local use tax is paid on stored items that are subsequently removed from Texas before they are used, the tax may be recovered in accordance with the refund and credit provisions of Comptroller Rule 3.325 (relating to Refunds and Payments Under Protest) and Rule 3.338 (relating to Multistate Tax Credits and Allowance of Credit for Tax Paid to Suppliers).

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[36] Direct Pay Permit Applications are available on the Comptroller's website at: http://www.window.state.tx.us/taxinfo/taxforms/ap-101.pdf.
[37] Comptroller Rule 3.346(g).

XV. Direct Sales Organizations

Direct sales organizations are businesses, such as Tupperware and Mary Kay Cosmetics, which primarily use independent representatives as distributors for their products. Direct sales organizations with representatives in Texas are considered to be "sellers" and are therefore responsible for collecting and remitting the sales tax collected by the independent salespersons selling the organization's product.[38] In contrast, independent salespersons of direct sales organizations are not required (and not allowed) to hold sales tax permits. Rather, it is the direct sales organization's responsibility to hold Texas permits and to collect Texas tax.

Texas Tax Code § 151.024 gives the Comptroller the power to determine that salesmen, representatives, peddlers, or canvassers are agents of a dealer, distributor, supervisor or employer, if necessary for the efficient administration of the tax laws. The Comptroller may make that determination regardless of whether the representative is making the sale on his own behalf or on behalf of the dealer, distributor, supervisor or employer.

In the case of *Alpine Industries v. Strayhorn*,[39] the Court held that a manufacturers air-purification equipment sold in Texas and elsewhere by Alpine's network of independent dealers, should be treated as a direct sales organization.

In the case of *Local Neon Co., Inc. v. Strayhorn*,[40] the Court held that an out of state manufacturer making sales to Texas customers through local representatives could be treated as a retailer under Texas Tax Code § 151.107.

In the case of *Combs v. Entertainment Publications, Inc.*,[41] the Court issued an injunction against the Comptroller from treating a fundraising catalog sales company as a direct sales organization. This case is discussed in more detail in the Exemptions Chapter under Exempt Student Fundraisers.

Since their distributors don't generally don't qualify for sales and use tax permits, direct sales organizations must collect tax from their distributors in different amounts based upon the circumstances:

(a) Existing Customer Orders. If the distributor takes orders before purchasing from the direct sales organization, the order blank should indicate the amount of tax due and to which local taxing jurisdictions it should be allocated. The direct sales organization should collect and remit the appropriate *taxes from copies of the orders*.

[38] Comptroller Rule 3.286(a)(3).
[39] 2004 WL 1573159, No. 03-03-00643-CV (Tex. App.—Austin 2004, pet denied) (unpublished).
[40] 2005 WL 1412171, No. 03-04-00261-CV (Tex. App.—Austin 2005, reh'g overruled) (unpublished).
[41] 292 S.W.3d 712, Tex. App.—Austin (June 12, 2009, reh'g overruled).

(b) <u>Inventory Purchases</u>. If the distributor purchases the items before the customer's order is taken, the direct sales organization should collect and remit the amount of tax based on the *suggested retail sales price* and the tax rate in effect for the *distributor's location*.

Reporting Requirements. Periodically, distributors should submit reports to the direct sales organization indicating the amount of sales in each local taxing jurisdiction, the amount of sales in areas having no local taxes, and any exempt sales such as products shipped by the distributor to customers outside Texas. The direct sales organization's sales tax return should reflect the compilation of these internal reports and the regular sales for that reporting period. Any amount of tax the direct sales organization collects from distributors which is not due should be refunded or credited to them.

(c) <u>Items Purchased for Distributor's Use</u>. All sales of items to a distributor for personal or business use should have tax computed on the direct sales organization's *actual price* to the distributor and at the rate of tax for the distributor's location. Examples of these items include products for the distributors own use, sales aids, training materials, and prizes given away to customers.

XVI. Prior Contract Exemptions

The provisions of Rule 3.319 (relating to Prior Contracts) concerning definitions and exclusions apply to prior contract exemptions.

Certain contracts and bids exempt. No local taxes are due on the sale, use, storage, or other consumption in this state of taxable items used:

(A) for the performance of a written contract executed prior to the effective date of any local tax if the contract may not be modified because of the tax; or

(B) pursuant to the obligation of a bid or bids submitted prior to the effective date of any local tax if the bid or bids and contract entered into pursuant thereto are at a fixed price and not subject to withdrawal, change, or modification because of the tax.

Annexations. Any annexation of territory into an existing local taxing jurisdiction is also a basis for claiming the exemption for prior contracts.

Local taxing jurisdiction rate increase; partial exemption for certain contracts and bids. When an existing local taxing jurisdiction raises its sales and use tax rate, the additional amount of tax that would be due as a result of the rate increase is not due on the sale, use, storage, or other consumption in this state of taxable items used:

(A) for the performance of a written contract executed prior to the effective date of the tax rate increase if the contract may not be modified because of the tax; or

(B) pursuant to the obligation of a bid or bids submitted prior to the effective date of the tax rate increase if the bid or bids and contract entered into pursuant thereto are at a fixed price and not subject to withdrawal, change, or modification because of the tax.

Three-year statute of limitations. The exemptions and partial exemptions for prior contracts have no effect after three years from the date the adoption or increase of the tax takes effect in the local taxing jurisdiction.

Leases. Any renewal or exercise of an option to extend the time of a lease or rental contract under the exemptions provided by this subsection shall be deemed to be a new contract and no exemption will apply.

Records. Persons claiming the prior contract exemption must maintain records which can be verified by the Comptroller or the exemption will be lost.

Exemption certificate. An identification number is required on the prior contract exemption certificates furnished to sellers. The identification number should be the person’s 11-digit Texas taxpayer number or federal employer’s identification (FEI) number

XVII. Rules for Special Localities

Dickinson Management District; purchasing office exclusion invalid. Special District Local Laws Code §3853.202(d) is invalid to the extent that it attempts to exclude the Dickinson Management District from the application of Tax Code §321.203(m) (formerly Tax Code §321.203(l)).

East Aldine Management District.

Special sales and use tax zones within district; separate sales and use tax rate. As set out in Special District Local Laws Code §§3817.154(e) and (f), the East Aldine Management District board may create special sales and use tax zones within the boundaries of the District and, with voter approval, enact a special sales and use tax rate in each zone that is different from the sales and use tax rate imposed in the rest of the district.

Exemptions from special zone sales and use tax. The sale, production, distribution, lease, or rental of; and the use, storage, or other consumption within a special sales and use tax zone of; a taxable item sold, leased, or rented by the entities identified in clauses (i) - (vi) below are exempt from the special zone sales and use tax. State and all other applicable local taxes apply unless otherwise exempted by law. The special zone sales and use tax exemption applies to:

(i) a retail electric provider as defined by Utilities Code §31.002;

(ii) an electric utility or a power generation company as defined by Utilities Code §31.002;

(iii) a gas utility as defined by Utilities Code §101.003 or §121.001, or a person who owns pipelines used for transportation or sale of oil or gas or a product or constituent of oil or gas;

(iv) a person who owns pipelines used for the transportation or sale of carbon dioxide;

(v) a telecommunications provider as defined by Utilities Code §51.002; or

(vi) a cable service provider or video service provider as defined by Utilities Code §66.002.

El Paso and Fort Bliss. Pursuant to Tax Code §321.1045 (Imposition of Sales and Use Tax in Certain Federal Military Installations), for purposes of the local sales and use tax imposed under Tax Code Chapter 321, the city of El Paso includes the area within the boundaries of Fort Bliss to the extent it is in the city's extraterritorial jurisdiction. However, the El Paso transit authority does not include Fort Bliss.[42]

[42] *See* Transportation Code, §453.051 concerning the Creation of Transit Departments.

WHO CAN SIGN TAX RETURNS AND MAKE TAX ELECTIONS

A review of who has signature authority to file tax returns and make tax elections

October 22, 2015

Prepared and Presented by:

KENNETH S. FREED

Crady, Jewett & McCulley, LLP
2727 Allen Parkway, Suite 1700
Houston, Texas 77019-2125
Telephone: (713) 739-7007
Facsimile: (713) 739-8403
e-mail: kfreed@cjmlaw.com

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WHO CAN SIGN TAX RETURNS AND MAKE TAX ELECTIONS

I. **Scope of Article**.

The purpose of this article is to provide you with an overview of the general filing requirements for individuals and business entities. This article will cover who must file returns, general return requirements, potential consequences of invalid returns, signature requirements, powers of attorney, and a discussion of partnership filing issues.[1]

II. **Who Must File an Income Tax Return**.

A. Individuals.

Generally, individual tax returns are required for (1) single individuals and heads of household having gross income for the taxable year of greater than the sum of the exemption amount plus the basic standard deduction applicable to such individual,[2] (2) married individuals filing jointly whose gross income, when combined with the gross income of his or her spouse, is, for the taxable year, greater than the sum of twice the exemption amount plus the basic standard deduction applicable to a joint return, but only if such individual and his or her spouse, at the close of the taxable year, had the same household as their home[3], and (3) a surviving spouse (as so defined) that has gross income for the taxable year greater than the sum of the exemption amount plus the basic standard deduction applicable to that spouse.[4] The following table illustrates the filing requirements for most individual taxpayers:

Filing Status	**Age at December 31, 2014**	**Must File If Gross Income Is Greater Than:**
Single	Under 65	$10,150
	65 or older	$11,700
Married Filing Jointly	Under 65 (both)	$20,300
	65 or older (both)	$22,700
	Under 65 (one)	$21,500
Married Filing Separately	Any	$6,200

[1] All references to the "Code" are to the Internal Revenue Code of 1986, as amended, and all references to "Treas. Reg." are to the Treasury Regulations promulgated thereunder.
[2] § 6012(a)(1)(A)(i), (ii).
[3] § 6012(a)(1)(A)(iv).
[4] § 6012(a)(1)(A)(iii).

Head of Household	Under 65	$13,050
	65 or older	$14,600
Qualifying Widow(er)	Under 65	$16,100
	65 or older	$17,300

As can be seen in the table above, there are five potential filing statuses. An individual's marital status is determined as of the last day of the tax year.[5] A husband and wife may file a joint return regardless of who receives income or has deductions as long as they are (i) not legally separated under a divorce decree or separate maintenance agreement as of the last day of the tax year and (ii) neither is a nonresident alien at any time during the tax year.[6] However, a U.S. citizen and their nonresident alien spouse may elect joint filing status if they agree to be taxed on their worldwide income and provide the necessary books and records and other applicable information upon request.[7] It is important to remember that a couple filing jointly has joint and several liability for the entire tax on the tax return and any future deficiencies determined by the Internal Revenue Service ("Service" or "IRS").[8] In some cases, though, one spouse may be relieved of joint responsibility for tax, interest, and penalties on a joint return for items of the other spouse that were incorrectly reported on the joint return.[9] There are three types of relief available: (1) Innocent spouse relief; (2) Separation of liability (available only to joint filers who are divorced, widowed, legally separated, or have not lived together for the 12 months ending on the date the election for this relief is filed); and (3) Equitable relief. Equitable relief is available to taxpayers who are not eligible for one of the other two methods of relief. A taxpayer must file Form 8857, Request for Innocent Spouse Relief, to request relief from joint responsibility. Publication 971, Innocent Spouse Relief, explains these types of relief and who may qualify for them. Individual taxpayers are required to file a tax return by the 15th day of the fourth month after the end of the tax year (e.g. April 15th for calendar year taxpayers).[10]

[5] § 7703(a)(1).
[6] Treas. Reg. § 1.6013-1.
[7] § 6013(g).
[8] § 6013(d)(3).
[9] § 6015.
[10] § 6072(a).

B. Corporations.

Corporations are required to file an annual income tax return whether or not the corporation received income or owed tax in a particular year.[11] On July 31, 2015, President Obama signed into law P.L. 114-41, the "Surface Transportation and Veterans Health Care Choice Improvement Act of 2015." Among other things, this bill revised due dates for C corporation and partnership returns and revised extended due dates for some returns. Previously, corporations were required to file their returns by the 15th day of the third month after the end of their tax year. Thus, corporations using the calendar year were required to file their returns by March 15th of the following year.[12] S corporations are also required to file their returns by the 15th day of the third month after the end of their tax year.[13] However, starting with tax returns for tax years 2016 and later, C corporations will have until the 15th day of the fourth month after the end of the tax year to file (e.g. April 15th for calendar year taxpayers). The filing deadline for S corporations will remain unchanged (i.e. the 15th day of the third month after the end of their tax year).

C. Partnerships.

Partnerships, and limited liability companies treated as partnerships for federal income tax purposes,[14] are required to file an annual information return to report the income, deductions, gains, losses and the like from its operations, even though such items "flow through" to the partners.[15] "Every partnership (as defined in section 761(a)) shall make a return for each taxable year, stating specifically the items of its gross income and the deductions allowable by subtitle A, and such other information for the purpose of carrying out the provisions of subtitle A as the Secretary ***may by forms and regulations prescribe***, and shall include in the return the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual."[16] The return includes partners' names, addresses, and allocable share of partnership items. Prior to the "Surface Transportation

[11] § 6012(a)(2); Treas. Reg. § 1.6012-2(a).
[12] § 6072(a).
[13] § 6072(b).
[14] The term "partnership" also includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate. *See* § 761; *see also* Treas. Reg. § 301.7701-2(c)(1).
[15] § 6031.
[16] § 6031(a) (emphasis added).

and Veterans Health Care Choice Improvement Act of 2015,"[17] the Partnership was required to file its information return by the 15th day of the fourth month after the end of the partnership's tax year; thus, April 15th of the following year for partnerships using a calendar year.[18] However, starting with tax returns for tax years 2016 and later, partnerships will have only until the 15th day of the third month after the end of the tax year to file (e.g. March 15th for calendar year taxpayers). By having most partnership returns due one month before individual returns are due, taxpayers and practitioners will generally not have to extend, or scurry around at the last minute to file, the returns of individuals who are partners in partnerships.

D. Limited Liability Companies.

Limited liability companies may be classified as a partnership, corporation, or entity disregarded from its owner for federal income tax purposes.[19] Accordingly, its filing requirements will depend on it federal income tax classification. If the LLC is an entity disregarded from its owner, the business income will be reported on the individual's Form 1040 tax return on Schedule C, E, or F. If the LLC has elected to be treated as a corporation under the "check-the-box" regulations, it will be required to file the Form 1120 of Form 1120S in accordance with the corporate filing guidelines outlined in Section II.B. above. Or, if the LLC is treated as a partnership for federal income tax purposes, it will be required to file a Form 1065 in accordance with the partnership filing guidelines outlined in Section II.C. above.

E. Trusts and Estates.

Generally, a fiduciary must file a Form 1041, U.S. Income Tax Return for Estates and Trusts, if (1) the estate has gross income of $600 or more for the tax year,[20] (2) the trust has any taxable income or gross income of $600 or more,[21] or (3) any beneficiary of the estate or trust is a nonresident alien.[22] It will not matter if the trust is a simple trust, a grantor trust, or a complex trust. However, filing a 1041 for a grantor trust is optional.[23] The fiduciary, or an authorized representative, must sign the Form 1041. If there are joint fiduciaries, only one is required to

[17] P.L. 114-41.
[18] § 6072(b).
[19] Treas. Reg. § 301.7701-3.
[20] § 6012(a)(3).
[21] § 6012(a)(4).
[22] § 6012(a)(5).
[23] *See* Treas. Reg. §1.671-4(b)(2)(ii); *See also* Instructions to Form 1041, pg. 13.

sign the return.[24] Taxpayers are required to file the Form 1041 by the 15th day of the fourth month after the end of the tax year (e.g. April 15th for calendar year taxpayers).[25]

For decedents who died in 2015, Form 706 must be filed by the executor of the estate of every U.S. citizen or resident: (1) whose gross estate, plus adjusted taxable gifts and specific exemption, is more than $5,430,000; or (2) whose executor elects to transfer the Deceased Spousal Unused Election ("DSUE") amount to the surviving spouse, regardless of the size of the decedent's gross estate. The estate tax return must be filed by the executor, administrator, or person in possession of the estate's assets.[26] If two or more persons are liable for filing the return, they should all join together in filing one complete return. However, if they are unable to join in making one complete return, each is required to file a return disclosing all the information the person has about the estate, including the name of every person holding an interest in the property and a full description of the property.[27] The return is due within nine months of the decedent's date of death, but a six-month extension of time to file is available.[28] The six-month extension is automatically available if: (1) Form 4768 – Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes – is filed by or before the due date for the estate tax return; (2) the application is filed with the IRS office designated in the application's instructions; and (3) an estimate of the amount of estate and generation-skipping transfer ("GST") tax liability is included.

The "Surface Transportation and Veterans Health Care Choice Improvement Act of 2015"[29] also provides new reporting requirements with regard to the value of property included in a decedent's gross estate for federal estate tax purposes. Generally, Code Section 1014(f) provides rules requiring that the basis of certain property acquired from a decedent, as determined under Code Section 1014, may not exceed the value of that property as finally determined for federal estate tax purposes, or if not finally determined, the value of that property as reported on a statement made under Code Section 6035. Code Section 6035(a)(1) provides that the executor of any estate required to file a return under section 6018(a) must furnish, both

[24] Instructions for Form 1041, page 8.
[25] § 6072.
[26] § 2203; § 6018(a).
[27] Instructions to Form 706, pg. 3.
[28] § 6075(a); Treas. Reg. § 20.6075-1.
[29] P.L. 114-41.

to the Secretary and the person acquiring any interest in property included in the decedent's gross estate for federal estate tax purposes, a statement identifying the value of each interest in such property as reported on such return and such other information with respect to such interest as the Secretary may prescribe. Each statement required to be furnished under Code Section 6035 shall be furnished at such time as the Secretary may prescribe, but in no case at a time later than the *earlier* of (i) the date which is 30 days after the date on which the return under section 6018 was required to be filed (including extensions, if any) or (ii) the date which is 30 days after the date such return is filed.[30]

For each statement required by Code Section 6035 to be filed with the IRS or furnished to a beneficiary before February 29, 2016, IRS Notice 2015-57[31] delays the due date for filing or furnishing that statement until February 29, 2016. The notice applies to executors of estates of decedents and to other persons who are required under section 6018(a) or (b) (i.e. Form 706) to file a return if that return is filed after July 31, 2015. The delay is to allow the Treasury Department and the IRS to issue guidance implementing the reporting requirements of new Code Section 6035. Executors and other persons required to file or furnish a statement under Code Section 6035(a)(1) or (a)(2) should not do so until the issuance of forms or further guidance by the Treasury Department and the IRS addressing the requirements of Code Section 6035.[32]

Fiduciaries for any tax-exempt trust that is subject to tax on its unrelated business taxable income must file Form 990-T for every tax year in which the trust has gross income from an unrelated trade or business of $1,000 or more. The IRS requires that colleges and universities of states and of other governmental units, as well as subsidiary corporations wholly owned by such colleges and universities, also must file Form 990-T.

F. <u>Exempt Organizations</u>.

In the case of an income tax return of an organization exempt from taxation under section 501(a) (other than an employees' trust described in section 401(a)), a return shall be filed on or before the 15th day of the 5th month following the close of the taxable year (i.e. Form 990).[33]

[30] § 6035(a)(3)(A).
[31] 2015-36 IRB.
[32] *Id.*
[33] § 6072(e).

Thus, for calendar year exempt organizations, the return is due by May 15th of the following tax year.

III. **Other Common Returns Required**.

A. Gift Tax Returns.

A citizen or resident of the United States must file a gift tax return if gifts were made to a person during a calendar year which total more than the gift tax annual exclusion for that year.[34] The gift tax annual exclusion amount for 2015 (as adjusted for inflation) is $14,000 per donor per beneficiary. Gift tax returns must be filed, and any gift tax must be paid, on an annual basis. Generally, the due date for filing the annual gift tax return will be April 15th.[35] However, for the calendar year in which the donor dies, the gift tax return will be due on the earlier of the due date (with extensions) for filing the donor's estate tax return, or the "normal" due date with respect to the gifts (i.e. April 15th following the calendar year in which the gifts were made).

Filing an extension to file a federal income tax return also automatically extends the due date to file the gift tax return. If a taxpayer is not extending the due date for his or her income tax return, then the taxpayer may use Form 8892, Application for Automatic Extension of Time to File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax, to request an automatic six month extension of time to file the gift tax return.

B. Foreign Bank Account and Financial Assets.

A Form TD F 90-22.1, Report of Foreign Bank Account and Financial Assets ("FBAR"), is an informational return required to be filed by U.S. persons that (1) had a financial interest in or signature authority over at least one financial account located outside of the United States; and (2) the aggregate value of all foreign financial accounts exceeded $10,000 at any time during the calendar year reported. U.S. person means United States citizens (including minor children); United States residents; entities, including but not limited to, corporations, partnerships, or limited liability companies created or organized in the United States or under the laws of the

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[34] § 6019.
[35] § 6075.

United States; and trusts or estates formed under the laws of the United States.[36] The FBAR is an annual report and, prior to the "Surface Transportation and Veterans Health Care Choice Improvement Act of 2015,"[37] was on or before June 30th of the year following the calendar year being reported.[38] However, starting for tax years 2016 and later, the FBAR deadline will be April 15th, but may also be extended by six months. Note that the FBAR is filed on the Bank Secrecy Act (BSA) E-Filing System through a FinCEN (Financial Crimes Enforcement Network) secure network.

IV. **General Return Requirements**.

A. What Is a Valid Return?

A valid return is one that (1) provides sufficient data to calculate the taxpayer's liability, (2) purports to be a return, (3) is an honest and reasonable attempt to satisfy the return requirements, and (4) is executed under penalty of perjury. The preceding requirements are what is generally known as the "substantial compliance standard."[39] The question of whether a tax return is a valid return generally arises in two situations: (1) has a valid return been filed that will start the statute of limitations; and (2) has a valid return been filed that will prevent the imposition of a failure to file penalty?

B. Who Can Sign a Tax Return?

Except as otherwise provided in the Code, every return, statement, or other document must be signed and verified in accordance with form instructions or regulations prescribed by the IRS.[40] Under certain circumstances, an agent may sign a return.

i. *Individual Returns.*

Individuals, including fiduciaries, are required to sign income tax returns.[41] However, an agent may sign on behalf of an individual if the individual: (1) is unable to sign due to disease or injury; (2) is absent from the United States (including Puerto Rico as part of the United States)

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[36] FinCEN Form 114.
[37] P.L. 114-41.
[38] *Id*.
[39] *Beard v. Comm'r*, 82 T.C. 766, 777 (1984), *aff'd per curiam*, 793 F. 2d 139 (6th Cir. 1986).
[40] § 6061(a).
[41] Treas. Reg. § 1.6061-1(a).

for a continuous period of at least 60 days prior to the due date for filing the return; or (3) obtains permission from the IRS.[42] In one of these circumstances, an unenrolled agent may be authorized to sign a taxpayer's return, provided the agent has been authorized to do so by a power of attorney.[43] If a power of attorney is executed and accompanies the return under one of the circumstances above, the return will be considered valid. A Form 2848 will be considered sufficient for these purposes.[44] Likewise, the Form 2848 is sufficient for establishing the agency of a spouse. Alternatively, one spouse may sign a joint return on behalf of another spouse who is physically unable to sign the return, provided there is oral consent from the incapacitated spouse. The incapacitated spouse's name should be signed followed by the words "By...Husband (or Wife)". A dated statement signed by the signing spouse must be attached to the return and must indicate: (1) the name of the return being filed; (2) the tax year; (3) the reason for the inability of the spouse who is incapacitated to sign the return; and (4) that the spouse who is incapacitated consented to the signing of the return.[45] If one spouse is unable to sign for reasons other than disease or disability, the signing spouse may do so with a valid power of attorney (e.g. Form 2848).[46] If a child is unable to sign his own tax return because of his age, his parent or guardian must do so. The parent or guardian should sign the child's return with the child's name followed by: "By….Parent or guardian for minor child."[47] Returns may also be signed by representatives or agents of nonresident aliens in certain cases, and a court-appointed representative can sign on behalf of a mentally incompetent individual.[48]

ii. *Decedent's Return.*

If a personal representative or administrator has been appointed, he must sign the final income tax return for the decedent (e.g. "By…Administrator (or Executor) of the Estate of…, Deceased."). If a joint return is filed, the surviving spouse must also sign. If no personal representative has been appointed, the surviving spouse (on a joint return) signs the return and writes in the signature area "Filing as surviving spouse."[49] If no personal representative has been

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[42] Treas. Reg. § 1.6012-1(a)(5).
[43] *Id*.
[44] Service Center Advice 200236043.
[45] Treas. Reg. §1.6012-1(a)(5).
[46] *Id*.
[47] Rev. Rul. 82-206, 1982-2 C.B. 356.
[48] Treas. Reg. § 1.6012-1(b); Treas. Reg. § 1.6012-3(b)(3).
[49] IRS Pub. No. 17 (2013) pg. 21.

appointed and if there is no surviving spouse, the person in charge of the decedent's property must file and sign the return as "personal representative."[50] In the case of joint fiduciaries, a return is required to be made by only one of such fiduciaries. A return made by one of the joint fiduciaries shall contain a statement that (1) the fiduciary has sufficient knowledge of the affairs of the person for whom the return is made to enable him to make the return, and (2) the return is, to the best of his knowledge and belief, true and correct.[51]

iii. *Corporate Returns.*

A corporation's income tax return must be signed by one of the following officers: (1) the president, (2) vice president, (3) treasurer, (4) assistant treasurer, (5) chief accounting officer, or (6) any other officer duly authorized to so act.[52] The fact that an individual's name is signed on the return shall be prima facie evidence that such individual is authorized to sign the return on behalf of the corporation.[53] It is also not necessary that the corporate seal be affixed to the return. Spaces provided on return forms for affixing the corporate seal are for the convenience of corporations required by charter, or by the law of the jurisdiction in which they are incorporated, to affix their corporate seals in the execution of instruments.[54] In the absence of a corporate officer's signature, a shareholder may not sign the corporation's return. In PLR 8024046, an S corporation's only operating officer vacated his personal residence and left no forwarding address. The 20% shareholder was not permitted to sign the corporation's return under such circumstances. The IRS reasoned that the shareholder, who was also a creditor of the corporation, but was never an officer, director or employee, had no knowledge of the financial affairs of the corporation beyond those that were communicated to him by the operating officer. Although PLR 8024046 involved a shareholder who had no knowledge of the corporation's financial affairs, there was no indication that the shareholder would have been permitted to sign even if he did have such knowledge.

Consider the following scenario: A sells S corporation stock to B during the year. B is also the president of S corporation. A is not an officer, and B does not file return for the S

[50] IRS Pub. No. 559, "Survivors, Executors, and Administrators".
[51] § 6012(b)(5); Treas. Reg. § 1.6012-3(c).
[52] § 6062.
[53] *Id.*
[54] Treas. Reg. § 1.6062-1(a)(1).

corporation. Accordingly, A does not receive a K-1. Who can file for the S corporation? It remains an open question, but appears from PLR 8024046 that since A was not an officer and did not have knowledge of the financial affairs of the corporation beyond those that were communicated to him by the operating officer, A cannot file the tax return on behalf of the S corporation.

iv. *Limited Liability Company Returns.*

Unless otherwise elected under the "check-the-box" regulations, a limited liability company with one member is treated as a disregarded entity for federal income tax purposes,[55] and a limited liability company with more than one member is treated as a partnership for federal income tax purposes.[56] Thus, if a limited liability company has at least two members and is classified as a partnership, it generally must file Form 1065 and is subject to the same filing and reporting requirements as partnerships. In the case of a limited liability company treated as a partnership, however, only a member manager can sign the tax return.[57] Furthermore, only a member manager can represent the limited liability company as the tax matters partner under the consolidated audit proceedings in sections 6221 through 6234.[58] A member manager is any owner of an interest in the limited liability company who, alone or together with others, has the continuing authority to make the management decisions necessary to conduct the business for which the limited liability company was formed. If there are no elected or designated member managers, each owner is treated as a member manager.[59]

If a limited liability company has elected to be treated as a corporation by filing Form 8832, or an S corporation by filing Form 2553, the same general rules apply regarding signature requirements for corporations. If the entity is a manager managed limited liability company, the manager should be able to sign the return as the officer duly authorized to so act.[60] In Chief Counsel Advice 201411024, the IRS concluded that where a limited liability company, treated as a C corporation, did not have any of the specific corporate officers listed in Code Section 6062, the person authorized to sign a Form 872 (i.e. consent to extension of the statute of limitations on

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[55] Treas. Reg. § 301.7701-2.
[56] *Id*.
[57] IRS Pub. No. 3402.
[58] *See* III.B.v.2. below.
[59] See IRS Pub. 3402, pg. 2.
[60] Chief Counsel Advice 201411024.

assessment) would be a managing member or other individual authorized to act for the company, for tax matters, under state law. More recently, however, the IRS held in Chief Counsel Advice 201536025 that the officer of the sole remaining member of a limited liability company, which in turn is the manager of the taxpayer (another limited liability company), has authority to sign the Form 1120 for the taxpayer. Counsel for the taxpayer had also represented that the officer had authority to act on its behalf. The CCA further noted that the taxpayer may also be estopped in the future from asserting that the officer lacked authority to sign the tax return or any Forms 2848 and Forms 872. The elements of estoppel, as set out in *Union Texas International Corp. v. Comm'r*[61], are:

(1) There was a false representation or a wrongful misleading silence by the taxpayer;

(2) The false representation or wrongful silence related to a question of fact and not an opinion or statement of law;

(3) IRS was adversely affected by the acts or statements (or failure to act or make statements) by the taxpayer; and

(4) IRS was ignorant of the true facts.

In this case, the representation at issue (i.e., that a certain officer had authority to sign a return or other document) is more in the nature of a question of fact, and not an opinion or statement of law. Thus, the IRS believes that under such circumstances the taxpayer would also be estopped from asserting that an officer did not have authority to sign the tax return.

v. *Partnership Returns.*

1. Tax Returns.

Code Section 6063 states that the "return of a partnership made under section 6031 shall be signed by any one of the partners. The fact that a partner's name is signed on the return shall be prima facie evidence that such partner is authorized to sign the return on behalf of the partnership." Treas. Reg. § 1.6063-1(a) provides that "[r]eturns, statements, and other documents required to be made by partnerships under the provisions of subtitle A or F of the

[61] 110 T.C. 321 (1998).

Code, or the regulations thereunder, with respect to any tax imposed by subtitle A of the Code shall be signed by any one of the partners." However, as stated in Section II.C. above, Code Section 6031 requires every partnership to make a return for each tax year stating specifically the information the Secretary may by forms and regulations prescribe. Based on the foregoing, the IRS takes the position that "limited partners should not be permitted to sign Forms 1065 in view of possible problems arising from state restrictions on the rights and powers of limited partners."[62] The instructions to Form 1065 provide: "Form 1065 is not considered a return unless it is signed. **One general partner must sign the return**. If a receiver, trustee in bankruptcy, or assignee controls the organization's property or business, that person must sign the return."[63] The IRS draws a distinction between a general partner and a limited partner for purposes of signing returns as further clarified below:

> First, a limited partner ordinarily does not manage the partnership or control the conduct of its business.[64] The signature instructions to Form 1065, however, clearly imply that a proper signer must be in control of the partnership inasmuch as the instructions indicate that even a general partner would not be a proper signer if a receiver, trustee in bankruptcy, or assignee controls the business. Requiring the signer of a Form 1065 to be in control of the partnership business or property is consistent with the general Service policy of requiring persons in control of property or business to make returns of income. See, e.g., sections 6012(b)(2); 6012(b)(3); 6062. Cf. O.M. 19446, *** I-89-81 (June 17, 1981) (concluding that a court appointed receiver who has custody of all or substantially all of an individual's assets must file and sign required returns). That position presumably is based on the expectation that such persons are best situated to make accurate returns due to their ongoing involvement with the business or property giving rise to income. We believe that rationale applies with equal force when considering whether limited partners, who are not involved in management of a partnership's business, should be permitted to sign the partnership's return.

[62] General Counsel Memorandum 38781.
[63] *Id*. (emphasis added).
[64] A. Bromberg, Crane and Bromberg on Partnership § 48, § 26(c) (1968).

Second, allowing limited partners to sign Form 1065 may place the Service in the position of contributing to the loss of those partners' limited liability. As noted above, U.L.P.A.[65] § 7 provides limited liability only to the extent a limited partner does not participate in the control of the partnership.[66] Whether signing a Form 1065 would be deemed participation in control is a moot question, but the proposed change could result in that issue becoming an element in litigation concerning the status of a partner. *See generally* Crane and Bromberg § 26(c). Although we do not think the Service has any particular responsibility to protect limited partners from the consequences of their actions, we believe the possibility of this result is another factor that militates against [allowing limited partners to sign the Form 1065].

The third and, in our view, most important reason for rejecting the [proposal to allow limited partners to sign the Form 1065] is the potential for returns signed by limited partners being treated as invalid because of the inability of a limited partner to execute documents on behalf of a partnership or represent it in dealings with others. As discussed above, each partner in a general partnership has the power to bind the partnership in performing acts in apparently carrying on the partnership's business and to execute instruments on behalf of the partnership. U.P.A.[67] § 9(1). Similarly, each general partner in a limited partnership has those powers. U.L.P.A. § 9(1). There is no indication in the uniform acts or the case law, however, that a limited partner may either bind the partnership or represent it through the execution of instruments. See U.L.P.A. § 10; Crane and Bromberg § 26(c) (footnote 46 and text). Accordingly, we have serious concerns about whether a Form 1065 signed by a limited partner and not deemed ratified by the partnership could properly be treated as a return made on behalf of the partnership. In addition, we believe the language of section 6063 contemplates that the signer of a return be authorized to represent the partnership. As we

[65] Uniform Limited Partnership Act.
[66] Currently, however, the newer version of the U.L.P.A. may allow a limited partner to take a somewhat greater part in the control and activities of the partnership without loss of limited liability.
[67] Uniform Partnership Act.

> understand the meaning of the provisions of the U.L.P.A., that ordinarily would not be the case with respect to limited partners.[68]

Accordingly, in ILM 201425011[69], the IRS reaffirmed its position that "[a] Form 1065 that is not signed by a general partner or a limited liability company member manager is not a valid partnership return." On January 20, 2015, at the ABA Section of Taxation Mid-Winter 2015 meeting, Elizabeth G. Chirich, Branch 1 Chief, IRS Office of Associate Chief Counsel (Procedure and Administration), participated in a panel discussion regarding the topic of who can sign tax returns and reminded the audience of the IRS position. Ms. Chirich further reminded the audience that it is the IRS's position that "the signer should sign by writing his name, rather than the name of the business entity…because only a natural person may sign tax returns, as opposed to an entity."[70]

On September 18, 2015, at the ABA Section of Taxation Fall 2015 meeting, Ashton P. Trice, Branch 2 Chief, IRS Office of Associate Chief Counsel (Procedure and Administration), addressed the question of whether such signature authority could be delegated to a management company or other agent via Form 2848 Power of Attorney. Once again, the IRS took the position that the Form 1065 must be signed by a general partner or a member manager in the context of a limited liability company lest the return not be considered valid. Citing *Weiner v. U.S.*[71], Mr. Trice stated that signature authority for a Form 1065 could not be delegated. In *Weiner*, the court wrote that:

> [t]he [Code] and case law provide no authority approving the substitution of the signature of an authorized agent who is not a partner on a partnership return. In general, signature requirements for returns have been strictly enforced. *See Burford Oil Co. v. Comm'r of Internal Revenue,* 153 F.2d 745, 746 (5th Cir.1946) (previous requirement that a corporate tax return must be sworn to by the president, vice president or other principal officer and by the treasurer, assistant treasurer, or chief accounting officer, is mandatory; return signed only by treasurer is not valid); *Elliott v. Comm'r of Internal Revenue,* 113 T.C. 125,

[68] General Counsel Memorandum 38781 (emphasis added).
[69] Feb. 21, 2014.
[70] ILM 201425011.
[71] 255 F.Supp. 2d 624, 645 (S.D. Tex. 2002).

> 128–29, 1999 WL 596946 (1999) (return that did not comply with signature requirements was not valid return and did not trigger running of limitations period for assessment). In at least one case, the Tax Court has strictly enforced the signature requirement of § 6063. *Agri–Cal,* 80 T.C.M. (CCH) at 303, 2000 WL 1211147 (finding that the AVA 1984 Form 1065 was not signed by a partner and, consequently, was not a valid partnership return).

Ms. Chirich stated at the Mid-Winter meeting on the subject, that once you determine who the appropriate partner is, you must look to state law to determine who can sign on behalf of that partner.

2. Partnership Items – Tax Matters Partner.

Under the "unified partnership audit procedures," which generally apply to partnerships (other than "small partnerships")[72], IRS audits and related activities involving the tax treatment of partnership items and affected items are done at the partnership level even though the individual partners are ultimately responsible for reporting the gains or losses recognized by a partnership.[73] Partnership items include each partner's share of:

(1) the partnership's income, gain, loss, deductions, and credits;

(2) the partnership's nondeductible expenditures, such as charitable contributions;

(3) tax preference items derived from the partnership;

(4) tax-exempt partnership income;

(5) partnership liabilities; and

[72] "Small partnerships" as defined under Code Section 6231 are excepted from the TEFRA "unified partnership audit procedures" unless the partnership makes a valid election to be considered a TEFRA partnership via Form 8893. A "small partnership" is one which has ten or fewer partners that are all US natural persons. The "small partnership" determination is made every year.

[73] § 6221.

(6) other amounts properly determinable at the partnership level, such as each partner's at-risk amount.[74]

A non-partnership item is any item that is, or is treated as, not a partnership item.[75]

The Tax Matters Partner ("TMP") serves as the partnership's representative in a partnership audit, and assumes an important role in guiding a partnership through administrative and judicial proceedings. The TMP is charged with full administrative responsibility for conducting the partnership's participation in the proceeding, and the TMP is the focal point for IRS and other partner contact. The TMP of any partnership is the general partner designated the TMP as provided in the Regulations.[76] If there is no general partner who has been so designated, the general partner having the largest profits interest in the partnership at the close of the taxable year involved (or, where there is more than one such partner, the one of such partners whose name would appear first in an alphabetical listing) shall be the TMP.[77] If there is no general partner designated under the preceding rules, the partner selected by the Secretary shall be treated as the TMP.[78] The Secretary shall, within 30 days of selecting a TMP under the preceding sentence, notify all partners required to receive notice under Code Section 6223(a) of the name and address of the person selected.

A person may be designated as the TMP of a partnership for a taxable year only if that person (i) was a general partner in the partnership at some time during the taxable year for which the designation is made, or (ii) is a general partner in the partnership as of the time the designation is made.[79] The Regulations provide that solely for purposes of applying Code Section 62371(a)(7) to a limited liability company, only a member-manager can be treated as a general partner, and a member who is not a member-manager is treated as a partner other than a general partner.[80] A non-U.S. person may not serve as the TMP without the Commissioner's consent.[81] A partnership may designate a TMP for a partnership taxable year on the partnership

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[74] § 6231(a)(3); Treas. Reg. §301.6231(a)(3)-1.
[75] § 6231(a)(4).
[76] § 6231(a)(7)(A).
[77] § 6231(a)(7)(B).
[78] § 6231(a)(7).
[79] Treas. Reg. § 301.6231(a)(7)-1(b)(1).
[80] Treas. Reg. § 301.6231(a)(7)-2(a).
[81] Treas. Reg. § 301.6231(a)(7)-1(b)(2).

return for that taxable year in accordance with the instructions on the form.[82] If a partner that was properly designated as the TMP of a partnership for a partnership taxable year later certifies that another partner has been selected as the TMP of the partnership for that taxable year, then the other partner will be designated as the TMP for that year.[83] The current TMP must make the certification by filing with the service center with which the partnership return is filed a statement that (i) identifies the partnership, the partner filing the statement, and the successor TMP by name, address, and taxpayer identification number; (ii) specifies the partnership taxable year to which the designation relates; (iii) declares that the partner filing the statement has been properly designated as the TMP of the partnership for the partnership taxable year and that the designation is in effect immediately before the filing of the statement; (iv) certifies that the other named partner has been selected as the TMP of the partnership for that taxable year in accordance with the partnership's procedure for making that selection; and (v) is signed by the partner filing the statement.[84]

3. TMP Authority.

It can be helpful to have a clear understanding of what a TMP is, and is not, authorized to do in a partnership agreement or a limited liability company agreement. Below is an excerpt of standard language that can be used in any such agreement for clearly identifying TMP duties and obligations.

> The TMP shall be specifically authorized by the Partners to (i) engage attorneys and/or accountants to represent the Partnership in connection with such audit and any subsequent actions relating thereto, (ii) to negotiate and enter into an agreement with the Internal Revenue Service which shall be binding on all the Partners, (iii) to seek administrative and judicial review of any administrative adjustments of Partnership items made by the Internal Revenue Service, and (iv) to take such other actions which relate to the tax audit of the Partnership. The TMP shall inform the Partners of all administrative and judicial proceedings which may arise with respect to the Partnership's tax returns. The TMP shall

[82] Treas. Reg. § 301.6231(a)(7)-1(c).
[83] Treas. Reg. § 301.6231(a)(7)-1(d).
[84] *Id*.

provide each Partner with any notice received from the Internal Revenue Service regarding any adjustments proposed by the Internal Revenue Service. In the event a Partner other than the TMP receives a notice of a proposed adjustment from the Internal Revenue Service, such Partner shall, immediately upon receipt thereof, provide such notice to the TMP so that the TMP may take such actions as the TMP deems necessary. The TMP shall exercise ordinary business judgment in carrying out the duties and responsibilities designated above, and unless gross negligence, fraud, deceit or willful misconduct shall be involved, the TMP shall not be liable or obligated to the Partners for any mistake of fact or judgment made by the TMP in carrying out such duties and responsibilities which result in any loss to the Partners. The TMP shall, within ninety (90) days after the issuance of a final partnership administrative adjustment, file a petition for readjustment, refund or redetermination of assessment in a court selected by the TMP if the filing of such a suit is approved by Requisite Approval of the Limited Partners and if funds to prosecute the suit are available or are made available. The General Partner shall have no obligation to provide funds to defend any Partnership tax position. All expenses incurred by the Partnership in connection with any such audit or lawsuit shall be borne by the Partnership as an expense of operations if Partnership funds are used to pay such expenses. None of the provisions of this Section 7.06 is intended to authorize the TMP to take any action which is left to the determination of an individual Partner under Code sections 6222 through 6231. The General Partner will not agree pursuant to Code section 6229(b)(1)(B) to extend the period for assessing any tax imposed by subtitle A of the Code with respect to any person that is attributable to any partnership item (or affected items) of the Partnership without Requisite Approval of the Limited Partner.

4. Summit Vineyard Holdings.

The Tax Court in *Summit Vineyard Holdings, LLC v. Comm'r*[85] held that the execution of Form 872-P to extend the limitations period for a partnership's tax year was valid because,

[85] T.C. Memo. 2015-140.

although the person who signed that form didn't have actual authority to do so, he had apparent authority under contract law to do so.

The TMP of any partnership is the general partner designated the TMP as provided in the Regulations.[86] A partnership may designate a TMP for a partnership tax year on the partnership return for that tax year.[87] The designation of a TMP for a tax year remains effective until: (i) the death of the designated TMP; (ii) an adjudication by a court of competent jurisdiction that the individual designated as the TMP is no longer capable of managing the individual's person or estate; (iii) the liquidation or dissolution of the TMP, if the TMP is an entity; (iv) the partnership items of the TMP become non-partnership items; or (v) the day that on which one of the following becomes effective – (A) the resignation of the TMP under section (i) of this paragraph; (B) a subsequent designation under certain specified circumstances; or (C) a revocation of the designation.[88]

The period for assessing any income tax attributable to a partnership item (or an affected item) for a partnership tax year may be extended by agreement.[89] Pursuant to Code Section 6229(b)(1)(B), the period may be extended with respect to all partners by an agreement entered into by IRS and either the TMP "or any other person authorized by the partnership in writing to enter into such an agreement."

Summit Vineyard Holdings ("Summit") was a limited liability company taxed as a partnership and was subject to the TEFRA partnership procedures outlined in Code Section 6221 through Code Section 6234. Summit SV Holdings ("Holdings") was designated as Summit's TMP on its 2007 Form 1065. During 2007, Holdings was a partner in Summit, and Eric Gjelde ("Gjelde") was the managing member of Holdings. Gjelde was also the managing member of Meridian Equity, LLC ("Meridian"). Beginning in 2009, Holdings was no longer a member of Summit, and Meridian replaced Holdings as Summit's TMP.

In 2010, the IRS audited Summit's 2007 Form 1065. Gjelde then executed Form 2848, Power of Attorney and Declaration of Representation, on behalf of Summit, designating

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[86] § 6231(a)(7)(A).
[87] Treas. Reg. § 301.6231(a)(7)-1(c).
[88] Treas. Reg. § 301.6231(a)(7)-1(l)
[89] § 6229(b)(1).

Travis Burgess ("Burgess") as Summit's representative. Burgess worked with IRS Agent Battaglino ("Agent Battaglino") throughout the audit process. In August, 2010, Battaglino prepared Form 872-P, Consent to Extend the Time to Assess Tax Attributable to Partnership. Thereafter, Gjelde's secretary filled in Meridian's name on page 2 of Form 872-P and Gjelde signed the Form 872-P. Burgess then attached a scanned copy of the signed form to an email that he sent Agent Battaglino, and Summit mailed the original Form 872-P to IRS.

Both Battaglino and his group manager believed that it was a valid Form 872-P because Meridian was Summit's TMP at the time the Form 872-P was signed in 2010, and both were fully aware that Summit's TMP had changed between the year at issue and the year the Form 872-P was signed. The IRS issued a notice of final partnership administrative adjustment ("FPAA") to Summit, and Holdings brought suit on the grounds that the FPAA was untimely because the consent to extend the period of limitations for making assessments against Summit was invalid.

The Court found that Holdings was the TMP for 2007. Holdings was the designated TMP on Summit's 2007 Form 1065. Although Holdings was no longer a member of Summit in 2010, it was still the TMP with authority to execute the Form 872-P for tax year 2007 as none of the events specified in Treas. Reg. § 301.6231(a)(7)-1(l) had occurred. However, the Court concluded that the Form 872-P was valid because Gjelde had apparent authority to sign the form and thus met the requirements of Code Section 6229(b)(1)(B), even though there was no evidence of any writing granting Gjelde, for Meridian, the actual authority to sign the Form 872-P. Under the law of Washington State, however, where the Form 872-P was signed, the law provides that an agent has apparent authority when a third party reasonably believes the agent has authority to act on behalf of the principal and that belief is traceable to the principal's manifestations.

Gjelde signed the Form 872-P in his capacity as managing member of Meridian. The Form 872-P was scanned and attached to an email to Agent Battaglino from Burgess, the representative for Summit, expressing the intention that the Form 872-P was to be signed. Summit, through its agent Burgess, also led Agent Battaglino to believe that Gjelde, as managing member of Meridian, had the power to execute such consents. Finally, Holdings admitted that

Gjelde was the correct natural person to sign, albeit in a different capacity. Thus, the Court found that IRS's reliance on the representations was not unreasonable.

C. Gift Tax Returns.

The donor filing a gift tax return must sign the return. If the donor dies after making a gift but before filing the gift tax return, the executor or administrator of the donor's estate must file the gift tax return.

Generally, both a husband and a wife must file his or her own gift tax return if the husband and wife elect gift splitting. There are two exceptions to this general rule.

Exception 1. During the calendar year:

- Only one spouse made any gifts,
- The total value of these gifts to each third-party donee does not exceed $28,000, and
- All of the gifts were of present interests.

Exception 2. During the calendar year:

- Only one spouse (the donor spouse) made gifts of more than $14,000 but not more than $28,000 to any third-party donee,
- The only gifts made by the other spouse (the consenting spouse) were gifts of not more than $14,000 to third-party donees other than those to whom the donor spouse made gifts, and
- All of the gifts by both spouses were of present interests.

If either of the above exceptions is met, only the donor spouse must file a return and the consenting spouse must sign line 18, in Part 1 of the return.

D. E-Filing Requirements.

Taxpayers may e-file their tax returns through a paid tax return preparer (or an electronic return originator), by using a personal computer, access to the internet, and commercial tax preparation software, or by qualifying for and enrolling in the Free File program. Taxpayers who file their tax returns electronically must use electronic signatures.[90] Electronic filers use a Self-Select Personal Identification Number ("PIN"), or if using a paid preparer, that preparer's Practitioner PIN.[91]

Corporations, S corporations, partnerships, and exempt organizations may also elect to electronically file, respectively, Forms 1120, 1120S, 1065, and 990. However, certain organizations are required to submit those returns electronically. Corporations and S corporations with assets of $10 million or more, and that file 250 or more returns during the year, must file Forms 1120 and 1120S electronically.[92] For purposes of calculating the 250 return threshold, information returns such as Forms W-2 and Forms 1099 will count towards that threshold.[93] A partnership with more than 100 partners must file Form 1065 (and Schedules K-1 and related forms) electronically.[94] Exempt organizations with assets of $10 million or more, and that file 250 or more returns annually, must file Form 990 electronically. If a private foundation or a Code Section 4947(a)(1) trust files 250 or more returns annually, regardless of asset size, it must file Form 990-PF electronically.[95] Although electronic filing is not required for any C corporation, S corporation or exempt organization filing less than 250 returns during the calendar year, the IRS encourages such organizations to do so. The IRS has updated the procedures that C corporations, S corporations, and tax-exempt organizations must use to request a waiver of the electronic filing requirement.[96]

For income tax returns of individuals, estates, or trusts (i.e., individual income tax returns), electronic filing is required if the return is prepared and filed by a "specified tax return

[90] IRS Fact Sheet FS-2011-7.
[91] IRS Pub. No. 1345.
[92] Treas. Reg. § 301.6011-5.
[93] Treas. Reg. § 301.6011-5(d)(5).
[94] Treas. Reg. § 301.6011-3.
[95] Treas. Reg. § 301.6033-4.
[96] Notice 2010-13.

preparer" for the calendar year during which the return is filed.[97] With respect to any calendar year, a "specified tax return preparer" means any tax return preparer, unless the preparer reasonably expects to file 10 or fewer individual income tax returns during the calendar year.[98] An individual income tax return is considered "filed" by a specified return preparer if the preparer submits the return to the IRS on the taxpayer's behalf. A return is not considered filed by a specified return preparer if the preparer obtains a hand-signed and dated statement from the taxpayer that the taxpayer chooses to file the return in paper format and that the taxpayer, and not the preparer, will submit the paper return to the IRS.[99] In certain cases, a specified return preparer may qualify for a waiver of the electronic filing requirement in cases of undue hardship or other administrative exceptions.[100] Generally, a Form 8879 will be used as a taxpayer's signature authorization for an e-filed return.

V. **Potential Consequences of an Invalid Return**.

As stated above in Section III.A., the question of whether a tax return is a valid return generally arises in two situations: (1) has a valid return been filed that will start the statute of limitations; and (2) has a valid return been filed that will prevent the imposition of a failure to file penalty? If a return is not properly signed, even though the Form includes sufficient data for all other purposes, it will not be considered a valid return.[101]

A. Penalties.

For any failure to file a tax return, the penalty is 5 percent for the first month of failure and an additional 5 percent for each month or part of a month thereafter, up to a maximum of 25 percent.[102] The penalty applies only if there is an underpayment of tax.[103] Thus, if there is a failure to file due to an invalid signature and the tax was paid, the taxpayer should avoid the failure to file penalty, but the statute of limitations will not begin to run.

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[97] § 6011(e)(3).
[98] *Id*.
[99] Treas. Reg. § 301.6011-7(a)(4).
[100] *See* Treas. Reg. § 301.6011-7(c)(1); Notice 2011-26.
[101] *Richardson v. Comm'r*, 72 T.C. 818 (1979).
[102] § 6651(a).
[103] § 6651(b)(1).

The penalty for failure to file a partnership return is $195 per partner for each month, or fraction of a month, during which the failure continues, up to a maximum of twelve months.[104] The penalty amount is multiplied by the total number of partners in the partnership during any part of the tax year for which the return is due.[105] Effective for returns required to be filed after December 31, 2014, the penalty for failure to file partnership returns will be subject to annual inflation adjustments, based on the cost-of-living adjustment determined under Code Section 1(f)(3), except that the current year will be compared to the base calendar year ”2013,” instead of ”1992.” If the adjusted amount is not a multiple of $5, the amount should be rounded to the next lowest multiple of $5.[106] Although the penalty imposed under Code Section 6698(a) for a partnership’s failure to file a timely partnership return, where one is required, or to furnish to requisite information on a partnership return is assessed against the partnership, each partner is individually liable for the penalty to the extent that the partner is liable for partnership debts generally.

A penalty will not be imposed under Code Section 6698(a) for a partnership’s failure to file a timely partnership return, where one is required to be filed, or provide the requisite information on a partnership return if such failure was due to a reasonable cause. A small partnership (those with 10 or fewer partners) will meet the reasonable cause test if:

(1) each partner is a natural person (other than a nonresident alien) or an estate;

(2) each partner’s share of each partnership item is the same as such partner’s share of every other item; and

(3) either the partnership or its partners establish that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns.[107]

An S corporation that fails to timely file a tax return (or files an incomplete return) is liable for a penalty of $195 per shareholder, per month for a maximum of twelve months, unless

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[104] § 6698(b).
[105] *Id*.
[106] § 6698(e).
[107] Rev. Proc. 84-35.

reasonable cause is shown. Beginning in 2015, the $195 penalty is adjusted for inflation.[108] An S corporation may not contest the penalty assessment in the Tax Court but can pay the entire penalty and then sue for a refund.

A partnership and an S corporation may also be subject to penalties for failure to furnish Schedules K-1 to its shareholders.[109] For each failure to furnish Schedule K-1 to a shareholder when due and each failure to include on Schedule K-1 all the information required to be shown (or the inclusion of incorrect information), a $100 penalty may be imposed with regard to each Schedule K-1 for which a failure occurs. Beginning January 1, 2016, however, the penalty increases to $250 per information return. If the requirement to report correct information is intentionally disregarded, each penalty is increased to the greater of $250 or 10 percent of the aggregate amount of items required to be reported. Beginning January 1, 2016, the penalty for an intentional disregard increases to $500 per information return.

B. Statute of Limitations.

With respect to the statute of limitations, the assessment period remains open indefinitely if the taxpayer fails to file a return, or files a false or fraudulent return.[110] In such a case, the tax can be assessed, or a proceeding in court for the collection of the tax can be begin without assessment, at any time after the date prescribed for filing the return.[111] In both cases, there is no "bright line" test to determine whether a form is a valid return under the substantial compliance standard; rather, it depends on the facts and circumstances. For example, the IRS has said that a Form 1040, which is otherwise valid because it meets the criteria listed in Section III.A. above, is sufficient to start the assessment period even if the supporting schedules required for particular items that were reported on the return are missing (e.g. the Taxpayer files a signed and otherwise complete Form 1040, but a commonly used schedule was not attached).[112] The return will be valid if it provides sufficient data to calculate tax liability, despite the missing schedule.[113] A

[108] § 6699.
[109] § 6722.
[110] § 6501(c).
[111] *Id*.
[112] Service Center Advice 200010046.
[113] *Id*.

Form 1041 is a valid return for a trust if it's filed with copies of the Schedules K-1 furnished to beneficiaries.[114]

A tax return filed erroneously, but in good faith, has been held to start the statute of limitations in the following scenarios: (1) a trust return was filed by a taxpayer that was later held to be a partnership;[115] (2) a trust or a partnership return was filed by a taxpayer that was later held to be a corporation;[116] and (3) a corporate return was filed by a taxpayer later held to be a partnership.[117] Conversely, a taxpayer who does not provide any income information, but who provides statements in which he says that the tax violates the Fourth or Fifth Amendment, or in which he invokes his Fifth Amendment right against self-incrimination, has not filed a valid return.[118] A return that is not signed under the penalty of perjury is not a valid return[119], and neither is a corporate return that is not signed by the proper officers.[120] The same will be true of a partnership return with respect to partnership items.[121]

C. Tax Elections.

Another potential consequence of filing an invalid partnership return is that any elections selected by the partnership could be lost. Elections affecting the computation of taxable income derived from a partnership must be made by the partnership.[122] Elections to be made at the partnership level include the following:

(1) The election to amortize partnership organization expenditures under Code Section 709;

(2) The election to deduct start-up expenditures up to $5,000 under Code Section 195;

[114] Chief Counsel Advise 200242037.
[115] FSA 1999-860.
[116] § 6501(g).
[117] *Mason v. U.S.*, 801 F.Supp. 718 (N. Distr. Georgia 1992).
[118] *U.S. v. Porth*, 426 F.2d 519 (10th Cir. 1970), *cert. den*.
[119] *Cupp v. Comm'r*, 65 T.C. 68 (1975).
[120] Rose v. Comm'r, 188 F.2d 355 (9th Cir. 1951), *cert. den.* 342 U.S. 850.
[121] *See* footnote 68.
[122] § 703(b).

(3) The election to use a tax year other than a required tax year under Code Section 444;

(4) The election to be excluded from subchapter K rules (opt-out) under Code Section 761;

(5) The election to make optional basis adjustments to partnership property under Code Sections 754, Code Section 743, and Code Section 734;

(6) The election to expense depreciable property under Code Section 179;

(7) The election to treat all interests in a real estate activity as a single activity under the passive activity loss rules under Code Section 469;

(8) The election to capitalize carrying charges of real estate under Code Section 266;

(9) The election to deduct intangible drilling costs under Code Section 612, plus other elections relating to oil and gas operations;

(10) The election to deduct research and experimentation expenditures under Code Section 174;

(11) The election to amortize certain AMT preferences under Code Section 59(e); and

(12) The election to take Code Section 481 adjustments into income in one year.

New Allocation Regulations Provide Flexibility for Issuers of Tax-Exempt Bonds

By: Peter D. Smith, Norton Rose Fulbright

Tax-exempt bonds are subject to a limitation on the amount of "private business use" of financed facilities. On October 26, 2015, the Internal Revenue Service promulgated final regulations (the "Regulations") relating to the allocation of tax-exempt bond proceeds to financed facilities for purposes of the private business use limitations. The Regulations generally allow for flexible allocations of tax-exempt bond proceeds and other equity for mixed-use projects such that the tax-exempt bond proceeds are allocated first to the governmental use of a financed facility and the equity is allocated first to the private business use of the financed facility (so-called "floating allocations"). The Regulations also update certain rules relating to remedial actions to cure private business use.

One of the significant changes contained in the Regulations is an increased ability to finance facilities to be owned or used by public private partnerships (known as "P3s"). The Regulations provide that for purposes of the private business use test, partnerships are treated as aggregates of their partners rather than as separate entities. As such, ownership or use of a financed facility by a P3 is treated as if the facility were owned or used in part by the governmental partners and in part by the nongovernmental partners. The Regulations provide that the amount of private business use resulting from ownership or use by a P3 is the nongovernmental partners' greatest percentage share of any item of partnership income, gain, loss, deduction or credit. For example, if the nongovernmental partners' greatest share of a P3 were 25 percent, then 25 percent of a financed facility owned or used by the P3 would constitute private business use. Under the flexible allocation rules described above, issuers may use a combination of tax-exempt bond proceeds and equity to finance facilities to be owned or used by P3s by allocating the equity to the private business use resulting from the nongovernmental partners' shares.

Similarly, the Regulations treat partnerships as aggregates of their partners for purposes of the rule that facilities financed with qualified 501(c)(3) bonds must be owned entirely by governmental persons or 501(c)(3) entities. As such, issuers of qualified 501(c)(3) bonds may finance facilities owned by P3s by using equity to finance the portion of the facilities allocable to the share of any non-501(c)(3) partners.

The Regulations apply to bonds sold on or after January 25, 2016. However, issuers generally may elect to apply the Regulations to bonds sold prior to such date.

<u>Resurgence of EOR Credits: Oil Tax Planning Opportunity</u>

By Drew Willey

With oil prices dropping, the potential for claiming Enhanced Oil Recovery ("EOR") tax credits may come back soon.

Why should we care now? For clients with already established marginal EOR projects, this credit could make it economical for them to begin producing those projects again. It could also attract clients to EOR projects. While most clients may not turn a field into a qualifying carbon dioxide ("CO2") or water injector project because of a predicted tax break, a 15% savings on cost just might mean the difference at a time when oil clients need to get creative to bring profits. At the very least, it's a bit of bright news to bring your oil clients when they probably need it.

Statutorily, the EOR credits are in effect when the oil price is $28 per barrel or below (adjusted for inflation), based on a yearly reference price issued by the IRS.[1] The credit is phased out as prices increase, up to $6 above this inflation adjusted number.[2] These numbers are all increased by inflation rates (inflation adjustment factors) issued by the IRS.[3]

For the 2013 calendar year, that inflation rate was 1.5974.[4] So, the EOR credit was at least partially available had the reference price been $50.73 per barrel (28*1.5974+6) or below. The reference price used for the 2013 calendar year was $96.13.[5] The reference price used for the 2014 calendar year was $87.39, which "exceeds $28 multiplied by the inflation adjustment factor for the 2014 calendar year ($28 multiplied by 1.6245 = $45.49) by $41.90".[6] Each year's phase out determination depends on the prior year's reference price. Consequently, the EOR credit was completely phased out for 2014 and 2015, as it has been since 2006.[7]

While we will not know what the reference price for 2016 will be until about October or November of this year, we can project. Even if the inflation rate does not increase, we are still looking at a reference price of about $51 per barrel as making EOR credits relevant again. The West Texas Intermediate ("WTI") Crude Oil Price for 2015 is $48.67 per barrel.[8] The projected WTI Crude Oil Price for 2016 is $38.54 per barrel.[9] Therefore, it is reasonable to assume EOR credits will be available for 2016. This price drop means you can viably expect tax savings for your oil and gas clients who have the option of utilizing EOR projects.

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[1] I.R.C. § 43.
[2] *Id.*
[3] *Id.*
[4] *Internal Revenue Bulletin* No. 2014-45, Notice 2014-64 issued November 3, 2014, "2014 Section 43 Inflation Adjustment".
[5] *Internal Revenue Bulletin* No. 2014-17, Notice 2014-25 issued April 21, 2014, "Nonconventional Source Fuel Credit, 2013 Section 45K Inflation Adjustment Factor and Section 45K Reference Price".
[6] *Internal Revenue Bulletin* No. 2015-40, Notice 2015-64 issued October 5, 2015, "2015 Section 43 Inflation Adjustment".
[7] *Supra*, note 4.
[8] U.S. Energy Information Administration, "Short-term Energy Outlook", Release Date: January 12, 2016 (Next Release Date: February 9, 2016) (WTI Crude Oil Price chart at http://www.eia.gov/forecasts/steo/report/prices.cfm).
[9] *Id*.

So what amount of tax credit and industry impact are we talking about? The credit is 15% of qualified enhanced oil recovery costs.[10] In 2010, the US had 114 active CO2 EOR projects producing over 280,000 barrels per day.[11] The cost of CO2 alone can be $20-$30 per barrel.[12] 15% of those costs would be about half a billion dollars. If this credit comes back, the U.S. oil industry could save a half a billion dollars, and probably much more. Some forecast EOR to increase U.S. oil output by as much as 25% in the coming years.[13] Tax advisors and consultants need to be aware of this potential impact.

The administration has pushed to repeal such tax breaks in the past.[14] This effort is likely in part due to the lack of need for them with high oil prices. However, we may see a renewed call to encourage U.S. oil production. With oil prices dropping and looking to continue to drop, Congress should be urged to expand this credit by increasing the phase-out prices. Hopefully, they will listen if presented with this idea.

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[10] *Supra*, note 1.
[11] U.S. Dept. of Energy, "Enhanced Oil Recovery" (http://energy.gov/fe/science-innovation/oil-gas-research/enhanced-oil-recovery).
[12] U.S. Energy Information Administration, "Oil prices drive projected enhanced oil recovery using carbon dioxide", July 30, 2014 (http://www.eia.gov/todayinenergy/detail.cfm?id=17331).
[13] Editors, "WoodMac: EOR could boost US tight oil output 3 million b/d by 2030", *Oil and Gas Journal*, Sept. 23, 2014 (http://www.ogj.com/articles/2014/09/woodmac-eor-could-boost-us-tight-oil-output-3-million-b-d-by-2030.html).
[14] Robert Pirog, "Oil and Natural Gas Industry Tax Issues in the FY2014 Budget Proposal", *Congressional Research Service*, Oct. 30, 2013 (https://www.fas.org/sgp/crs/misc/R42374.pdf).

Authors:

Alexia Noble
Associate, Polsinelli PC

Henry Talavera
Shareholder, Polsinelli PC

EEOC'S ATTEMPT TO REGULATE EMPLOYER INSTITUTED WELLNESS PLAN STRUCK DOWN

EEOC v. Flambeau and the Americans with Disabilities Act

The Equal Employment Opportunity Commission ("EEOC") brought suit against an employer under the Americans with Disabilities Act ("ADA"), alleging that the employer violated the ADA provision that "generally prohibits employers from requiring their employees to submit to medical examinations, by conditioning participation in its employee health insurance plan on completing a 'health risk assessment' and a 'biometric screening test.'" The Court ruled against the EEOC and held that a bona fide benefit plan was protected from normally applicable ADA rules.

EEOC v. Flambeau

On December 31, 2015, the U.S. District Court for the Western District of Wisconsin ruled against the EEOC's efforts to extend the ADA to any bona fide insurance benefit plan in *EEOC v. Flambeau,* No. 14-cv-638-bbc. http://scholar.google.com/scholar_case?case=14282607146472032348&q=EEOC+Flambeau&hl=en&as_sdt=6,44&as_ylo=2015. That District Court joined the 11th Circuit, which similarly ruled against the EEOC in *Seff v. Broward County, Florida*.

http://scholar.google.com/scholar_case?case=12890185575118658708q=EEOC+Flambeau&hl=en&as_sdt=6,44&as_ylo=2015.

The EEOC argued that Flambeau's conditioning of health insurance coverage on the completion of health examinations was prohibited under the ADA if not shown to be job-related and consistent with business necessity. The District Court rejected the claim, and instead found that Flambeau's wellness program was protected under the ADA "safe harbor" rule, which exempts "bona fide benefit plans" from such regulation under the ADA.

The EEOC's Regulatory Power over Bona Fide Benefit Plans

The rulings in *Flambeau* and *Seff* call into question the EEOC's ability to regulate wellness programs that are "group health plans" (including medical, vision and dental plans) subject to HIPAA, which generally applies to most, if not all, group health plans through either ERISA, the IRC or the Public Health Service Act, as amended ("PHS Act").

The EEOC has proposed ADA regulations that intend to address issues under all wellness programs, including, but not limited to, those subject to HIPAA. https://www.federalregister.gov/articles/2015/04/20/2015-08827/amendments-to-regulations-under-the-americans-with-disabilities-act.

If other courts agree with *Flambeau* and *Seff*, the EEOC may be precluded from (or at least be limited in) enforcing ADA regulations that apply to group health plans subject to HIPAA. Alternatively, even if the ADA regulations are finalized and found to apply to all wellness programs, the courts may provide less deference to the EEOC's position. In *King v. Burwell*, the U.S. Supreme Court upheld certain provisions of the Patient Protection and Affordable Care Act of 2010 ("ACA"), but the Supreme Court also appeared to provide less deference to the agency positions with respect to the ACA. http://scholar.google.com/scholar_case?case=6184792205191652755&q=king+v.+burwell&hl=en&as_sdt=6,44&as_ylo=2015

Other recent decisions have also arguably eroded the deference that governmental agencies typically have been accorded in their agency rulemaking. *See generally Altera v. Comm'n*, 145. http://ustaxcourt.gov/InOpHistoric/AlteraCorporationDiv.Marvel.TC.WPD.pdf. Based upon the decisions above and others, the EEOC's attempts to regulate wellness programs under the ADA may be limited or at least vigorously challenged.

Recommendations

In light of this case development, we recommend that employers carefully consider whether and how their wellness programs are tied to their major medical and other "bona fide benefit plans" to avoid (or at least provide the best possible arguments to place such wellness programs outside of) the reach of the EEOC to the extent possible. This issue is far from settled, so we will be watching this case on appeal and other pending litigation that the EEOC has related to wellness programs sponsored by other employers.

Please contact your Polsinelli attorney or any member of our Employee Benefits and Executive Compensation practice group if you should have any questions.

Addressing the Corporate Inversion Loophole: A Proposal to Redefine Domestic Corporation Status

By Sara Anne Giddings

Corporate inversions allows a corporation to change its country of residence and therefore, how it is taxed even if the company continues to be headquartered and managed from within the United States. This ability is derived from Section 7701(a)(4), which defines domestic corporations as "created or organized in the United States or under the law of the United States or of any State." A foreign corporation is any corporation that is not domestic. I.R.C. § 7701(a)(5). These definitions do not reflect business realities. Unless the definition of corporation is changed to better reflect business realities, more corporations will choose to incorporate abroad rather than in the United States, costing the United States significant lost tax revenue.

The Problem

The determination of whether an entity is domestic or foreign is important because the system of taxation differs depending upon the type of entity. A corporation that is a resident of the United States is taxed on its income worldwide regardless of where it is earned. In contrast, a foreign corporation is taxed only on its effectively connected income and on certain types of United States source investment income.

Corporations have sought to take advantage of the difference in the taxation of domestic and foreign entities by reincorporating abroad. The most common type of transactions are corporation inversions. Prior to the inversion, the United States incorporated parent served as the holding company for United States and foreign subsidiaries. After the inversion, a foreign company serves as holding company for United States and foreign subsidiaries. Although the jurisdiction of the corporation is changed through an inversion transaction, no change in the location of the company's headquarters or business operations is necessary. As noted by Treasury Secretary Jacob Lew "U.S. companies are currently taking advantage of an environment that allows them to move their tax residence overseas in order to avoid paying taxes in the United States without making significant changes in the nature of their overall business operations." Andrew Soergel, *Treasury's New Inversion Guidelines a Quick Fix to Big Problem*, US News and World Report, November 20, 2015, www.usnews.com/news/articles/2015/11/20/treasurys-new-inversion-guidelines-a-quick-fix-to-big-big-problem (November 20, 2015). Recent companies that have engaged in these transactions include Burger King, Meditronic, Tyco International/Johnson Controls, Eaton/Copper, and Liberty Global PLC. Perhaps no inversion has gained as much attention as the potential inversion between Pfizer and Allergan, a merger worth approximately $160 billion, which would result in potential corporate tax savings to Pfizer of $1 billion a year. Michael Hiltzik, *Solving the inversion crisis: How the U.S. can keep companies at home,* Los Angeles Times, (December 4, 2015) http://www.latimes.com/business.com/hiltzik.com/la-fi-hiltzik-20151204-column.html. It is estimated that corporate inversions will cost the US in tax revenue potentially $20 billion over the next 10 years. *Id.*

The American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, attempted to address this problem by imposing a tax on so-called inversion gain. Section 7874(a)(2)(B) & (b), as added by the AJCA, applies if: (1) in a transaction completed after March 4, 2003, a foreign

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incorporated entity ("surrogate foreign corporation") directly or indirectly acquires substantially all of the properties held by a domestic corporation; (2) after the acquisition, former shareholders of the domestic corporation hold at least 80%, by vote or value, of stock in the foreign incorporated entity; and (3) the foreign incorporated entity, including the expanded affiliate group, does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized as compared with the total business activities of the affiliate group. The ACJA largely eliminated generic naked inversions but two alternatives still remained: the naked inversion via the business activity exemption and merger with a smaller company. Post ACJA there was shift from inversions involving countries such as Bermuda and the Bahamas and a movement to countries with substantial economic activity such as the UK, Canada, and Ireland.

Treasury Notice 2014-52 issued on September 22, 2014 addressed two basic aspects of inversions: (1) limiting the ability to access the accumulated deferred earnings of foreign subsidiaries of US firms and (2) restricting certain techniques that allowed firms to achieve the less than 80% ownership requirement. This regulation was effective for inversions closing on or after September 22, 2014. The regulations do not prevent inversions via merger and do not address earnings stripping by shifting debt to the US firm. Donald J. Marples and Jane G. Gravelle, *Corporate Expatriation, Inversions, and Mergers: Tax Issues*, Congressional Research Service, at 9 (November 30, 2015).

Treasury Notice 2015-79 issued on November 19, 2015 provides three new rules to make it more difficult for US companies to invert. First, in the case where the foreign parent is a tax resident of a third company, stock issued by that parent to the existing foreign firm will be disregarded for purposes of the ownership requirement. This regulation is intended to address situations where a US firms merges with a partner and then chooses a tax friendly third country to headquarter in. Second, the regulations clarify the "anti-stuffing" rules, where the foreign firm's size is inflated by adding assets to that firm. Third, the current business activity exception requires 25% of the business activity to be in the foreign country where the new parent is created or organized, but does not require it to be a foreign parent. It prevents inversion based on the business activity test when the foreign parent has a tax residence in another country without substantial business activities. This notice applies to transactions undertaken on or after November 19, 2015.

Recognition of Need for Change

The President's Advisory Panel on Tax Reform, formed in 2005 to identify the major problems in the Internal Revenue Code, proposed modifying the definition of corporations subject to United States tax. This reform would essentially result in a tax system that taxes business income uniformly. The Panel proposed treating a business as a resident of the United States if either it is incorporated in the United States or if the United States is its primary place of management and control. The Panel believed that changing the definition would ensure that corporations that do business in the United States would pay their fair share and "businesses whose day-to-day operation are managed in the United States cannot avoid taxes simply by receiving mail and holding a few board meetings each year at an island resort." *See* Report of President's Advisory Panel on Federal Tax Reform 135 (2005), available at http://www.govinfo.library.unt.edu/taxreformpanel/final-report/TaxPanel_5-7.pdf. The Joint Committee on Taxation (JCT) echoed these sentiments and proposed that the definition of domestic corporation be changed to include the effective place of management. The JCT stated that the current definition allows foreign corporations that are economically similar or identical to domestic corporations to avoid being taxed as one. *See* Staff of Joint Comm. on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* 178-81, JCS 02-05 (2005), available at http://www. jct.gov/s-2-05.pdf.

Despite a recognition of a problem in our current corporate tax structure and recognition that there is a need to change the definition of a corporate to include an effective place of management test, only stop gap measures have been enacted in response to companies taking advantage of low tax jurisdictions. As House Speaker Paul Ryan said "It's very clear that the solution here is tax reform. Because if we try to do some short-term patch, all we'll end up doing is accelerating the trend of foreign companies buying US companies. So we will actually make problems worse. We will make things worse off and we will lose even more companies." Andrew Soergel, *Treasury's New Inversion Guidelines a Quick Fix to Big Problem*, US News and World Report, November 20, 2015, www.usnews.com/news/articles/2015/11/20/treasurys-new-inversion-guidelines-a-quick-fix-to-big-big-problem (November 20, 2015).

Effective Place of Management and Control Test

The effective place of management and control test is the best tool for determining the residency of a corporation. The test provides a connection between the "brains of an entity" and the applicable jurisdiction. This test derives its form from the United Kingdom and was expressed in Lord Loreburn's opinion in *De Beers Consolidated Mines Ltd v. Howe*, [1906] A.C. 455, 458 ("A company resides, for the purposes of Income Tax, where its real business is carried on…. and the real business is carried on where the central management and control actually abides…. This a pure question of fact to be determined, not according to the construction of this or that regulation or bye-law, but upon a scrutiny of the course of business and trading"). The test of effective place of management and control looks to where the highest levels of strategic decisions of the corporation are made, including financial, administrative, and policy decisions. Factors to look at include where major contracts are negotiated, where company accounts are made and audited, and where the main office is. The place of effective management is often found where an individual or a group of individuals exercise day-today responsibility for these decisions. This is often where the executive officers and senior management reside.

This test offers advantages over the current system of defining corporate residency. First, the test is more costly to manipulate. It would require physical relocation of executives and their support staff to a low tax jurisdiction to avoid being taxed under the effective place of management and control test. Second, there is a current advantage to having the everyday management in a centralized location. Third, it better reflects business realities. Although a corporation can be incorporated in a variety of countries it can only have one place of effective management and control.

However, this test does have some disadvantages. The test is inherently uncertain, as the effective place of management could potentially change from year to year. Thus, the system might not be simple to administer. It likely would require an increase in resources in order for the Service to determine if the company has an effective place of management within the United States. However, in the long run the costs are worth the benefits. The current system has allowed many corporations to take advantage of the system, and the solutions to fix it are stop gap in nature. They address one problem at a time rather than a providing a true overhaul to address the underlying problem: the definition of corporation.

Proposal for Change

A successful change to the current system cannot involve merely changing the definition to effective place of management and control but also must take into consideration various other issues. The first such consideration is maintaining some of the current system's administrative simplicity. This can be accomplished by maintaining that a corporation will be treated as a domestic corporation if it is incorporated in the United States or if it elects to be treated as a domestic corporation. The next consideration is to include the effective place of management and control test; however, to truly reflect business realities, an exception should be provided if a corporation can prove that it has a closer connection with another jurisdiction on the basis of effective place of management and control and is incorporated in that jurisdiction. Third, an exit tax should be charged to all corporations that expatriate to discourage any necessary restructuring and so that the Service could formulate guidelines as to the factors it would consider in determining the effective place of management and control.

My proposal for an amendment to the Code would be as follows:

(a) DEFINITION OF DOMESTIC AND FOREIGN CORPORATION. —

(1) IN GENERAL. For purposes of this title. —

(A) DOMESTIC CORPORATION. —A corporation shall be treated as a domestic corporation of the United States if:

(i) CREATED OR ORGANIZED IN THE UNITED STATES. —Such corporation is created or organized in the United States or under the law of the United States or of any State; or

(ii) ELECTION. —Such corporation elects to be treated as domestic for the current tax year; or

(iii) EFFECTIVE PLACE OF MANAGEMENT. —Such corporation is deemed to have its place of effective management and control residing within the United States.

(B) FOREIGN CORPORATION. —The term "foreign" when applied to a corporation is one which is not domestic.

(2) EXCEPTION TO DOMESTIC TREATMENT. —A corporation that qualifies for domestic treatment will be treated as foreign if:

(A) INCORPORATED ABROAD. —Such corporation is incorporated under the laws of a foreign country; and

(B) SUBSTANTIAL PRESENCE. —Such corporation establishes that it has substantial presence in the foreign country in which it is incorporated. Substantial presence is deemed to occur when the company's principal class of shares is listed on the recognized stock exchange in the country in which it is incorporated; and

(C) EFFECTIVE PLACE OF MANAGEMENT. —Such corporation establishes that its effective place of management and control actually resides within the jurisdiction in which it is incorporated.

(3) TAX CHARGED FOR CHANGE IN CORPORATE STATUS. —

(A) DEEMED DISPOSAL OF ASSETS. — A corporation that changes its status from domestic to foreign will be deemed to dispose of all chargeable assets and immediately reacquire them at their fair market value. Tax will be charged on all gains at this time.

(B) UNITED STATES SOURCE PROPERTY. —Such corporation will be taxed on all United States source property for three (3) years as if it were a domestic corporation, despite any treaties to the contrary.

(C) WHEN CHARGED. —The tax will be charged prior to expatriation. The tax will be charged each time such corporation transfers its corporate status from domestic to foreign.

(4) EFFECTIVE DATE. —This Code section will be effective one year from the date of its enactment.

TEXAS BAR ASSOCIATION

U.S. INTERNATIONAL TAX DEVELOPMENTS

November 12-13, 2015

by

James P. Fuller
Adam S. Halpern
Fenwick & West LLP
Mountain View, California

I. FOREIGN TAX CREDITS.

A. FTC Splitter Regulations.

1. Treasury and the IRS finalized the foreign tax credit splitter regulations. A public hearing was not requested and none was held, but the IRS and Treasury received a number of written comments. The proposed regulations under § 909 were adopted as amended by the Treasury decision we will discuss below. The Treasury Decision also adopted the proposed regulations under § 704 (dealing with splitters in the context of partnerships) without amendment.

2. Reverse Hybrid Splitter Arrangements. A reverse hybrid splitter arrangement exists with respect to a reverse hybrid entity when a payor pays or accrues foreign income taxes with respect to the income of the reverse hybrid. The split taxes are the taxes paid or accrued with respect to the income of the reverse hybrid. The related income with respect to the split taxes is the earnings and profits of the reverse hybrid attributable

to the activities of the reverse hybrid that gave rise to the foreign taxable income on which the split taxes were paid or accrued.

(a) A comment indicated there is some lack of clarity regarding the amount of related income with respect to a reverse hybrid splitter arrangement in a case in which the reverse hybrid subsequently incurs a loss, causing its earnings and profits to fluctuate over multiple taxable years. Treasury and the IRS agreed with this comment, and added two new examples.

(b) In the first example, the reverse hybrid earns 200 of income on which it pays 60 of tax. In year 2, the reverse hybrid earns no income and incurs no losses or expenses. At the end of year 2, the reverse hybrid distributes 100 to its shareholder. This is a splitter arrangement, the taxes are split taxes, and a credit for those taxes is suspended. In year 2, 50% of the taxes, a ratable portion of the split taxes, can be taken into account.

(c) In the Example 2, the facts are the same as in Example 1, except that in year 2 the reverse hybrid has a 100 loss, which it may not carryback to year 1. At the end of year 2, the reverse hybrid distributes 100 to its shareholder. The total related income of the reverse hybrid is reduced to a 100 because of its year 2 loss. In year 2, 100 was distributed, so 100% of the taxes can be taken into account.

3. Loss-Sharing Splitter Arrangements. A splitter arrangement exists to the extent that the "usable shared loss" of a "U.S. combines income group," which is an individual or corporation and all entities with which it combined items of income and expense under U.S. federal income tax law, is used to offset federal taxable income of another U.S. combined group. A usable shared loss is defined as a shared loss of a U.S. combined group that could be used under foreign law to offset the group's own income.

(a) A comment requested that the definition of usable shared loss be clarified to exclude any shared loss that could not be used within the U.S. combined income group in a foreign taxable year but that could be used within a group by carrying the loss either forward or back to a different foreign tax year. Treasury and the IRS agree that the usable shared loss definition should not require a U.S. combined group to carry forward losses because it will not necessarily be foreseeable whether the group will have sufficient foreign taxable income in a future taxable year to use a loss that cannot be used currently or carried back within the group. Accordingly, the regulations modify the definition to clarify that a usable shared loss is a shared loss that could be used under foreign tax law to offset income of the U.S. combined group in a current or previous foreign taxable year.

(b) Two additional comments were not adopted, but a question has arisen, states the preamble, about what references to "income" are in Temp. Treas. Reg. § 1.909-2T(b)(2). The question: are these references intended to refer to income for U.S. federal income tax purposes or to income for purposes of foreign tax law? The final regulations clarify that the reference to the term "income" of that U.S. combined income group refers to income for purposes of foreign law.

4. <u>Hybrid Instrument Splitter Agreements</u>. There is a U.S. equity hybrid instrument splitter arrangement if payments or accruals with respect to a U.S. equity hybrid instrument (1) give rise to foreign income taxes paid or accrued by the owner of the instrument, (2) are deductible by the issuer under the laws of its foreign jurisdiction, and (3) do not give rise to income for U.S. federal income tax purposes.

(a) The preamble states that a question has arisen as to whether there is a splitter arrangement if an accrual for foreign law purposes with respect to a U.S. equity hybrid instrument does not give rise to income under U.S. law but a separate payment of the accrued amount is made that gives rise to income under U.S. law equal to all or a portion of the amount of accrual. The preamble states that the reference to "payments or accruals" created confusion regarding the effect of payment.

(b) The final regulations are clarified to provide that if an accrual under foreign law with respect to a U.S. equity hybrid instrument give rise to a foreign-law deduction by the issuer, then regardless of whether a payment is made on the instrument, a splitter arrangement exists whenever an accrual gives rise to the imposition of foreign income taxes on the instrument owner without giving rise to income under U.S. federal income tax law.

(c) Any actual payment of the accrued amount, whether or not it is made periodically under the terms of the instrument, does not prevent the hybrid instrument from being a splitter arrangement. The payments, however, will then be treated as a distribution of related income to the extent the regulations otherwise apply.

5. <u>Mechanical Rules for Tracking Related Income and Split Taxes</u>. A comment recommended that the regulations should generally provide additional mechanical rules for tracking related income. Treasury and the IRS recognize there are a number of mechanical issues related to tracking related income and split taxes that were not fully addressed in the

temporary regulations. The preamble states that other mechanical issues are under consideration and will be addressed in future guidance. Other comments with respect to the mechanical rules for tracing related income were not adopted.

6. Section 381 Transactions. One comment incorrectly interpreted the temporary regulations as providing that when a payor § 902 corporation with suspended split taxes combines with the covered person with the related income in a transaction described in § 381, all related income is treated as taken into account even if the full amount of related income is not reflected in the earnings and profits of the payor § 902 corporation as a result of the transaction.

   (a) Treasury and the IRS did not intend for a transaction described under § 381 to result in the unsuspension of split taxes if the transaction does not cause the payor of the split taxes to take into account earnings and profits of the covered person equal to the amount of related income specified in the relevant splitter arrangement definition.

   (b) Accordingly, the final regulations clarify that split taxes are unsuspended only when the appropriate amount of related income is taken into account by the payor § 902 corporation either as a result of a distribution or inclusion out of the earnings and profits of the covered person as a result of the combination of the payor § 902 corporation and the covered person in a transaction described in § 381.

7. Additional Splitter Arrangement Fact Patterns. One comment recommended that the U.S. debt hybrid instrument splitter arrangement definition be expanded to include certain fact patterns in which the instruments owner is not related to the issuer of the instrument. Treasury and the IRS concluded that it is not appropriate at this time to extend the existing splitter arrangement list to include transactions between unrelated parties and did not adopt the comment. The preamble states that Treasury and the IRS continue, however, to consider other arrangements that inappropriately separate foreign income taxes from related income, and the circumstances under which a splitter arrangement described in regulations or other guidance under § 902 should be applied to arrangements between unrelated persons.

B. Salem Financial.

1. *Salem Financial, Inc. v. United States* was generally affirmed on appeal. Salem financial is a subsidiary of BB&T, a financial holding company chartered under the laws of North Carolina. The case was on appeal from a Court of Federal Claims decision denying BB&T's claim for a refund of

taxes, interest and penalties. The Federal Circuit affirmed with respect to denial of the foreign tax credit and the assertion of penalties, but reversed in part with respect to a deduction for interest and remanded the case for further proceedings.

2. Salem Financial involved a STARS transaction which we will not describe here as STARS transactions are not new. That is, previous cases were already litigated. Essentially, Salem Financial, a U.S. bank placed assets in a trust in the context of a loan that was subject to U.K. tax and claimed a foreign tax credit for that tax. Barclays, a U.K. bank, also got benefits through that trust and made a payment to Salem Financial of approximately half of Barclays' U.K. tax benefit. This produced a lower cost of borrowing for Salem Financial. The question was whether Salem Financial could claim foreign tax credits for the tax.

3. The first issue was whether the trust transactions lacked economic reality, whether they lacked a bona fide business purpose, and whether they are the kinds of transactions with respect to which Congress intended to confer the benefit of the foreign tax credit provisions.

4. Initially, the government argued that the payments Barclays made to Salem Financial, which were set to equal 51% of the U.K. taxes paid by the trust, "in substance" were rebates of the U.K. tax that was paid by BB&T on income from the assets that BB&T contributed to the trust. The court concluded that those payments should not be characterized as tax rebates but rather constituted income to BB&T.

5. The court then addressed the government's argument that BB&T realized no profit from the trust transactions absent the $500 million in foreign tax credits generated by the transaction because the payments by Barclays must be offset against the trust's U.K. taxes that were paid by BB&T. BB&T contended that the government was wrong in seeking to have the trust's U.K. taxes treated as an item of expense, citing certain other circuit courts' holdings. The court stated, however, that its precedent, like the approach of several other courts, supported the government's argument, *i.e.*, to assess a transaction's economic reality, and in particular is profit potential, the analysis must be done independent of the expected tax benefits.

6. In this case, stated the court, BB&T incurred a large foreign tax expense to obtain only a small income amount. The trust transaction therefore was profitless before taking into account BB&T's expected foreign tax credit benefits.

7. However, the court disagreed with the government's contention that a transaction's lack of profit potential before taking into account U.S. tax

benefits conclusively established that the transaction lacked economic reality.

8. The court stated it is critical to identify transactions lacking economic reality, *i.e.,* those that do not alter the taxpayer's economic position in any meaningful way apart from their tax consequences, typically entailing no risk and no significant possibility of profit other than as a result of tax considerations.

9. While looking to the potential for economic profit is useful, the Supreme Court has cautioned that there is "no simple device available to peel away the form of [a] transaction to reveal its substance." Therefore, stated the Federal Circuit, although inquiring into post-foreign-tax profit can be a useful tool for examining the economic reality of a transaction, the court believed that a transaction that fails the profit test is not necessarily deemed a sham.

10. In this case, the trial court's finding that the trust transaction lacked economic substance was supported by more than just the absence of a prospect for profit. The trial court found that the trust transaction consisted of "three principal circular cash flows," which, apart from their intended tax consequences, had no real economic effect.

11. The court agreed with the trial court that the trust transaction was a contrived transaction performing no economic or business function other than to generate tax benefits.

12. The court then turned to the second element of the "economic substance" test: whether the STARS trust transaction, nonetheless had a bona fide business purpose. The trial court found that the STARS trust had no non-tax business purpose and that, instead, its sole function was to "self-inflict" U.S.-sourced BB&T income to tax in order to reap U.S. and U.K. tax benefits. The court stated that finding is amply supported by the evidence.

13. The court stated the evidence supports the trial court's finding that the STARS trust was a "prepackaged strategy" created to generate U.S. and U.K. tax benefits for BB&T and Barclays. Further, the payments by Barclays did not represent profit from any business activity. The payments were simply the means by which Barclays and BB&T shared the tax benefits of trust transaction. That is, the transaction that generated the income leading to the payment to BB&T involved no genuine business activities, and the transaction that produced the payment would not have been engaged in but for the system of taxes imposed by the U.S. and U.K. governments.

14. The court stated that it therefore sustained the trial court's finding that the STARS trust lacked a bona fide business purpose. Thus, the $500 million of foreign tax credits were disallowed.

15. BB&T also sought to recover deductions for the interest it paid on the $1.5 billion STARS loan. That is, there was a loan component to the transaction. The trial court disallowed the interest deductions, holding that the loan, like the trust, lacked economic substance. The interest deductions were in the amount of approximately $75 million.

16. The court stated that incorporating a loan component into STARS to give the entire transaction the appearance of "low cost financing" no doubt was one of the intended purposes of the loan. However, the structure of the STARS loan appeared to be straightforward.

17. The court stated that while it may be true that the loan operated partly to camouflage the payments by Barclays to BB&T, it also resulted in a substantial change in BB&T's economic position. As a result of the loan transaction, BB&T obtained the unrestricted access to $1.5 billion in loan proceeds.

18. In the *Bank of New York Mellon* case, which involved a similar STARS trust and loan transaction, the Tax Court in its initial opinion did not separately address the question whether the interest on the loan component of the transaction was deductible. On reconsideration, however, the court held that the interest on the loan component was deductible.

19. The Federal Circuit agreed with the Tax Court's analysis of the loan component of the STARS transaction. Accordingly, the court held that the loan portion of the transaction satisfied the economic substance test and that BB&T was entitled to claim interest deductions for the interest it paid on the loan.

20. The final issue on appeal was whether the trial court properly upheld the $112 million in penalties asserted by the government. BB&T contended that it had reasonable cause for the underpayments because it reasonably relied on the favorable tax opinions of a law firm and received additional supportive advice from its accounting-firm auditor. On appeal, BB&T no longer argued that it reasonably relied on the advice it received from KPMG, the principal marketer of STARS.

21. The trial court found that BB&T's reliance on the law firm's opinion was unreasonable because the law firm had an inherent conflict of interest of which BB&T knew or should have known. That finding was not clearly erroneous. BB&T had selected that firm on the recommendations of KPMG, the principal marketer of STARS.

22. The trial court also found that the auditor's participation did not give BB&T a reasonable basis for believing that its tax position was sound, because the accounting firm provided no opinion to BB&T. That finding also was not erroneous. Moreover, the accounting firm ultimately arrived at a "less than should" level of comfort that the IRS would accept the STARS transaction.

23. The trial court stated that BB&T's reliance on its advisor's opinions was unreasonable for the additional reason that it should have known that the STARS transaction was too good to be true.

24. Accordingly, the court concluded that the trial court did not err in imposing the accuracy-related penalties on BB&T. The amount of the penalties, however, will require a reassessment, as the appellate court found BB&T was entitled to claim interest deductions for the interest it paid on the STARS loan.

C. <u>BNY/AIG</u>.

1. The Second Circuit affirmed the lower courts in *Bank of New York Mellon v. Commissioner* and *American International Group v. United States* regarding applying the economic substance doctrine to transactions involving foreign tax credits. ___ F.3d ___ (2d Cir. 2015). The Tax Court in *Bank of New York Mellon* (*"BNY"*) considered the effect of foreign taxes in its pre-tax analysis and denied the claimed foreign tax credits as lacking economic substance, but allowed interest expense deductions for the loan associated with the transactions. The district court in *AIG* held that the economic substance doctrine applies to transactions involving foreign tax credits generally and that foreign taxes are to be included in calculating pre-tax profit. In *BNY*, $215 million in deficiencies were asserted by the IRS. In *AIG*, a tax refund of $300 million is sought.

2. The court stated that entitlement to foreign tax credits is predicated on a valid transaction. To be "valid" and not just a "sham," a transaction must involve more than tax benefits: it must have independent economic substance. Through the transactions at issue, the taxpayers asserted they were able to borrow funds at economically favorable rates below LIBOR and invested the funds at rates above LIBOR.

3. AIG claimed that the cross-border transactions had economic substance because they were expected to generate a pre-tax profit of at least $168 million for AIG over the life of the transactions. To reach this number, AIG calculated pre-tax profit by taking a special purpose vehicle's (SPV) investment income and subtracting only AIG's operating expenses and obligations to the foreign lending banks. Thus, in calculating pre-tax profit, AIG ignored (1) the foreign tax paid by the SPV, (2) the U.S. tax

paid by AIG on the SPV's investment income, and (3) the value of the foreign tax credits claimed by AIG.

4. *BNY* involved a STARS transaction. The Tax Court bifurcated its analysis of the STARS trust structure and the $1.5 billion loan and found: (1) foreign taxes but neither loan proceeds nor the tax-spread should be considered in the pre-tax analysis of economic substance; (2) the STARS trust transaction lacked economic substance as BNY had no purpose in entering the transaction except tax avoidance; (3) the tax-spread should be included in BNY's taxable income rather than considered a component of loan interest, as it served as a device to monetize anticipated foreign tax credits and (4) all expenses incurred from the STARS transactions, including interest expense from the $1.5 billion loan, were not deductible.

5. In a supplemental opinion in *BNY*, the Tax Court held that (1) the tax-spread was not includible in BNY's income because it was part of the trust transaction that was disregarded for tax purposes for lacking economic substance; and (2) BNY was entitled to interest expense deductions because the $1.5 billion loan, bifurcated from the STARS trust transaction, had independent economic substance.

6. The Second Circuit said that substance rather than form determines tax consequences. The court also said that the economic substance doctrine exists to provide courts a "second look" to ensure that particular uses of tax benefits comply with Congress's purpose in creating that benefit. The court also found no support for the taxpayers' contention of foreign tax credits, by their nature, are not reviewable for economic substance. The court also noted the recent codification of economic substance by Congress, and Treasury and the IRS's issuance of new regulations disallowing foreign tax credits associated with STARS and "other similarly convoluted transactions designed to take advantage of foreign tax credits."

7. The court noted the Federal Circuit's decision in *Salem Financial, Inc. v. United States*, ___ F.3d ___ (Fed. Cir. 2015), a case involving the same STARS transaction at issue in *BNY*. The Federal Circuit concluded that foreign taxes are economic costs that are properly deducted in assessing profitability for the purposes of economic substance. The Federal Circuit held, however, that this lack of post-foreign-tax profit did not conclusively establish that a transaction lacks objective economic substance. The Federal Circuit ultimately held that STARS lacked objective economic substance, based on both the lack of post-foreign-tax profit and on the circular cash flows through the trust whose only purposes was generating tax benefits.

8. In factually different contexts, the Fifth and Eighth circuits have taken a different approach to assessing objective economic substance, holding that

foreign taxes are not economic costs and should not be deducted from pre-tax profit. *Compaq v. Commissioner*, 277 F.3d 778 (5th Cir. 2001) and *IES Industries v. United States*, 253 F.3d 350 (8th Cir. 2001).

9. The Second Circuit said that it agreed with the Tax Court in *BNY* and the Federal Circuit in *Salem*. The purpose of calculating pre-tax profit in this context is not to perform mere financial accounting, subtracting costs from revenue on a spreadsheet: it is to discern, as a matter of law, whether a transaction meaningfully alters a taxpayers economic position other than with respect to tax considerations.

10. The court stated that the purpose of the foreign tax credit is to facilitate global commerce by making the IRS indifferent as to whether a business transaction occurs in this country or in another, not to facilitate international tax arbitrage. The court stated that the trust transaction in *BNY* had little to no potential for economic return apart from the tax benefits. When the record in *AIG* is viewed most favorably to the government (AIG moved for summary judgment), a reasonable factfinder could reach the same conclusion as to the cross-border transactions. Accordingly, the court held that foreign taxes are economic costs for purposes of the economic substance doctrine and thus should be deducted from profit before calculating pre-tax profit.

11. The objective economic substance inquiry, however, does not end at profit, as a legitimate transaction could conceivably lack economic profit. There is no simple device to peel away the form of a transaction and to reveal its substance. A court should also look to the overall economic effect of the transaction in determining objective economic substance. In conducting this inquiry, the court agreed with the Tax Court that "economic benefits that would result independent of a transaction do not constitute a non-tax benefit for purposes of testing its economic substance."

12. The court also must look to the subjective business purpose of a transaction to determine whether it has economic substance. A court must ask whether the taxpayer has a legitimate, non-tax business purpose for entering into the transaction. The business purpose inquiry concerns the motives of the taxpayer in entering into the transaction; it asks whether the taxpayer's "sole motivation" for entering a transaction was to realize tax benefits. The focus is the reasonableness of the transaction and can be articulated as: would a "prudent investor," absent tax benefits, have made the deal. The court concluded that BNY's STARS transaction failed this test.

13. The court also felt that it was appropriate to bifurcate the transaction and the loan, as the Tax Court did. The loan, independent of the trust structure, had economic substance.

D. Lehman Brothers.

1. Lehman Brothers asserted the IRS wrongfully disallowed certain foreign tax credits claimed by Lehman. The issue was decided for the government under § 901(k). *Lehman Brothers Holdings, Inc. v. United States*, ____ F. Supp. ____ (SDNY 2015).

2. Lehman contended it was entitled pursuant to the U.S.-U.K. treaty to claim foreign tax credits for taxes imposed by the U.K. on so-called substitute dividend payments received by Lehman from one of its U.K. subsidiaries under the terms of "hundreds" of stock loan transactions. That is, the parties' sole dispute was a legal one: whether the treaty causes a substitute dividend payment -- which is not a dividend under U.S. law -- to be treated as a dividend for U.S. foreign tax credit purposes and thus whether § 901(k), which is a "limitation of the law of the United States" applicable to dividends, applies to deny the foreign tax credits claimed by Lehman with respect to the substitute dividend payments.

3. Lehman entered into hundreds of "stock loan transactions" with its U.K. subsidiary. In each stock loan transaction, Lehman borrowed shares of stock in U.K. corporations from various third-party U.S.-based lenders "over" the stocks' respective dividend record dates, the dates on which the record owners of the stock became entitled to receive dividends declared by the companies. Within 1-2 business days of borrowing the U.K. companies' stock, Lehman "on-lent" the stock to its U.K. subsidiary. When the U.K. corporations that issued the stock paid dividends to the owners of the stock, Lehman's U.K. subsidiary, rather than Lehman received the dividends.

4. The borrower -- in this case Lehman's U.K. subsidiary – received the dividend and then was required, pursuant to the terms of the stock loan transactions, to make a substitute dividend payment to the immediate prior lender in an amount equal to the dividend. Thus, in the stock loan transactions at issue, whenever a dividend was paid to Lehman's U.K. subsidiary on borrowed stock, the U.K. subsidiary made a substitute dividend payment to Lehman. Lehman, in turn, made a substitute dividend payment to the original U.S.-based lender on the same business day.

5. The court used the following example. Lehman treated as taxable income the amount of $10 when the substitute dividend payment was $90, *i.e.*, the $90 substitute dividend payment received by Lehman from its U.K. subsidiary, plus a $10 U.K. tax payment, minus the $90 substitute dividend payment paid by Lehman to its third-party lender. The U.S. tax on $10 (at the 35% corporate tax rate) was $3.50. Against this amount, Lehman claimed a foreign tax credit of $10 (*i.e.*, the amount of the U.K.

tax). This left a balance of $6.50 in excess foreign tax credits which Lehman sought to use to offset other U.S. tax obligations.

6. The court stated that Lehman's interpretation of the several treaty provisions runs contrary to an established canon of construction that "similar language contained within the same section of a [statute or treaty] must be accorded a consistent meaning." The court cited *National Credit Union Administration v. First National Bank & Trust Co.,* 522 U.S. 479, 501 (1998); and *Sacirbey v. Guccione*, 589 F.3d 52, 66 (2d Cir. 2009) ("basic canons of statutory construction are equally applicable to interpreting treaties").

7. The court stated that Lehman inconsistently "cherry picked" among various provisions of the treaty to achieve a desired tax result. That is, stated the court, by inconsistently interpreting the term dividend in the treaty, Lehman sought to obtain benefits provided for in the foreign tax credit provision while avoiding negative ramifications of other provisions (*i.e.*, the "limitations of U.S. law" on dividend-based foreign tax credits).

8. The court cited a 2006 chief counsel advice (CCA 200612013) which evaluated a taxpayer's contention nearly identical to Lehman's contention that "the treaty's purported characterization of the substitute dividend payments and deemed refunds of ACT as dividends applies to allow it to claim foreign tax credits under the treaty for amounts deemed withheld from those payments, but is jettisoned for purposes of applying the statutory limitations on the foreign tax credit, such as § 901(k)…" The court stated that neither party seems to have cited to, much less discussed, this chief counsel advice in its briefs. The court stated that, while not binding on the court, the CCA's thorough analysis of the U.K. treaty article was instructive.

9. The parties also had disagreed over the purpose of the stock borrowings. The government contended that the evidence on the economic purpose of the disputed trades would have shown that for almost all trades, Lehman had no reason to borrow the U.K. stock as it had no profitable use for it…and that the only reason Lehman entered into the trades was to claim that the treaty generated foreign tax credits that it could use to avoid paying U.S. tax on millions of dollars of unrelated profits. Lehman countered by stating that there are many uses of stock loan transactions, which it then enumerated on.

10. The court stated that its resolution of Lehman's claim was based principally on the plain language of the treaty. The court stated that it was not based on the economic substance or purposes of the stock loan transactions.

11. Section 901(k)(1)(A)(ii) reads as follows: "In no event shall a [foreign tax] credit be allowed…for any withholding tax on a dividend with respect to stock in a corporation if…the recipient of the dividend is under an obligation…to make related payments with respect to positions in substantially similar or related property."

II. <u>SECTION 482</u>.

A. <u>APA Report for 2014</u>.

1. The IRS completed 101 APAs in 2014, a decrease from the 145 completed in 2013, and the median completion time went up to 35.3 months from 32.7 months in 2013.

2. The APA report states that 108 applications were filed in 2014. Of the bilateral applications, 41% involve Japan, 12% Canada, and 10% the U.K. Thus, nearly two-thirds of the bilateral APA applications filed in 2014 involve these three countries. Similarly, of the bilateral APAs executed in 2014, 47% involved Japan, 15% Canada and 10% the U.K. These three countries thus represent nearly three quarters of the executed bilateral APAs in 2014.

3. Fifty-five percent of the APAs executed in 2014 involved foreign parent and U.S. subsidiary transactions. Thirty-one percent involved U.S. parent and foreign subsidiary transactions. The remaining 14% involved a U.S. company and its foreign branch, and a category described as "sister companies." Thus, as in the past, there was a predominance of APAs involving foreign parent companies versus the category involving U.S. parent companies.

4. Most APAs had a five-year term. Some extended for six years or more.

5. CPM/TNMM was used in 78% of APAs involving tangible and intangible property, and 77% of APAs involving services. For tangible and intangible property, the profit level indicator "operating margin" was used in 88% of the APAs involving CPM and TNMM, and the operating profit to total services cost ratio (45%) and operating margin (47%) were the predominant profit level indicators used for services APAs involving CPM or TNMM.

6. More than 60% of the tested parties involved distribution or related functions (marketing and product support).

B. <u>Altera</u>.

1. *Altera Corporation v. Commissioner*, 145 T.C. No. 3 (2015), is a follow-on to the *Xilinx v. Commissioner case*, 125 T.C. 37 (2005), *aff'd*, 598 F.3d 1191 (9th Cir. 2010).

2. In *Xilinx*, the Tax Court held that, under the § 1995 cost-sharing regulations, controlled entities entering into qualified cost-sharing agreements ("QCSAs") need not share stock-based compensation costs because parties operating at arm's length would not do so. In an effort to overrule *Xilinx*, Treasury and the IRS in 2003 issued Treas. Reg. § 1.482-7(d)(2). The 2003 regulation requires controlled parties entering into QCSAs to share stock-based compensation costs. *Altera v. Commissioner* addressed that regulation, and held that it was invalid.

3. The § 482 regulations provide that in determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length within another uncontrolled taxpayer. The arm's length standard also is incorporated into numerous income tax treaties between the United States and foreign countries. In *Xilinx,* as noted, the Tax Court held that unrelated parties would not share the value of stock-based compensation in a cost-sharing arrangement. The Ninth Circuit, in *affirming*, held that the "all costs" requirement of the 1995 cost-sharing regulations was irreconcilable with the arm's length standard.

4. In issuing the new regulations, Treasury and the IRS first published a proposed version of the regulations with a notice of proposed rulemaking and a notice of public hearing. At the hearing a number of persons testified, and many written comments were submitted.

5. Several of the commentators informed Treasury that they knew of no transactions between unrelated parties, including any cost-sharing arrangement, service agreement, or other contract, that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation. Some comments were based on a survey of an association's members. Some commentators represented that they had conducted multiple searches of electronic data gathering and found no cost-sharing agreements between unrelated parties in which the parties agreed to share either the exercise spread or grant date value of stock-based compensation.

6. Several commentators identified arms-length agreements in which stock-based compensation was not shared or reimbursed. Some cited the practice of the federal government, which regularly enters into cost-reimbursement contracts at arm's length. They noted that federal acquisition regulations prohibit reimbursement of amounts attributed to stock-based compensation.

7. Treasury and the IRS nonetheless issued the regulation as a final regulation. The final rule explicitly required parties to QCSAs to share stock-based compensation costs. Treasury and the IRS also added sections to Treas. Reg. §§ 1.482-1(b)(2)(i) through 1.482-7(a)(3) to

provide that a QCSA produces an arm's-length result only if the parties' costs are determined in accordance with the final rule.

8. When Treasury and the IRS issued the final regulation, the government's files relating to the final rule did not contain any expert opinions, empirical data or published or unpublished articles, papers, surveys, or reports supporting a determination that the amounts attributable to stock-based compensation must be included in the cost rule of QCSAs to achieve an arm's-length result. Those files also did not contain any record that Treasury searched any data base that could have contained agreements between unrelated parties relating to joint undertakings with the provision of services. Treasury was also unaware of any written contract between unrelated parties that required one party to pay or reimburse the other party for amounts attributable to stock-based compensation.

9. The Court considered the applicable principles of Administrative Law, including especially the Administrative Procedure Act ("APA"). Pursuant to APA § 553, in promulgating regulations through informal rulemaking, an agency must (1) publish a notice of proposed rulemaking in the Federal Register; (2) provide interested parties an opportunity to participate in the rulemaking through submission of written data, views, or arguments with or without the opportunity for oral presentation; and (3) after consideration of the relevant matter presented incorporate in the rules adopted a concise general statement of their basis and purpose.

10. The Court stated that these requirements do not apply to interpretive rules (those which merely explain pre-existing substantive law), or when an agency for good cause finds--and incorporates its findings in the rules issued--that the notice and public procedure thereon are impracticable, unnecessary or contrary to the public interest. The regulations at issue, however, were legislative (substantive) regulations, *i.e.*, those that create rights, impose obligations, or effect a change in existing law.

11. The notice and comment requirements of APA § 553 are intended to assist judicial review as well as to provide fair treatment for persons affected by a rule. There must be an exchange of views, information, and criticism between interested parties and the agency. The opportunity to comment is meaningless unless the agency responds to significant points raised by the public. The failure to respond to comments is significant only insofar as it demonstrates that the agency's decision was not based on a consideration of the relevant factors.

12. Pursuant to APA § 706(2)(A), a court must hold unlawful and set aside agency action, findings and conclusions that it finds to be arbitrary, capricious and an abusive discretion or otherwise not in accordance with the law. A court's review under this standard is narrow and a court is not to substitute its judgment for that of the agency. *Motor Vehicle Mfrs.*

Ass'n of the U.S. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29 (1983). A reviewing court, however, must ensure that the agency "engaged in reasoned decision making." Under *State Farm*, normally an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.

13. The standard to be applied in every case under § 482 is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. *Commissioner v. First Sec. Bank of Utah*, 405 U.S. 394 (1972) (*quoting* Treas. Reg. § 1.482-1(b)(1)); *accord* Treas. Reg. §§ 1.482-1(a)(1), (b)(1) and Treasury Department technical explanations of a number treaties.

14. The IRS countered that Treasury should be permitted to issue regulations modifying--or even abandoning--the arm's-length standard. But the preamble to the final rule, stated the Court, did not justify the final rule on the basis of any modification or abandonment of the arm's-length standard, and the IRS conceded that the purpose of § 482 is to achieve tax parody. The preamble to the regulation also did not dismiss any of the evidence submitted by commentators regarding unrelated party conduct as addressing an irrelevant or inconsequential factor. The Court stated that it did not decide whether Treasury would be free to modify or abandon the arm's-length standard because it had not done so here.

15. The taxpayer contended that the final regulation is invalid because (1) it lacks a basis in fact, (2) Treasury failed rationally to connect the choice it made with the facts it found, (3) Treasury failed to respond to significant comments and (4) the final rule is contrary to the evidence before Treasury.

16. A court will generally not override an agency's "reasoned judgment about what conclusions to draw from technical evidence or how to adjudicate between rival scientific or economic theories." Treasury, however, failed to provide a reasoned basis for reaching the conclusions that support the regulation from any evidence in the administrative record. Indeed, every indication in the record pointed the other way. The Court concluded that by failing to engage in any fact finding, Treasury failed to examine the relevant data and it failed to support its belief that unrelated parties would share stock-based compensation with any evidence in the record. The Court also stated that the final rule was contrary to the evidence before Treasury when it issued the final rule.

17. Because the final regulation lacks a basis in fact, the Court held that Treasury failed to rationally connect the choice it made with the facts found, Treasury failed to respond to significant comments when it issued the final rule, and Treasury's conclusion that the final rule is consistent with the arm's-length standard was contrary to all of the evidence before it. Thus, the Court concluded that the final rule failed to satisfy the *State Farm's* reasoned decision making standard and therefore is invalid.

18. The Court closed with the statement that Treasury's *ipse dixit* conclusion coupled with its failure to respond to contrary arguments resting on solid data, epitomizes arbitrary and capricious decision making.

19. The decision was "reviewed by the Court," which means that all of the Tax Court's judges considered whether to join in with the Court's opinion, file concurring opinions, or dissent. All of the judges who participated agreed with the opinion of the Court. There were no dissenting opinions.

20. The term *ipse dixit* refers to an unsupported statement that rests solely on the authority of the individual who made it. The term describes a dogmatic statement that the speaker expects the listener to accept as valid.

21. In this regard, we cannot resist quoting a high-ranking government official as stating in 2008 "We can simply interpret arm's-length to mean what we think it should mean, and if we say it correctly, that is what it means." *See* Lee Sheppard, Tax Notes Int'l. Sept. 22, 2008, p. 970.

22. Unfortunately, this is the very issue that raises serious problems in BEPS. For example, the "special measures" exceptions to the arm's-length standard in BEPS has the U.S. government and taxpayers both concerned that it will lead to many *ipse dixit* pronouncements by foreign taxing authorities. Perhaps, these BEPS exceptions from the arm's length standard, instead of being referred to "special measures," should be called *ipse dixit* pronouncements. That's what they will be.

C. BMC: § 965/§ 482.

1. *BMC Software Inc. v. Commissioner*, ____ F.3d ___ (5th Cir.), reversed the Tax Court regarding the interrelationship of § 965 and a § 482-related repatriation under Rev. Proc. 99-32. The Fifth Circuit held that benefits under § 965 were not reduced by reason of the Rev. Proc. 99-32 repatriation closing agreement.

2. Congress enacted § 965 to encourage U.S.-based corporations to repatriate to the U.S., through dividends, funds sitting in the accounts of their foreign subsidiaries. To prevent abuse, Congress included an exception to § 965. The exception, set forth in § 965(b)(3), prevents U.S. corporations from making loans to their foreign subsidiaries to fund repatriated § 965 dividends. The Fifth Circuit referred to this as "round-tripping" and stated

that it would defeat Congress's purpose of inducing fresh investment of foreign cash into the United States.

3. The Court stated that when the IRS adjusts a corporation's transfer prices, the "primary adjustment" shifts taxable income from one related party to another, for example, from a foreign subsidiary to its U.S.-based parent company. "Secondary adjustments" also must be made so that the corporations' taxable income and cash accounts are not imbalanced. To make a secondary adjustment, stated the court, both parties revise their books to show that the foreign subsidiary holds cash that, due to the primary adjustment, is now effectively owned by the U.S.-based parent.

4. In 2006, BMC decided to repatriate funds pursuant to the § 965 rules. BMC correctly reported no related-party indebtedness on its 2006 tax return. In 2007, BMC and the IRS signed a transfer pricing closing agreement to reflect a § 482 adjustment. This was completely unrelated to the 2006 repatriation under § 965.

5. Pursuant to Treas. Reg. § 1.482-1(g)(3) and Rev. Proc. 99-32, BMC elected to treat the allocated amount as an accounts receivable, payable to the U.S. parent by the foreign subsidiary, with interest accruing from the date of deemed creation of the account. The subsidiary thereafter paid the account receivable and BMC was not taxed on receipt of those funds. The Rev. Proc. 99-32 closing agreement ("99-32 closing agreement") included introductory language stating that the agreement was "for federal income tax purposes." The parties also agreed that when the subsidiary paid off their newly created accounts receivable, the payments would be "free of the federal income tax consequences of the secondary adjustments that would otherwise result from the primary adjustment."

6. In 2011, four years after execution of the 99-32 closing agreement, the IRS issued to BMC a notice of tax deficiency based on the assertion that the accounts receivable which BMC established pursuant to the 99-32 closing agreement constituted related-party indebtedness between BMC and its subsidiary during the relevant § 965 testing period. The Tax Court agreed with the IRS's assertion of a deficiency.

7. BMC made two arguments in support of its appeal. First, BMC contended that as a question of statutory interpretation, the accounts receivable established by the 99-32 closing agreement did not constitute "indebtedness" within the meaning of § 965(b)(3). Second, BMC argued that it did not contractually agree, in the 99-32 closing agreement, that the accounts receivable would be treated as indebtedness for purposes of § 965(b)(3).

8. The IRS conceded at oral argument that the Service cannot prevail on the language of the statute alone. This is because it was undisputed that as of

the close of BMC's 2006 taxable year, with which ended BMC's § 965(b)(3) testing period, the accounts receivable did not exist. Nor could the accounts receivable have existed at that time: they were not created until after the parties executed the 99-32 closing agreement in 2007.

9. The Service argued that under the closing agreement, BMC agreed to backdate the accounts receivable. The Court stated the fact that accounts receivable are backdated does nothing to alter the reality that they did not exist during the testing period. The Court also stated that even assuming *arguendo* that a correction of a prior year's accounts could create indebtedness for purposes of § 965(b)(3), that is not what happened here. This is not a situation in which a subsequent adjustment was made in order to accurately reflect what actually happened in the taxable year ending on March 31, 2006.

10. BMC agreed to create previously non-existing accounts receivable with fictional establishment dates for purpose of calculating accrued interest in correcting the imbalance in its cash accounts that resulted from the primary adjustment. The text of § 965(b)(3) requires that, to reduce the allowable § 965 benefits, there must have been an indebtedness "as of the close of" the applicable taxable year. The accounts receivable were not created until 2007, and therefore BMC's § 965 benefits cannot be reduced under § 965(b)(3).

11. The Service also argued that Notice 2005-64, § 10.06, issued in 2005, supports its position. The notice states that accounts such as those created under the closing agreement "are to be treated as indebtedness for purposes of § 965(b)(3)." The Court stated there is no basis for relying on the notice to alter its interpretation of § 965(b)(3).

12. The Service correctly conceded in its brief that the notice is not entitled to deference under *Chevron USA Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984). At most, the notice might be entitled to deference under *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944). Under *Skidmore*, courts defer to the agency only to the extent that the agency's interpretation is persuasive.

13. The Court held the notice was unpersuasive for several reasons. The notice contained only a single sentence regarding the treatment of accounts receivable as indebtedness. Moreover, the treatment of accounts receivable in the notice is entirely conclusory. The notice contains no analysis or explanation. This is particularly problematic, stated the court, in light of the fact that the notice advocates a treatment of accounts receivable that runs counter to the plain language of § 965.

14. The Court also noted that the Service has since changed its treatment of the § 965 tax consequences in closing agreements, explicitly outlining the § 965 tax consequences in these agreements.

15. With no reasoning or analysis to support its directive, and with the Service's subsequent decision to explicitly provide for the § 965 tax consequences in closing agreements, the Court held that the notice is entirely unpersuasive and unworthy of deference.

16. The Court next considered the parties' arguments over a possible alternative basis for affirming the Tax Court's holding: whether BMC nevertheless contractually agreed in the 99-32 closing agreement to treat the accounts receivable as indebtedness for purposes of § 965. In essence, stated the Court, this presents an issue of contractual interpretation.

17. The 99-32 closing agreement neither cites nor refers to § 965. The Service primarily relies upon the introductory clause, which states that "now it is hereby determined and agreed for federal income tax purposes …" The Court stated this is a boilerplate provision required by the IRS in every closing agreement. Nonetheless, the Service argued that this demonstrates that the accounts receivable created related-party indebtedness for all income tax purposes, including § 965.

18. The Court rejected the Service's expansive interpretation of the boilerplate provision because it would render much of the agreement superfluous, and also because the agreement's enumeration of tax consequences was inclusive. The 99-32 closing agreement lists the transaction's tax implications in considerable detail. One of the paragraphs, for example, explains the tax implications flowing from the interest payments on the accounts receivable. If the parties agreed, in the boilerplate provision, to treat the accounts receivable as retroactive indebtedness for all federal income tax purposes, then these additional provisions would be surplusage. Moreover, where the specificity and apparent comprehensiveness of an agreement's enumeration of a category of things (here, tax implications) implies that things not enumerated are excluded, the Court will apply the canon of *expressio unius est exclusio alterius* (that which is not included is excluded).

19. The Court stated that the agreement lists, with specificity, several tax implications. The tax-consequence-setting function of the agreement, coupled with the specificity of its enumeration of tax consequences, strongly implies that the agreement excluded those tax consequences which it failed to enumerate.

20. Applying the rule against surplusage and the *expressio unius* canon, the Court concluded that the plain language of the 99-32 closing agreement thus precluded the IRS's expansive interpretation of the agreement's

boilerplate provision, and the agreement covers only those tax consequences that it expressly enumerates.

21. Moreover, the Court stated, even if the agreement were ambiguous as to whether the accounts receivable were retroactively established for all tax purposes, the unrebutted extrinsic evidence (testimony at trial) would require the court to resolve the ambiguity in BMC's favor.

22. The Fifth Circuit's holding would seem to eliminate a number of unnecessary collateral issues to which the Tax Court's holding would have given rise. First, under the Tax Court's holding that a Rev. Proc. 99-32 closing agreement gives rise to retroactive indebtedness, currency gain or loss presumably would arise at the foreign-subsidiary level with respect to every such retroactive indebtedness. That is, it would be a retroactive dollar receivable held by the U.S. parent company and presumably a retroactive dollar payable owed by the non-dollar foreign subsidiary. Subpart F issues would arise under § 954(c).

23. Second, in certain cases, retroactive § 956 inclusions could have resulted.

24. Third, if the receivable in the hands of the parent company were treated as a retroactive receivable, then the possibility of writing off that receivable as a bad debt under § 166 could have arisen. In at least one previous case, a taxpayer indeed made this assertion, but unsuccessfully. The Tax Court's holding in *BMC* would have given new life to the bad debt argument.

25. Finally, the retroactive receivable, as found by the Tax Court, would have created a retroactive foreign asset for purposes of allocating and apportioning interest expense under Treas. Reg. § 1.861-8 in any number of prior years.

26. Unexpected collateral consequences like these would seem not to arise under the Fifth Circuit's reversal of the Tax Court.

D. Other Pending Cases.

1. *Amazon.com, Inc. v. Commissioner*, T.C. Dkt. 31197-12, involves a cost sharing agreement with allocated amounts of over $1 billion for each of the two years in issue. It seems to involve some of the same issues that were litigated in *Veritas v. Commissioner*, 133 T.C. 297 (2009), *nonacq*, which is cited in Amazon's Tax Court Petition.

2. *Medtronic v. Commissioner*, T.C. Dkt. 6944-11, involving §§ 482 and 367(d), was tried in Spring 2015.

3. *3M Company v. Commissioner*, T.C. Dkt. No. 5816-13, filed March 11, 2013, involves the IRS's allocation of royalty income from a Brazilian

subsidiary. The taxpayer asserts that the royalties in issue are not permitted under Brazilian law. *First Security Bank of Utah v. Commissioner*, 405 U.S. 394 (1972) held that if the law prevents the taxpayer from earning certain income, the taxpayer did not have the necessary control that § 482 requires, and an allocation under § 482 would be inappropriate. Subsequently, *Proctor & Gamble v. Commissioner,* 961 F.2d 1255 (6^{th} Cir. 1992), held that this applies where foreign law is involved, as well. *Exxon Corp. v. Commissioner*, 66 TCM 1707 (1993), *aff'd*, *Texaco v. Commissioner*, 98 F.3d 825 (5^{th} Cir. 1996), followed these cases with respect to Saudi Arabian crude pricing. Treasury and the IRS have tried to reverse these decisions with a regulation issued in 1994: Treas. Reg. § 1.482-1(h). We have long wondered how Treasury and the IRS could write a regulation *under* § 482 to overrule the Supreme Court's holding that *§ 482 does not apply in the first case*.

E. IRS Outsources Microsoft § 482 Audit to Law Firm.

1. In a quite surprising development, the IRS has retained the law firm of Quinn Emanuel to assist in a transfer pricing audit of Microsoft. The IRS's outsourcing effort became public when Microsoft brought an action for declaratory and injunctive relief under the Freedom of Information Act ("FOIA"). Microsoft seeks to compel the disclosure of the complete government contract and related records arising from the IRS's engagement of Quinn Emanuel. Under the agreement, Quinn Emanuel will receive $2,185,500 for its provision of these legal services.

2. Quinn Emanuel is described in Microsoft's complaint as a "650-lawyer business litigation firm—the largest in the United States devoted solely to business litigation and arbitration." Quinn Emanuel appears not to have a tax practice.

3. Previously, Microsoft had filed a FOIA request seeking all documents representing proposals for services to be rendered by Quinn Emanuel, its partners, and/or its employees in connection with the IRS's examination of Microsoft for its tax years ended June 30, 2004 through June 30, 2009. Microsoft's request included the complete contract between Quinn Emanuel and the IRS. The IRS did not produce the requested materials.

4. As discussed in an excellent article by Ajay Gupta at 2014 TNT 230-4, the disclosed portions of the contract make it clear that Quinn Emanuel will be closely associated with the IRS examination team. They state "Contractor will work collaboratively with the Service to support the examination." The law firm is tasked in the agreement with reviewing all the "key documents, including reports, position papers, IDR responses, etc. (prepared by or on behalf of the Taxpayer or the Service) and all relevant legal authorities to build a thorough understanding of the factual and legal issues and the record to date."

5. According to Gupta, the issue under scrutiny appears to involve a pre-2009 cost-sharing agreement and the sufficiency of buy-in payments. As Gupta notes, similar disputes involving cost-sharing buy-in payments were/are in issue in *Veritas* and the pending case involving Amazon.com.

6. Gupta states that under the agreement, the contractor's attorneys may "as necessary for the performance of his or her duties under this contract, be given access to confidential tax returns and return information…" Quinn Emanuel, Gupta notes, thus must be, under § 6031(n), a person to which the IRS is authorized to disclose returns and return information "for purposes of tax administration…in connection with a written contract or agreement" for services.

7. This is a very interesting and unfortunate development in the tax law: the IRS appears to have retained an outside law firm to sue a taxpayer, or assist in bringing an action against a taxpayer, asserting that the taxpayer might owe additional U.S. federal income taxes. The law firm apparently also will assist in determining whether taxes are owed and then presumably assert the grounds for arguing that those taxes, determined in part by the law firm, should be paid to the IRS. Somehow, this doesn't seem right.

8. Senator Hatch (R-UT), Senate Finance Committee Chairman, learned about this new approach and wrote to the IRS demanding that it immediately stop using Quinn Emanuel, the law firm or one of the law firms involved, and that the IRS provide "without delay" answers regarding its use of private contractors in its audits. He wants the IRS to provide the legal justification for its "novel" reading of the tax statute in hiring an outside law firm.

9. Hatch questioned the IRS's decision and criticized the fact that the IRS gave Quinn Emanuel the authority to conduct sworn interviews and perform other actions that would give the law firm access to confidential taxpayer information.

10. He said that Congress intentionally chose to restrict the performance of specific revenue functions, such as examinations and the taking of sworn testimony, to the IRS and "limited delegates."

11. In Microsoft's legal proceedings regarding this specific issue, the IRS says Hatch's letter is irrelevant to the issue.

12. In an interesting opening statement in the Microsoft evidentiary hearing dealing with the legitimacy of the IRS's use of an outside law firm, Quinn Emanuel, a Microsoft attorney raised concerns about taxpayer confidentiality. Quinn Emanuel is primary outside counsel to Google, one of Microsoft's largest competitors. Microsoft's attorney stated that at one

point after having been hired by the IRS, Quinn Emanuel was involved in 34 cases adverse to Microsoft. This fact was made known to the IRS at the time that the IRS was disclosing confidential information about Microsoft to the law firm. This is discussed along with other points from the hearing in a report by Amanda Athanasiou at 2015 TNT 165-1.

13. Two government persons stated that Quinn Emanuel was hired because the IRS believed advice from a commercial litigator with experience in evaluating large complex cases would help to determine the correct adjustment and support its numbers. The IRS had also reached out to Boies Schiller for expert services, but the firm ultimately wasn't used because of a conflict of interest.

F. Eaton.

1. Eaton Corporation has a pending § 482 case. While the case has not yet been tried, an order in the case is sufficiently surprising that we thought we would mention it. The order, dated May 11, 2015, affirmed a prior order dated April 6, 2015. The order involves the production of documents.

2. The IRS asserts that Eaton should be charged a transfer pricing accuracy-related penalty under § 6662(h). Eaton says that the penalty should not apply because it has reasonable cause for any portion of an understatement attributable to a net § 482 transfer pricing adjustment.

3. The Court's order states that although the reasonable cause defense is an objective one, it ultimately involves all the facts and circumstances, including several factors that are particular to the taxpayer asserting the defense. The taxpayer must reasonably have concluded that a particular transfer pricing method provided a reliable measure of an arm's length result. Further, the taxpayer's experience and knowledge and the extent to which the taxpayer relied on a study or other analysis performed by a qualified attorney, accountant, or economist are relevant.

4. The order states that in asserting a reasonable cause defense, Eaton has put at issue otherwise protected information that would reveal the expertise and knowledge and state of mind of those who acted on its behalf in this matter. The court cited *Ad Inv. 2000 Fund LLC v. Commissioner*, 142 T.C. 248 (2014). Thus, documents that the IRS seeks, states the order, are directly relevant to Eaton's penalty defense.

5. The issue involves attorney-client privilege with respect to the documents at issue. The court concluded that Eaton waived privilege and work product protections to withhold the documents in dispute from discovery as a consequence of asserting that the penalty should not apply. The order further states that if Eaton does not produce the documents, the court will

grant so much of the IRS's motion to compel production of documents as seeks an appropriate sanction by striking relevant portions of the petition and barring the introduction of evidence related thereto.

6. This is surprising, to say the least: attorney-client privilege is waived simply because the taxpayer asserts that a penalty should not apply. This cannot be right. In enacting penalties, did Congress really intend that privilege must be waived as the price of asserting that a penalty should not apply?

7. Imagine a typical non-tax civil or criminal case. If the defendant asserts a defense that relates to his state of mind or reasonable cause, would he be viewed as waiving privilege? We don't think so. The attorney-client privilege is a common law privilege that's pretty deeply ingrained in our legal system. It shouldn't vary by the court involved.

G. New APA Procedures.

1. Rev. Proc. 2015-41 provides guidance on requesting and obtaining advance pricing agreements and on the administration of executed APAs. A proposed version of this revenue procedure was released for public comment in Notice 2013-79, and was the subject of substantial commentary.

2. The principal differences between the final revenue procedure and the proposed version may be summarized as follows:

(a) The revenue procedure clarifies that if APMA (Advance Pricing and Mutual Agreement personnel) requires, as a condition of continuing with the APA process, that the taxpayer expand the proposed scope of its APA request to cover interrelated matters (interrelated issues in the same years, covered issues or interrelated issues in the same or other years and the same as applied to other countries), APMA will do so with due regard to considerations of principled, effective, and efficient tax administration and only after considering the views of the taxpayer and the applicable foreign competent authority. Further, APMA will communicate to the taxpayer any concerns about interrelated matters and possible scope expansion as early as possible.

This seems like a bit of "hardball" that could make the APMA a not-so-friendly program. After all, the APMA apparently will discuss these interrelated issues with the applicable foreign competent authority even if the taxpayer doesn't want it to. The only alternative for the taxpayer is to withdraw its APA request, but by then the damage may have been done.

Examples of interrelated matters include a taxpayer that proposes to cover a country's license of intangible property in specific years to a second company in the same controlled group, when that intangible property had been sold in an earlier year by the second company (the licensee) to the first company (the licensor). In such a case, APMA might consider that the ongoing license should be evaluated in a manner consistent with the evaluation performed for the previous sale (for example, using the same underlying assumptions unless they were specific reasons why certain assumptions would have changed in the interim).

Another example involves cost sharing. In evaluating a platform contribution transaction in a cost sharing arrangement, APMA might also consider whether the intangible development cost in that arrangement are being properly shared.

A third example assumes that the taxpayer makes a bilateral APA request to cover sales of goods from a manufacturer in a treaty country to a U.S. distributor that is in the same controlled group, when the U.S. distributor, in turn, resells most of the goods to a distributor in another country (which may or may not be a treaty country) that is in the same controlled group. Before agreeing to a price that the U.S. distributor should pay to the manufacturer, APMA might consider the price the distributor receives for its resale.

(b) Rollback years may be formally covered within an APA. A rollback will be included in an APA when a rollback is either requested by the taxpayer and approved after coordination and collaboration between APMA and other offices within the IRS or, in some cases, is required by APMA, after coordination and collaboration with other offices within the IRS, as a condition of beginning or continuing the APA process.

(c) The required contents of APA requests that were specified in the appendix of the proposed revenue procedure have been refined but generally retained, which APMA uses to view as necessary to conduct informed and efficient evaluations of APA requests.

(d) Taxpayers are required to execute consent agreements to extend the period of limitations for assessment of tax for each year of the proposed APA term, and the required consent could be either general or restricted. The revenue procedure expands on the proposed revenue procedure by expressly providing that APMA will coordinate and collaborate with other offices within the IRS and with the taxpayer on the type of consent the taxpayer will be instructed to execute, which, if restricted, will follow standardized language provided by APMA. The revenue procedure also provides that in certain cases, only general consents will be used.

(e) The revenue procedure increases user fees for APA requests and provides that total user fees may be reduced for multiple APA requests filed by the same controlled group within a 60-day period.

3. Highlights of Other Selected Provisions.

(a) The APA guidelines express a preference for bilateral and multilateral APAs. If a taxpayer requests a unilateral APA to cover any issue that could be covered under a bilateral or multilateral APA under the applicable tax treaties, the taxpayer must explain in a mandatory pre-filing memorandum why a unilateral APA is appropriate to cover that issue. The taxpayer might state, for example, that it believes there is no APA process with the treaty country, or that the taxpayer's proposed covered issues involve so many treaty countries that the taxpayer believes that bilateral APAs or a multilateral APA would be impractical. APMA will inform the taxpayer whether it will accept the unilateral APA request in such a situation.

(b) Mandatory pre-filing memoranda in Section 3.02(4) must be filed if (1) the taxpayer wishes to file a unilateral APA request to cover an issue that could be covered in a bilateral or multilateral APA (as discussed above); (2) the taxpayer seeks permission to use an abbreviated APA request, for example, for an APA renewal or expansion of a competent authority request under Rev. Proc. 2015-40 into APA years; or (3) the covered issues proposed by the taxpayer will, or could reasonably be expected to, involve (i) the license or other transfer of a intangibles in connection with, or the development of intangibles under, an intangible development agreement, (ii) a global trading arrangement (iii) a business restructuring, or the use of intangibles whose ownership changed as a result of the business restructuring, or (iv) unincorporated branches, pass-through entities, hybrid entities or entities disregarded for U.S. tax purposes.

(c) Section 4.02 sets forth rules regarding denial or discontinuance of the APA process. APMA may decline to enter into or continue with the APA process if, for example, any of the circumstances described in, or similar to those described in Rev. Proc. 2015-40 § 7.02 are present, including failure to include the materials required by Rev. Proc. 2015-41 in the request. Rev. Proc. 2015-40 § 7.02 says these circumstances may include but are not limited to: (1) the taxpayer has failed to comply with the procedural requirements in the revenue procedure; (2) the taxpayer is not eligible for the treaty benefit or the assistance requested according to a plain reading of the U.S. tax treaty; (3) if the taxpayer's conduct before or after its competent authority request has undermined or been prejudicial to the competent authority process, including but not limited to conduct that has significantly impeded the ability of IRS Exam, the U.S. competent authority or any other part of the IRS, or the foreign tax authority to adequately examine the competent authority issues for which the assistance has been requested.

(d) Examples of detrimental conduct include: (1) the taxpayer agreed to or acquiesced in a foreign-initiated adjustment or entered into a unilateral APA with a foreign tax authority involving significant legal or factual issues in a manner that impeded the U.S. competent authority from engaging in full and fair consultations with the foreign competent authority on the competent authority issues; (2) the taxpayer entered into a unilateral APA with the IRS when the competent authority issue could reasonably and practically have been covered if the taxpayer had instead pursued a bilateral APA; (3) the taxpayer rejected a request to extend the period of limitations for assessment of tax for taxable periods covered by the competent authority request, (4) the taxpayer has failed to comply with the provisions coordinating the competent authority process and administrative and judicial proceedings or has pursued its rights within such proceedings and within the competent authority process in a way that has undermined or is prejudicial to the competent authority process; (5) the taxpayer has presented new material information or evidence during the competent authority process that reasonably could have been presented to IRS Exam during the examination of the taxable years covered by the competent authority request; and (6) in competent authority requests or competent authority cases involving taxpayer-initiated positions, the taxpayer failed to request the assistance of the foreign competent authority and the U.S. competent authority in a timely manner in relation to the taxable year for which relief is sought, or the taxpayer otherwise pursued competent authority assistance in a way that has undermined or prejudiced the competent authority process or has impeded the U.S. or foreign competent authority from engaging in full and fair consultations on the competent authority issues.

(e) Rev. Proc. 99-32 will govern the repatriation of funds to conform the taxpayer's accounts following an APA adjustment, unless the Competent Authority Repatriation provision applies to the APA primary adjustment. For bilateral and multilateral APAs, APMA will apply the rules of Rev. Proc. 2015-40 governing Competent Authority Repatriation to determine the terms of any repatriation of funds to conform the accounts following an APA primary adjustment if the Competent Authority Repatriation is agreed to a part of the competent authority resolution underlying the APA. The previous APA revenue procedure, Rev. Proc. 2006-9, stated that such a repatriation would be consistent with the *principles* of Rev. Proc. 99-32. It is not clear if the Service intends a substantive change in the repatriation rules in the context of an APA or competent authority proceeding by reason of using this different language.

(f) Section 7.06 sets forth rules on when APMA may revoke or cancel an APA.

(g) Section 8 deals with renewing an APA. A request to renew a current APA may be made either by filing a complete APA request or by filing an abbreviated APA request with APMA's permission.

(h) User fees were increased to $60,000 from $50,000 for an APA. An APA renewal requires a fee of $35,000, and a small-case APA will cost $30,000. In addition, a fee of $12,500 will be due for each amendment to a current unilateral, bilateral or multilateral APA. If multiple APA requests are filed by the same controlled group within a 60-day period, the maximum total fee charged will be $60,000, plus $30,000 for each foreign competent authority involved (if any) beyond the first two.

(i) Treasury and the IRS received a number of comments on the proposed APA guidelines published in Notice 2013-79. TEI, for example, stated that the proposed new APA procedure took an audit-like approach that would significantly undermine the benefits of an APA for both taxpayers and the government. TEI stated that the APA program has historically been a collaborative process between taxpayers and the IRS, aimed at promoting trust and providing certainty for both parties. TEI expressed the view that the proposed procedures and additional information required would only lengthen the time it takes to complete an APA request, significantly decreasing the utility of an APA.

(j) The final APA procedures set forth in Rev. Proc. 2015-41 would seem to have addressed some of these criticisms, but not all. Time will tell, however, how these revised procedures work in practice.

H. Section 482. Treasury and the IRS issued temporary and proposed regulations under § 482 at the same time they proposed the § 367 regulations discussed below. They state the new regulation is to coordinate the application of the arm's length standard and the best method rule under § 482 with other Code provisions.

The coordination rules apply to controlled transactions, including those subject in whole or in part to both §§ 367 and 482.

1. Consistent Valuation of Controlled Transactions.

   (a) Section 482 authorizes Treasury and the IRS to adjust the results of controlled transactions to clearly reflect the income of commonly controlled taxpayers in accordance with the arm's-length standard and, in the case of transfers of intangible property (within the meaning of § 936(h)(3)(B)), so as to be commensurate with the income attributable to the intangible.

   (b) While the determinations of arm's-length prices for controlled transactions is governed by § 482, the tax treatment of controlled transactions is also governed by other Code and regulatory rules applicable to both controlled and uncontrolled transactions. Controlled transactions always remain subject to § 482 in addition to these generally applicable provisions.

   (c) The new temporary regulations provide for the coordination of § 482 with those other Code and regulatory provisions. The new coordination rules thus apply to controlled transactions including controlled transactions that are subject in whole or in part to §§ 367 and 482. Transfers of property subject to § 367 that occur between controlled taxpayers require a consistent and coordinated application of both sections to the controlled transfer of property. The controlled transactions may include transfers of property subject to § 367(a) or (e), transfers of intangible property subject to § 367(d) or (e), and the provision of services that contribute significantly to maintaining, exploiting or further developing the transferred properties.

   (d) Treasury and the IRS say the consistent analysis and valuation of transactions subject to multiple Code and regulatory provisions is required under the best method rule described in Treas. Reg. § 1.482-1(c). A best method analysis under § 482 begins with a consideration of the facts and circumstances related to the functions performed, the resources employed, and the risks assumed in the actual transaction or transactions among the controlled taxpayers, as well as in any uncontrolled transactions used as comparables.

   (e) For example, states the preamble, if consideration of the facts and circumstances reveals synergies among interrelated transactions, an aggregate evaluation under § 482 may provide a more reliable measure of an arm's length result than a separate valuation of the transactions. In contrast, an inconsistent or uncoordinated application of § 482 to interrelated controlled transactions that are subject to tax under different Code and regulatory provisions may lead to inappropriate conclusions.

(f) The best method rule requires the determination of the arm's-length result on controlled transactions under the method, and particular application of that method, that provides the most reliable measure of an arm's-length result. The preamble also refers to the "realistic alternative transactions" rule and states that "on a risk-adjusted basis" this may provide the basis for application of unspecified methods to determining the most reliable measure of an arm's length result.

(g) Based on taxpayer positions that the IRS has encountered in examinations and controversy, Treasury and the IRS are concerned that certain results reported by taxpayers reflect an asserted form or character of the parties' arrangement that involves an incomplete assessment of relevant functions, resources, and risks and an inappropriately narrow analysis of the scope of the transfer pricing rules. In particular, Treasury and the IRS are concerned about situations in which controlled groups evaluate economically integrated transactions involving economically integrated contributions, synergies, and interrelated value on a separate basis in a manner that results in a misapplication of the best method rule and fails to reflect an arm's length result.

(h) Taxpayers may assert that, for purposes of § 482, separately evaluating interrelated transactions is appropriate simply because different statutes or regulations apply to the transactions (for example, with § 367 and the regulations thereunder applying to one transaction and the general recognition rules of the Code applying to another related transaction). Treasury and the IRS believe these positions are often combined with inappropriately narrow interpretations of Treas. Reg. § 1.482-4(b)(6), which provides guidance on when an item is considered similar to the other items identified as constituting intangibles for purposes of § 482. The interpretations purport to have the effect, contrary to the arm's length standard, of requiring no compensation for some value provided in controlled transactions despite the fact that compensation would be paid if the same value were provided in uncontrolled transactions.

2. <u>Compensation Independent of the Form or Character of Controlled Transaction</u>.

(a) New Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(A) provides that arm's-length compensation must be consistent with, and must account for all of, the value provided between parties in a controlled transaction, without regard to the form or character of the transaction. For this purpose, it is necessary to consider the entire arrangement between the parties, as determined by the contractual terms, whether written or imputed in accordance with the economic substance of the arrangement, in light of the actual conduct of the parties.

(b) Is this not the very BEPS proposal the U.S. fought (is fighting) against? We're not sure we can reconcile the two U.S. positions here and in BEPS.

(c) The preamble says this requirement is consistent with the principles underlying the arm's length standard, which require that arm's length compensation in controlled transactions equal the compensation that would have occurred if a similar transaction had occurred between similarly situated uncontrolled taxpayers.

(d) This is the very position of the pro-BEPS countries in regard to this provision. There, the U.S. disagrees. Here, Treasury and the IRS like the argument.

3. Aggregate or Separate Analysis.

(a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(B) changes (the preamble asserts this is a "clarification") Treas. Reg. § 1.482-1(f)(2)(i)(A), which provided that the combined effect of two or more separate transactions (whether before, during, or after the year under review) may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis of these transactions provides the most reliable measure of an arm's-length result determined under the best method rule of Treas. Reg. § 1.482-1(c).

(b) Specifically, a new clause was added to provide that this aggregation principle also applies for purposes of an analysis under multiple provisions of the Code or regulations. A new sentence also elaborates on the aggregation principle by noting that consideration of the combined effect of two or more transactions may be appropriate to determine whether the overall compensation is consistent with the value provided, including any synergies among items and services provided.

(c) The temporary regulation does not retain the statement in Treas. Reg. § 1.482-1(f)(2)(i)(A) that transactions generally will be aggregated only when they involve "related products or services."

(d) Curiously, the Obama Administration proposed a change in the statute to permit this type of aggregation (a "clarification" of the law said the explanation), but that proposal was never enacted. This would seem to raise some questions about Treasury and the IRS's changing the law by regulations when Congress has declined to act.

4. Aggregation and Allocation for Purposes of Coordinated Analysis.

(a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(C) provides that, for one or more controlled transactions governed by one or more provision of the Code and regulations, a coordinated best method analysis and evaluation of the transactions may be necessary to ensure that the overall value provided (including any synergies) is properly taken into account. A coordinated best method analysis of the transactions includes a consistent consideration of the facts and circumstances of the functions performed, resources employed, and risks assumed, and a consistent measure of the arm's length results, for purposes of all relevant Code and regulatory provisions.

(b) For example, situations in which a coordinated best method analysis and evaluation may be necessary include: (1) two or more interrelated transactions when either all of the transactions are governed by one regulation under § 482 or all are governed by one subsection of § 367, (2) two or more interrelated transactions governed by two or more regulations under § 482, (3) a transfer of property subject to § 367(a) and an interrelated transfer of property subject to § 367(d), (4) two or more interrelated transactions when § 367(d) applies to one transaction and the general recognition rules of the Code apply to another interrelated transaction, and (5) other circumstances in which controlled transactions require analysis under multiple Code and regulatory provisions.

(c) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(D) provides that it may be necessary to allocate the arm's length result that was properly determined under a coordinated best method analysis described in Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(C) among the interrelated transactions. An allocation must be made using the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result for each allocated amount.

5. Examples of Coordinated Best Method Analysis.

(a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(E) provides 11 examples to illustrate the new guidance. Examples 1 through 4 are materially the same as the examples in Treas. Reg. § 1.482-1(f)(2)(i)(B). Treasury and the IRS do not intend for the revisions to those examples to be interpreted as substantive. The rest of the examples are new.

(b) Example 1 is titled "Aggregation of Interrelated Licensing, Manufacturing and Selling Activities." Example 2 describes an aggregation of interrelated manufacturing, marketing and services activities. Example 3 is titled "Aggregation and Reliability of Comparable Uncontrolled Transactions," and Example 4 is described as covering non-aggregation of transactions that are not interrelated.

(c) The first new example, Example 5, is titled "Aggregation of Interrelated Patents." In the example, P owns 10 individual patents that in combination, can be used to manufacture and sell a successful product. P anticipates that it can earn \$25 from the patents based on a discounted cash flow analysis that provides a more reliable measure of the value of the patents exploited as a bundle rather than separately.

(d) P licenses all 10 patents to S-1 to be exploited as a bundle. Evidence of uncontrolled licenses of similar individual patents indicates that, exploited separately, each license of each patent would warrant a price of \$1, implying a total value for the patents of \$10. The example states that it would not be appropriate to use the uncontrolled licenses as comparables for the license of the bundle of patents, because, unlike the discounted cash flow analysis, the uncontrolled licenses considered separately do not reasonable reflect the enhancement to value resulting from the interrelatedness of the 10 patents exploited as a bundle.

(e) Example 6, "Consideration of Entire Arrangement, Including Imputed Contractual Terms," states that P contributes the foreign rights to conduct a business, including foreign rights to certain IP, to newly incorporated S-1. P treats the transaction as a transfer described in §§ 351 and 367. Subsequently, P and S-1 enter into a cost sharing arrangement. P takes the position that the only platform contribution transactions ("PCTs") in connection with the second transaction (the cost sharing agreement) consist of P's contribution of the U.S. business IP rights and S-1's contribution of the rest-of-the-world rights of which S-1 had become the owner due to the prior transaction.

(f) The example states that the IRS may consider the economic substance of the entire arrangement between P and S-1, including the parties' actual conduct throughout their relationship, regardless of the form or character of the contractual arrangement that the parties have expressly adopted. In the example, the IRS determines that the parties' formal arrangement fails to reflect the full scope of the value provided between the parties in accordance with the economic substance of their arrangement. Therefore, the

IRS may impute one or more agreements between P and S, consistent with the economic substance of their arrangement.

(g) Example 7 is titled "Distinguishing Provision of Value from Characterization." P developed a collection of resources, capabilities and rights ("Collection") that it uses on an interrelated basis in ongoing R&D. Under § 351, P transfers certain IP to S-1 related to the Collection. P claims a portion of the property (Portion 1) is subject to § 367(d), and that another portion (Portion 2) is not taxable under § 367. The new temporary regulations are applied to determine the value to P. Whether Portion 2 is characterized as "property" under § 367 is irrelevant because any value in Portion 2 must be compensated by S-1 in a manner that is consistent with the new rules.

(h) Examples 8 and 9 also involve multiple transactions regarding § 351 and a cost sharing agreement.

(i) Example 10, "Services Provided Using Intangibles," states that P's worldwide group produces and markets product X and subsequent generations of products that result from research and development activity performed by P's R&D team. Through this collaboration with respect to P's proprietary products, the members of the R&D team have individually and as a group acquired specialized knowledge and expertise subject to non-disclosure agreements.

(j) P arranges for the R&D team to provide research and development services to create a new line of products, building on the product X platform to be owned and exploited by S-1 in the overseas market. P asserts that the arm's-length charge for the services is only a reimbursement to P of its associated R&D team compensation costs.

(k) Even though P did not transfer the platform or the R&D team to S-1, P is providing value associated with the use of the platform, along with the value associated with the use of the know-how, to S-1 by way of the services performed by the R&D team for S-1 using the platform and the know-how.

(l) The example states that the R&D team's use of the intangible property, and any other valuable resources, in P's provision of services must be evaluated under the § 482 regulations, including the regulations specifically applicable to the controlled services transactions in Treas. Reg. § 1.482-9.

(m) Example 11 deals with "Allocating Arm's-Length Compensation Determined Under an Aggregate Analysis." P provides services to

S-1. P licenses intellectual property to S-2 and S-2 sublicenses the intellectual property to S-1. The example states that if an aggregate analysis of the service and license transactions provides the most reliable measure of an arm's-length result, then an aggregate analysis must be performed. If an allocation of the value that results from the aggregate analysis is necessary, for example, for purposes of sourcing the service income that P receives from S-1 or to determine the deductible expenses incurred by S-1, then the value determined under the aggregate analysis must be allocated using the method that provides the most reliable measure of the services income and the deductible expenses.

6. Effective/Applicability Dates. The regulations apply to taxable years ending on or after September 14, 2015. The preamble contains the usual caveat: No inference is intended regarding the application of the provisions amended by the temporary regulations under current law. The IRS may, when appropriate, challenge transactions, including those described in the temporary regulations, under currently applicable Code or regulatory provisions or judicial doctrines.

III. SUBPART F.

A. Subpart F Branch Rule.

1. AM 2015-002, a Chief Counsel Advice ("CCA"), addresses the § 954(d)(2) branch rule regulations and how to determine the effective foreign rates of tax under the tax-rate disparity test.

2. The CCA states the issue as: "What is the most appropriate method of calculating the actual effective rate of tax and the hypothetical effective rate of tax for purposes of determining whether there is a rate disparity pursuant to the regulations under § 954(d)(2) in the case of property manufactured by a CFC?"

3. The CCA concludes: "In the case of property manufactured by a CFC, the most appropriate method of calculating the actual effective rate of tax and the hypothetical effective rate of tax is to divide the actual tax and the hypothetical tax by the hypothetical tax base determined under the laws of the manufacturing jurisdiction."

4. In year 1, CFC, a controlled foreign corporation incorporated in Country B, purchased raw materials from an unrelated supplier and used them to manufacture (under the principles of Treas. Reg. § 1.954-3(a)(4)) Product X in Country B. DE is the wholly owned subsidiary of CFC and is treated as a disregarded entity under the check-the-box regulations. DE is located in Country A and does not engage in any manufacturing activities.

5. DE derives 100x of commission income in connection with the sale of Product X by CFC to unrelated customers located outside of Country A and Country B. DE incurs 30x of sales expenses related to the sale of Product X. CFC has no other income that would constitute foreign base company income under § 954.

6. Countries A and B both impose a 20% statutory rate of tax on sales income. Country A allows DE to exclude half of its income from the sale of products manufactured and sold for use outside of Country A. Country B does not tax DE's sales income until it is remitted to CFC as a dividend. Both Country A and Country B would allow a 30x deduction for the sales expenses. DE paid 4x of income tax in Country A in year 1.

7. <u>What's a branch</u>? The CCA states that for federal income tax purposes, DE is treated as a branch or division of CFC. While perhaps not an issue in the CCA, we would note that significant additional analysis could be necessary in reaching this conclusion. Under former Treas. Reg. § 1.963-1(f)(4), for example, a branch (at least for purposes of former § 963) was defined to mean "a permanent organization maintained in a foreign country or possession…to engage in the active conduct of a trade or business." That regulation also stated that as a general rule, "a permanent organization shall be considered to be maintained in such a country or possession if the U.S. shareholder maintains there in a significant workforce or significant manufacturing, mining, warehousing, sales, office or similar business facilities of a fixed or permanent nature." The examples indicated that a significant workforce was necessary as well as significant facilities. In one of the examples, a few clerical employees did not give rise to a branch.

8. Under *Ashland Oil v Commissioner*, 95 T.C. 348 (1990), the term "branch" for branch rule purposes similarly is to be construed using its customary and normal business meaning: "a division, office or other unit of business located at a different location from [the] main office or headquarters." *Ashland* also held that the term "similar establishment" means "an establishment that bears the typical characteristics of an ordinary-usage branch, yet goes by another name for accounting, financial reporting, local law or other purposes." See also *Vetco v Commissioner*, 95 T.C. 579 (1990). *Vetco*, interestingly, also cited former Treas. Reg. § 1.963-1(f)(4)(i), discussed above.

9. <u>Selling activities</u>. A second, separate analysis also is necessary before engaging in a branch-rule tax-rate comparison. A branch can give rise to branch-rule issues only if the branch performs selling activities (or if the remainder does so under the manufacturing branch rule). The CCA states that DE could either purchase Product X from CFC and sell it to unrelated customers at a markup or receive commissions from CFC *ostensibly* for facilitating sales from CFC to unrelated customers, without taking title to

Product X. It is not clear what "ostensibly for facilitating sales" means. Are these commissions paid for DE's performing selling activities? Do the activities in "facilitating sales" constitute the required "selling activities"?

10. Under TAM 8509004, the following activities do not constitute selling activities: (1) "management personnel charged with the responsibility of supervising various aspects of the business," and (2) "market research activities, such as forecasting demand of new markets and analysis of methods of financing export sales."

11. In *Ashland Oil*, the Tax Court considered the dictionary definition of the term "branch" in determining its customary and normal business meaning. A California case similarly looked to the dictionary to determine the common usage of the terms "selling" and "selling activity." The State Board of Equalization in *Barnes & Noble.com*, September 12, 2002, after considering the dictionary's definition, held that selling is "inclusive of all activities that are an integral part of making sales." This includes "offering for sale" and "solicitation." The term "selling," in the Board's view, is not synonymous with the term "sale." *See also Borders Online.com*, State Board of Equalization, September 26, 2001. The California Court of Appeals subsequently affirmed this interpretation (although *Barnes & Noble* itself was reversed by a lower court on a different issue).

12. These items would seem to put into question the CCA's use of the term "facilitating sales." Is this activity, which is not further described in the CCA, an "integral part" of making the sales? The answer is not apparent from the CCA.

13. <u>Tax-rate test</u>. In any event, we now turn to the CCA's discussion of the tax-rate test. The CCA quotes Treas. Reg. § 1.954-3(b)(1)(i)(b):

> "The use of the branch or similar establishment for such activities will be considered to have substantially the same tax effect as if it were a wholly owned subsidiary corporation of the controlled foreign corporation if [that income derived by the branch or similar establishment from the purchase or sale of personal property on behalf of a related person] is, by statute, treaty obligation, or otherwise, taxed in the year when earned at an effective rate of tax [(the "actual effective rate of tax")] that is less than 90 percent of, and at least 5 percentage points less than, the effective rate of tax [(the "hypothetical effective rate of tax")] which would apply to such income under the laws of the country in which the controlled foreign corporation is created or organized if, under the laws of such country, the entire income of the controlled foreign corporation were considered derived by the controlled foreign corporation from sources within such

> country from doing business through a permanent establishment therein, received in such country, and allocable to such permanent establishment, and the corporation were managed and controlled in such country."

14. The quote above applies under the sales-branch rules. The tax-rate disparity test that applies under the manufacturing-branch rules compares the actual effective rate of tax in the CFC's country of organization to the hypothetical effective rate of tax in the manufacturing branch's location. Branch-to-branch tax-rate comparisons also can result under those rules, depending upon where the selling activities are located.

15. The tax-rate disparity test compares the effective rate of tax that applied or would apply to the income from certain sales transactions in two different countries, states the CCA. For the comparison to be meaningful, an appropriate common tax base must be used to calculate the actual effective tax rate and the hypothetical effective tax rate. Computing the actual and hypothetical effective tax rates with respect to dissimilar tax bases would be contrary to the legislative purpose of § 954(d), states the CCA. It would ignore the incentive to shift income from the manufacturing jurisdiction to a sales jurisdiction that grants exclusions and deductions to achieve a smaller tax base.

16. Thus, the most appropriate method of computing the actual effective tax rate and the hypothetical effective tax rate, states the CCA, is to use the hypothetical sales income tax base in the manufacturing jurisdiction (the "hypothetical tax base") as a common denominator to determine the difference in the effective tax rates on the sales income shifted from the manufacturing jurisdiction.

17. The CCA calculates the tax rate disparity in five steps. First, the relevant income must be identified. The relevant income on which the tax-rate disparity test is based is the sales branch's gross income derived in connection with the sale of property sold on behalf of the CFC. Second, the actual rate of tax (in Country A) must be determined. Third, the hypothetical tax base must be determined by calculating the amount of gross income that hypothetically would be subject to income tax in the CFC's jurisdiction (Country B). This requires applying the income assumptions set forth in the regulation (above). The gross income determined by applying the special rules in the branch rule regulation is reduced by exclusions and deductions that would be permitted under laws of the country in which the property is manufactured (Country B). Fourth, the hypothetical tax base is multiplied by the applicable marginal tax rates in the CFC's country of incorporation (the manufacturing jurisdiction) to yield the hypothetical tax. Finally, the hypothetical tax and actual tax paid are each divided by the hypothetical tax base to determine the effective

rates of tax that will be compared for purposes of determining whether there is a tax rate disparity.

18. Based on the facts set forth in the CCA, DE derives 100x of gross income in connection with the sale of Product X. Thus, the relevant gross income is 100x. The actual tax rate paid or incurred in Country A must be determined. Under the facts set forth in the CCA, the actual tax paid or incurred in Country A is 4x. DE has 100x of gross income less an exclusion of 50x and a deduction for sales expenses of 30x. Country A taxable income is 20x. The statutory rate is 20%. Tax is 4x.

19. Next, the hypothetical tax base must be determined. The hypothetical tax base is 70x, calculated by starting with the 100x of gross income and deducting the 30x of sales expenses that are allocable and apportionable to the gross income under Country B's laws. The hypothetical tax that would have been incurred had the income been derived in Country B is calculated as follows: 100x – 30x sales expenses = hypothetical tax base of 70x. 70x times the statutory rate of 20% equals 14x in hypothetical tax.

20. The actual tax of 4x over 70x equals an actual tax rate of 5.71%. The hypothetical effective rate of tax is 14x over 70x equals 20%.

21. Thus, on these facts the branch rule will apply as the actual tax in Country A (the sales jurisdiction) is less than 90% of, and at least 5 percentage points below, the hypothetical effective tax rate in Country B (the manufacturing jurisdiction).

22. Previous regulation erroneously was deleted. Hypothetical tax rate issues used to be covered in the Subpart F regulations. They were covered in previous Treas. Reg. § 1.954-3(b)(2)(i)(d). That regulation said that "In determining the hypothetical effective rate of tax, the principles of Treas. Reg. § 1.954-1(b)(4)(ii) shall be used to determine the hypothetical tax rate." The cross-referenced regulation subsequently was renumbered Treas. Reg. § 1.954-1(b)(3)(iv).

23. The cross-referenced regulation was entitled "Determination of Hypothetical Tax." It stated, among other things, that the hypothetical tax shall be computed on the basis of the actual facts concerning the corporation (except for the assumptions made with respect to source, receipt and allocation of income, type of establishment, etc.) and by deducting from such item of income all deductions allocable thereto other than income, war profits, and excess profits or similar taxes.

24. The regulation stated that if the laws of the country impose a graduated rate of income tax on the income of corporations, the tax shall be computed on the basis of the amount of the corporation's income which would be taken into account for the taxable year in determining the tax

under the assumptions but otherwise using the actual facts concerning the corporation.

25. The regulation also provided that if the effective rate of tax which that country imposes differs from class-to-class of income (whether because the law of the country prescribes a different rate for each class or does so in effect by prescribing special deductions or credits with respect to that class), the tax in respect of the item of income shall be computed on the basis of the tax which under the assumptions would have been imposed for the taxable year on the class containing that item but otherwise using the actual facts concerning the corporation.

26. The regulation stated that if the rate of tax imposed by the country on a corporation with respect to income not distributed differs from the rate with respect to its distributed income, the tax in respect of the item of income shall be computed at the effective rate of tax applicable to such corporation for the taxable year, computed on the basis of the assumptions and the distributions actually made for such year by the corporation.

27. In adopting the modified branch rule regulations in 2008, Treasury and the IRS seemingly inadvertently dropped that cross-reference. Today, Treas. Reg. § 1.954-3(b)(2)(i)(d) is marked "reserved." We never understood the reason for deleting the cross-reference since the guidance for determining the hypothetical tax rate was very important.

28. By deleting this important cross-reference, the Service was left with a need to issue rulings addressing the matter on a case-by-case basis. For example, LTRs 200942034 and 200945036 involved issues such as the treatment of a disregarded note (holding that it should be taken into account since it's regarded in the foreign country), a deemed deduction on net equity, and the existence of a foreign advance pricing agreement.

29. These issues all would seem to have been addressed in the previous regulation (that is, use the "actual facts").

30. It would be helpful if the Service were to modify Treas. Reg. § 1.954-3(b)(2)(i)(d) to remove the "reserved" label and insert a rule with respect to determining hypothetical tax. The previous regulation's reference to using the "actual facts" by itself was a helpful directive. There should not be a need to issue rulings and chief counsel advices from time to time addressing the issue on a case-by-case basis.

B. <u>§ 956 Anti-Avoidance Rule: Temporary Regulations</u>.

1. Temp. Treas. Reg. § 1.956-1T(b)(4) contains a § 956 anti-avoidance rule. Previously, the rule provided that at the IRS's discretion, a CFC will be considered to hold indirectly investments in U.S. property acquired by any other foreign corporation that is controlled by the CFC if one of the

principal purposes for creating, organizing, or funding (through capital contributions or debt) the other foreign corporation is to avoid the application of § 956 regarding the CFC.

2. As modified, the rule can also apply when a foreign corporation controlled by a CFC is funded other than through capital contributions or debt. The new temporary regulation provides that for purposes of § 956, U.S. property held indirectly by a CFC involves:

   (a) United States property acquired by any other foreign corporation that is controlled by the CFC if a principal purpose of creating, organizing or funding by any means (including through capital contributions or debt) the other foreign corporation is to avoid the application of § 956 with respect to the CFC; and

   (b) Property acquired by a partnership that is controlled by the CFC if the property would be U.S. property if held directly by the CFC, and a principal purpose of creating, organizing or funding by any means (through capital contributions or debt) the partnership is to avoid the application of § 956 with respect to the CFC.

3. The temporary regulation adds an example involving the funding of one CFC by another CFC that controls it to illustrate the application of the anti-avoidance rule when the principal purpose for funding the first CFC is to avoid the application of § 956 regarding the funding CFC, even though there would be a § 956 inclusion related to the CFC that received the funding.

4. The example illustrates that the CFCs' tax attributes associated with § 956 inclusion (such as total earnings and profits, previously taxed earnings and profits, and foreign tax pools) are taken into account in determining whether a principal purpose of funding was to avoid the application of § 956 with respect to the funding CFC. The example also clarifies that if the CFC is considered to indirectly hold U.S. property pursuant to Temp. Treas. Reg. § 1.956-1T(b)(4), then the CFC that actually holds the U.S. property will not be considered to hold the property for purposes of § 956.

5. Previously, the temporary Treasury regulation applied if "one of the principal purposes" for the transaction was to avoid the application of § 956 with respect to the CFC. As modified, the temporary regulation applies when "a principal purpose" for the transaction is to avoid the application of § 956 with respect to the CFC. Treasury and the IRS do not view this modification as a substantive change, since both formulations appropriately reflect that there may be more than one principal purpose for a transaction.

6. Treasury and the IRS also believe the regulation should apply without requiring the IRS to exercise its discretion, and, therefore, modified the rule so that it is now self-executing.

7. The preamble also says that Treasury and the IRS "understand" that taxpayers may be using partnerships to structure transactions that are similar to the types of transactions addressed by the anti-abuse rule. For example, with a principal purpose of avoiding the application of § 956, a CFC might contribute cash to a partnership in exchange for an interest in the partnership, which in turn lends the cash to a U.S. shareholder of the CFC. In such a case, the shareholder may take the position that the CFC is not treated as indirectly holding the entire obligation of the U.S. shareholder but instead is treated as holding the obligation only to the extent of the CFC's interest in the partnership under Treas. Reg. § 1.956-2(a)(3). The new temporary regulation's provision applicable to partnerships will apply only to the extent that the amount of U.S. property that a CFC would be treated as holding under the new rule exceeds the amount that it would be treated as holding under Treas. Reg. § 1.956-2 (a)(3).

8. Treasury and the IRS also understand that CFCs are engaging in transactions in which a CFC lends funds to a foreign partnership, which then distributes the proceeds from the borrowing to a U.S. partner that is related to the CFC and whose obligation would be U.S. property if it were held (or treated as held) by the CFC. Alternatively, the CFC could guarantee a loan to the foreign partnership, which then would distribute the loan proceeds to a related U.S. partner. Treasury and the IRS are concerned that these taxpayers take the position that § 956 does not apply to these transactions even though the CFC's earnings are effectively repatriated to a related U.S. partner.

9. In response to these transactions, the temporary regulations add § 1.956-1T(b)(5) to address cases in which a CFC funds a foreign partnership (or guarantees a borrowing by a foreign partnership) and the foreign partnership makes a distribution to a U.S. partner that is related to the CFC.

10. For purposes of § 956, new Temp. Treas. Reg. § 1.956-1T(b)(5) treats the partnership obligation as an obligation of the distributee partner to the extent of the lesser of the amount of the distribution that would not have been made but for the funding of the partnership or the amount of the foreign partnership obligation. For example, if a related U.S. shareholder of a CFC has an interest in a foreign partnership, the CFC lends $100 to the partnership, and the CFC distributes $100 to the U.S. shareholder in a distribution that would not have been made but for the loan from the CFC, then the entire $100 partnership obligation held by the CFC will be treated as an obligation of the U.S. shareholder that constitutes U.S. property.

11. The rules in Temp. Treas. Reg. § 1.956-1T(b)(4) apply to taxable years of CFCs ending on or after September 1, 2015, and to taxable years of U.S. shareholders in which or with which such taxable years end, with respect to property acquired, including property treated as acquired as a result of a deemed exchange of property pursuant to § 1001, on or after September 1, 2015.

12. The rule in Temp. Treas. Reg. § 1.956-1T(b)(5) (regarding partnerships) applies to taxable years of CFCs ending on or after September 1, 2015, and to taxable years of U.S. shareholders in which or with which such taxable years end, in the case of distributions made on or after September 1, 2015.

13. The preamble states that no inference is intended as to the application of the provisions amended by these provisions under current law. The IRS may, where appropriate, challenge transactions, including those described in these temporary regulations under currently applicable Code or regulatory provisions or judicial doctrines.

C. <u>Section 956 Proposed Regulations</u>.

1. <u>Obligations of Foreign Partnerships</u>.

(a) The IRS and Treasury sought comments regarding whether the rules under § 956 should treat an obligation of a foreign partnership held by a CFC as an obligation of a foreign person, rather than as an obligation of its partners, including any partners that are U.S. persons. The comments noted that the inclusion of a domestic partnership in the definition of U.S. in § 7701 causes an obligation of a domestic partnership to be treated as an obligation of a U.S. person for purposes of § 956. Thus, comments asserted that § 956 implicitly treats both domestic and foreign partnerships as entities, rather than as aggregates of their partners, for purposes of determining whether an obligation of a partnership is U.S. property. As a result, an obligation of a foreign partnership with one or more partners that are U.S. persons should not be treated as an obligation of a U.S. person for purposes of § 956.

(b) The preamble to the proposed regulations states that § 956 is intended to prevent a U.S. shareholder of a CFC from inappropriately deferring U.S. taxation of CFC earnings by preventing the repatriation of income to the U.S. in a manner that does not subject it to U.S. tax. In the absence of § 956, a U.S. shareholder of a CFC could access the CFC's funds (untaxed earnings and profits) in a variety of ways other than by payment of an actual taxable dividend. Absent § 956, there would be no reason for the U.S. shareholder to incur a dividend tax. Section

956 ensures that, to the extent CFC earnings are made available for use in the U.S. or for use by a U.S. shareholder, the U.S. shareholder of the CFC is subject to current U.S. tax with respect to these amounts.

(c) Treasury and the IRS have determined that failing to treat an obligation of a foreign partnership as an obligation of its partners would allow deferral of U.S. taxation of CFC earnings and profits in a manner inconsistent with the purposes of § 956. When a U.S. shareholder can conduct operations through a foreign partnership using deferred CFC earnings, those earnings effectively have been made available to the U.S. shareholder. Additionally, states the preamble, because assets of a partnership generally are available to the partners without additional U.S. tax, a U.S. shareholder could directly access deferred CFC earnings lent to a foreign partnership in which the U.S. shareholder is a partner without those earnings becoming subject to current U.S. tax by causing the partnership to make a distribution.

(d) In light of these considerations, the proposed regulations treat an obligation of a foreign partnership as an obligation of its partners for purposes of § 956, subject to a minor exception for obligations of foreign partnerships in which neither the lending CFC nor any person related to the lending CFC is a partner (*see* § 956(c)(2)(L)). More specifically, Prop. Treas. Reg. § 1.956-4(c)(1) generally treats an obligation of a foreign partnership as an obligation of the partners to the extent of each partner's share of the obligation as determined in accordance with the partner's interest in partnership profits.

(e) Treasury and the IRS considered various methods for determining a partner's share of a partnership obligation, including the regulations under § 752, the liquidation value percentage, and the partner's interest in partnership profits. They believe that using the partner's interest in partnership profits to determine a partner's share of a partnership obligation is consistent with the observation that, to the extent the proceeds of a partnership borrowing are used by the partnership to invest in profit-generating activities, partners in the partnership (including service partners with limited or no partnership capital) will benefit from the partnership obligation to the extent of their interests in the partnership profits. They also believe this will make the rule more administrable. However, Treasury and the IRS solicited comments in this regard.

(f) The determination of a partner's share of the obligation will be made as of the close of each quarter of the CFC's taxable year in connection with the calculation of the amount of U.S. property held by the CFC for purposes of § 956. Thus, for example, if a partner in a foreign partnership is a U.S. shareholder of a CFC, an obligation of the partnership that is held by the CFC will be treated as U.S. property to the extent of the U.S. shareholder partner's share of the obligation as determined in accordance with the partner's interest in partnership profits as of the close of each quarter of the CFC's taxable year.

(g) The new rule also applies to determine the extent to which a CFC guarantees or otherwise supports an obligation of a related U.S. person when the related U.S. person is a partner in a foreign partnership that incurred the obligation that is the subject of the CFC's credit enhancement. Similarly, if a CFC is a partner in a foreign partnership that owns property that would be U.S. property if held by the CFC, and the property is subject to a liability that would constitute a specific charge within the meaning of Treas. Reg. § 1.956-1(e)(1), the CFC's share of the liability, as determined under proposed Treas. Reg. § 1.956-4(c)(1), would be treated as a specific charge that, under Treas. Reg. § 1.956-1(e)(1), could reduce the amount taken into account by the CFC in determining the amount of its share of U.S. property.

(h) This newly proposed approach to partnerships and § 956 raises important legal issues. If the foreign partnership is a limited liability entity treated as a partnership for U.S. tax purposes, such as an entity to which a check-the-box election applies, assuming those entities are subject to the new rule, then the partners do not have liability for the partnership's liabilities. In such a case, there is no "obligation of a U.S. person" to which § 956 could apply. Can there even be a § 956 obligation in that case? Can Treasury and the IRS's policy concerns override the clear statutory language? This is discussed further below in the context of disregarded entities.

(i) The newly proposed rule also doesn't consider whether the funds were distributed to the U.S. partner. What if the foreign partnership is a large operating company that borrowed the money to use in its business? Can there even be a § 956 policy concern in that case?

(j) In a NYS Bar Association Tax Section ("NYSBA") commentary dated June 30, 2006, the NYSBA recommended that subject to an exception, a loan by a CFC to a related foreign partnership should not be treated as an investment in U.S. property for § 956 purposes (irrespective of whether the partners in the foreign partnership are U.S. or foreign persons) if the loan proceeds are not invested in U.S. property or otherwise distributed to any U.S. partners in the partnership. A loan by a CFC to a foreign partnership, however, should be treated as an investment in U.S. property for purposes of § 956 if the loan would be treated under general U.S. federal income tax principles (such as "Plantation Patterns") as made to a U.S. partner of the foreign partnership that is a U.S. shareholder of the CFC.

(k) On a different point, one commentator said that if a U.S. shareholder of a CFC is a partner in a foreign partnership and is treated as having an inclusion under § 956 when the CFC makes a loan to the partnership and that partner later receives an actual distribution from the partnership, the partner could have an inappropriate second inclusion later when it is deemed to receive a distribution from the partnership upon the partnership's repayment of the loan. The second inclusion could arise under Subchapter K to the extent the partner is required to reduce its basis in its partnership interest on the actual distribution and again reduce its basis as a result of the deemed distribution under § 752(b) when its share of the loan is repaid. If the distributions succeed the partner's basis in the partnership, including the increase to basis under § 752(a) when the partnership originally incurred the obligation, the partner could recognize gain under § 731. The commenter suggested that having inclusions under both § 956 and Subchapter K would be inappropriate.

(l) In considering this comment, Treasury and the IRS concluded that the proposed regulations and the existing rules under Subchapter K and § 959 provide the appropriate result in that fact pattern. The potential for gain under Subchapter K exists regardless of the application of § 956. In the view of Treasury and the IRS, the required inclusion under the proposed regulations to the extent a CFC is treated as holding an obligation of a U.S. person reflects policy considerations distinct from the policy considerations underlying the potential results under Subchapter K. Moreover, in the fact pattern, the U.S. property held by the CFC in connection with its loan to the partnership generates previously taxed earnings and profits under § 959 and, in general, those earnings and profits are available for distribution by the CFC to its U.S. shareholder without further U.S. tax on the distributed amount.

2. Special Rule in the Case of Certain Distributions.

(a) The proposed regulations contain a provision that would increase the amount of a foreign partnership obligation that is treated as U.S. property under the general rule when the following requirements are satisfied: (1) a CFC lends funds (or guarantees a loan) to a foreign partnership whose obligation is, in whole or in part, U.S. property with respect to the CFC pursuant to proposed Treas. Reg. § 1.956-4(c)(1); (2) the partnership distributes the proceeds to a partner that is related to the CFC (within the meaning of § 954(d)(3)) and whose obligation would be U.S. property if held by the CFC; (3) the foreign partnership would not have made the distribution but for a funding of the partnership through an obligation held (or treated as held) by the CFC; and (4) the distribution exceeds the partner's share of the partnership obligation as determined in accordance with the partner's interest in partnership profits.

(b) When these requirements are satisfied, proposed Treas. Reg. § 1.956-4(c)(3) provides that the amount of the partnership obligation that is treated as an obligation of the distributee partner (and thus as U.S. property held by the CFC) is the lesser of the amount of the distribution that would not have been made but for the funding of the partnership and the amount of the partnership obligation.

(c) For example, assume a U.S. shareholder of a CFC that is related to the CFC within the meaning of § 954(d)(3) has a 60% interest of the profits of the foreign partnership and the CFC lends $100 to the partnership. If the partnership in turn distributes $100 to the U.S. shareholder in a distribution that would have not been made but for the funding of the CFC, the CFC will be treated as holding U.S. property in the amount of $100.

(d) Temp. Treas. Reg. § 1.956-1T(b)(5), discussed in the previous section above, also addresses this funded distribution fact pattern. That temporary regulation also provides that the obligation of the foreign partnership is treated as an obligation of the distributee partner when similar conditions are satisfied. Treasury and the IRS expect to withdraw Temp. Treas. Reg. § 1.956-1T(b)(5) as unnecessary when proposed Treas. Reg. § 1.956-4(c), including proposed Treas. Reg. § 1.956-4(c)(3), is adopted as a final regulation.

3. Pledges and Guarantees.

(a) Treas. Reg. § 1.956-2(c)(1) provides that, subject to an exception, any obligation of a U.S. person with respect to which a CFC is a pledgor or a guarantor is considered for purposes of § 956 to be U.S. property held by the CFC. This rule will be revised to clarify that the CFC that is a pledgor or guarantor of an obligation of a U.S. person is treated as holding the obligation. Accordingly, under the proposed rule, the general exceptions to the definition of

U.S. property would apply to the obligation treated as held by the CFC.

(b) The proposed regulations provide that the pledge and guarantee rules under Treas. Reg. § 1.956-2(c) apply to a CFC that directly or indirectly guarantees an obligation of a foreign partnership that is treated as an obligation of a U.S. person under proposed Treas. Reg. § 1.956-4(c). Accordingly, if an obligation of a foreign partnership is treated as an obligation of a U.S. person pursuant to the proposed regulation and the CFC directly or indirectly guarantees the partnership obligation, the CFC will be treated as holding an obligation of the U.S. person.

(c) The proposed regulations also extend the pledge and guarantee rule in Treas. Reg. § 1.956-2(c)(1) to pledges and guarantees made by partnerships. Thus, proposed Treas. Reg. § 1.956-2(c)(1) provides that a partnership that guarantees an obligation of a U.S. person will be treated as a holding the obligation for purposes of § 956. As a result, proposed Treas. Reg. § 1.956-4(b) will then treat the partners of the partnership that is the pledgor or guarantor as holding shares of that obligation. For example, if a partnership with one CFC partner guarantees an obligation of the CFC's U.S. shareholder, the CFC will be treated as holding a share of the obligation under the proposed regulations.

(d) Under current Treas. Reg. § 1.956-2(c)(2), a CFC is treated as a pledgor or guarantor of an obligation of a U.S. person if its assets serve at any time, even though indirectly, as security for the performance of the obligation. Consistent with this rule, a partnership should be considered a pledgor or guarantor of an obligation of a U.S. person if the partnership's assets serve indirectly as security for the performance of the obligation, for example, because the partnership agrees to purchase the obligation at maturity if the U.S. person does not repay it. Thus, proposed Treas. Reg. § 1.956-2(c)(2) applies the indirect pledge or guarantee rule to domestic and foreign partnerships.

(e) In the case of a partnership that is considered a pledgor or guarantor of an obligation under the proposed regulations, Treasury and the IRS believe it would not be appropriate to separately apply the existing Treasury regulation directly to a CFC partner in the partnership to treat the partner as a pledgor or guarantor (in addition to treating the partnership as a pledgor or guarantor) solely as a result of the partnership's indirect pledgor guarantee. Therefore, proposed Treas. Reg. § 1.965-2(c)(2) provides that when a partnership is considered a pledgor or guarantor of an obligation, a CFC that is a partner in the partnership will not be treated as a pledgor or guarantor of the obligation solely as a result of its ownership of an interest the partnership. Accordingly, the CFC will be treated under the proposed regulations as holding its share of the obligation to which the pledge or guarantee relates but will not also be treated as a separate and direct pledgor or guarantor of the obligation.

(f) As discussed above, an obligation of a foreign partnership generally is treated as an obligation of the partners in the partnership. A partner in a partnership is treated as holding its attributable share of property held by the partnership. The application of these two rules in the proposed indirect pledge or guarantee rule could create uncertainty. For example, if a CFC and related U.S. person were the only partners in a foreign partnership that borrowed from a person unrelated to the partners, an issue could arise as to whether the partnership assets attributed to the CFC under proposed Treas. Reg. § 1.956-4(b) are considered under proposed § 1.956-2(c)(2) to indirectly serve as security for the performance of the portion of the partnership obligation that is treated as an obligation of the U.S. person.

(g) Treasury and the IRS believe that a CFC that is a partner in a partnership should not be treated as a pledgor or guarantor of an obligation of the partnership merely because the CFC partner is treated under the proposed regulations as owning a portion of the partnership assets that support the obligation that is allocated to a partner that is a U.S. person. Accordingly, proposed Treas. Reg. § 1.956-4(d) provides that, for purposes of § 956 and the proposed regulations, if the CFC is a partner in a partnership, the attribution of assets of the partnership to the CFC under the proposed regulations does not in and of itself give rise to an indirect pledge or an indirect guarantee of an obligation of the partnership that is allocated under proposed Treas. Reg. § 1.956-4(c) to a partner that is a U.S. person.

(h) The preamble states that this rule is consistent with the new rule under proposed Treas. Reg. § 1.956-2(c)(2) providing that a CFC that is a partner in a partnership will not be treated, solely as a result of its interest in the partnership, as a pledgor or guarantor of an obligation with respect to which the partnership is considered to be a pledgor or guarantor. However, the determination of whether a CFC's assets serve as security for the performance of an obligation for purposes of proposed Treas. Reg. § 1.956-2(c)(2) is based on all facts and circumstances. In appropriate circumstances, states the preamble, the existence of other factors, such as the use of proceeds from a partnership borrowing, the use of partnership assets as security for a partnership borrowing, or special allocations of partnership income or gain, may result in a CFC partner being considered a pledgor or guarantor of an obligation of the partnership pursuant to proposed Treas. Reg. § 1.956-2(c)(2) when taken into account in conjunction with the attribution of the assets of the partnership to the CFC.

(i) Under current Treas. Reg. § 1.956-1(e)(2), the amount taken into account by a CFC in determining the amount of its U.S. property with respect to a pledge or guarantee described in Treas. Reg. § 1.956-2(c)(2) is the unpaid principal amount of the obligation with respect to which the CFC is a pledgor or guarantor. In connection with the proposed revision to Treas. Reg. § 1.956-2(c)(1), which treats a partnership as holding an obligation with respect to which it is a pledgor or guarantor, the proposed regulations would revise Treas. Reg. § 1.956-1(e)(2) to also apply in cases in which partnerships are pledgors or guarantors of an obligation.

(j) Accordingly, under proposed Treas. Reg. § 1.956-1(e)(2), as under current law, each pledgor or guarantor is treated as holding the entire unpaid principal amount of the obligation to which its pledge and guarantee relates. As a result, in cases in which there are, regarding a single obligation, multiple pledgors or guarantors that are CFCs or partnerships in which a CFC is a partner, the aggregate amount of U.S. property treated as held by CFCs may exceed the unpaid principal amount of the obligation. To the extent that the CFCs have sufficient earnings and profits, there could be multiple § 951 inclusions with respect to the same obligation that exceed, in the aggregate, the unpaid principal amount of the obligation.

(k) Treasury and the IRS are considering whether to exercise the authority granted under § 956(e) to prescribe regulations as may be necessary to carry out the purposes of § 956 to allocate the amount of the obligation among the relevant CFCs so as to eliminate the potential for multiple inclusions and, instead, limit the aggregate inclusions to the unpaid principal amount of the obligation. Comments were requested.

(l) Alternatively, Treasury and the IRS could seek to establish a generally applicable method for allocating unpaid principal amount of the obligation among the various grantors. Allocating the unpaid principal amount of the obligation among multiple CFCs and partnerships in accordance with their available credit capacities, measured, for example, by relative net values of their assets might be broadly consistent with a creditor's analysis of the support for the obligation but such an approach would give rise to administrability concerns. A more administrable option would be to require taxpayers to allocate the unpaid principal amount based on the earnings and profits of the CFCs that are treated as holding the obligation (or a portion thereof). Several other alternative methods based on earnings and profits also might be possible.

(m) In considering options, Treasury and the IRS will consider whether it is appropriate to select a method that could result in an aggregate § 951 inclusions for a year totaling less than the unpaid principal amount of the obligation, the extent to which a particular method creates planning opportunities inconsistent with the policies underlying §§ 956 and 959, and how administrable and effective the method is over multiple years.

4. Partnership Property Indirectly Held by a CFC Partner.

(a) Under current Treas. Reg. § 1.956-2(a)(2), if a CFC is a partner in a partnership that holds property that would be U.S. property if held directly by the CFC partner, the CFC partner is treated as holding an interest in the property based on its interest in the partnership. The proposed regulations provide rules on the determination of the amount that the CFC partner is treated as holding under this rule, which is redesignated under the proposed regulations as Prop. Treas. Reg. § 1.956-4(b).

(b) Under proposed Treas. Reg. § 1.956-4(b), a CFC partner will be treated as holding its share of partnership property determined in accordance with the CFC partner's liquidation value percentage, taking into account any special allocation of income, or, where appropriate, gain from that property that is not disregarded or reallocated under § 704(b) or any other Code section, regulation, or judicial doctrine that does not have a principal purpose of avoiding the purposes of § 956. Treasury and the IRS believe this rule serves, in general, as a reasonable measure of a partner's interest in property held by a partnership because it generally results in an allocation of specific items of property that corresponds with each partner's economic interest in that property, including any income, or gain, that might be subject to special allocations.

(c) The proposed regulations include examples illustrating the application of the proposed rule, including an example that illustrates a case in which it is appropriate to take into account the special allocation of gain because the property is anticipated to appreciate in value but generate relatively little income. Although proposed Treas. Reg. § 1.956-4(b) would apply only to property acquired on or after publication of the Treasury Decision adopting the rule as a final regulation, the preamble states that it generally would be reasonable to use the method set forth in the proposed regulation to determine the partners interest in property acquired prior to finalization as well.

(d) Although the method provided by the proposed regulations generally should reflect the partner's economic interest in partnership property, Treasury and IRS requested comments on whether there may be situations in which the method would not reflect the partners' economic interest in the partnership or its property.

5. Trade or Service Receivables.

(a) Section 956(c)(3) provides that U.S. property generally includes trade or service receivables acquired from related U.S. persons in a factoring transaction when the obligor with respect to the receivables is a U.S. person. Temp. Treas. Reg. § 1.956-3T(b)(2) provides rules for determining when a trade or receivable has been indirectly acquired from a related U.S. person for purposes of § 956(c)(3). These provisions include a rule that applies to receivables held on a CFC's behalf by a partnership in which the CFC owns (directly or indirectly) a beneficial interest. This rule is similar to the rule in both current Treas. Reg. § 1.956-2(a)(3) and proposed Treas. Reg. § 1.956-4(b). Temp. Treas. Reg. § 1.956-3T(b)(2) also includes a rule that applies to receivables held on a CFC's behalf by another foreign corporation controlled by the CFC if one of the principal purposes for creating, organizing, or funding the other foreign corporation (through capital contributions or debt) is to avoid the application of § 956.

(b) Treasury and the IRS believe that the rules in Temp. Treas. Reg. § 1.956-3T(b)(2)(ii) applicable to factoring transactions involving partnerships should be consistent with the rules provided in Temp. Treas. Reg. § 1.956-1T(b)(4) and proposed Treas. Reg. § 1.956-4(b), which generally apply when partnerships own property that would be U.S. property in the hands of a CFC partner. Accordingly, Treasury and the IRS propose to revise the rules governing factoring transactions so that rules similar to the rules in Temp. Treas. Reg. § 1.956-1T(b)(4) and proposed Treas. Reg. § 1.956-4(b) apply to factoring transactions involving partnerships. These proposed regulations also would revise the rules governing factoring transactions to remove the reference to S corporations, which are treated as partnerships for purposes of Subpart F, including § 956. *See* § 1373(a).

6. Disregarded Entities.

(a) Treasury and the IRS understand that issues have arisen as to the proper treatment under § 956 of obligations of entities that are disregarded as entities separate from their owner for federal tax purposes. Accordingly, the proposed regulations state explicitly in proposed Treas. Reg. § 1.956-2(a)(3) that, for purposes of § 956, an obligation of a disregarded entity is treated as an obligation of the owner of the disregarded entity. Thus, for example, an obligation of a disregarded entity that is owned by a domestic corporation is treated as an obligation of the domestic corporation for purposes of § 956. The rule in proposed Treas. Reg. § 1.956-2(a)(3) follows from an application of the check-the-box rules, and, states the preamble, is therefore not a change from current law.

(b) This newly proposed rule, which the preamble states is not a change from current law, raises a number of issues. Does it matter if the owner of the disregarded limited-liability entity is not liable at law for repayment? That is, the foreign disregarded entity might be a limited-liability entity. After all, an "obligation of a U.S. person" is necessary to trigger operation of the statute.

(c) What if the borrowed funds remain with the disregarded entity, are used in its business like bank-loan proceeds, and are paid back with funds earned by the disregarded entity? Should a § 956 investment result if the borrowed funds or comparable amounts are never remitted to or in the possession of the U.S. owner of the disregarded operating entity? What is the purpose of § 956?

(d) The IRS has consistently adopted the position in regulations and other guidance that a legal entity that has made a check-the-box election to be disregarded should nonetheless be treated as separate from its owner when the law at issue requires that treatment.

(e) Treas. Reg. § 1.752-2(k) treats owners of disregarded entities that, in turn, own partnership interests as having risk of economic loss with respect to partnership liabilities (giving rise to basis) only to the extent of the disregarded entity's net value. The rule does not apply if the owner of the disregarded entity is required to make payments with respect to the obligation. Under this reasoning, the U.S. owner of a disregarded foreign entity should not be treated as the obligor on the disregarded entity's legal obligations if the U.S. company in fact has no liability with respect to those obligations.

(f) Rev. Rul. 2004-88, 2004-2 C.B. 166, holds that a disregarded LLC that is a general partner in a partnership under state law may be designated the tax matters partner ("TMP") to serve as the representative of the partnership in a TEFRA proceeding. Moreover, the LLC's owner, A, may *not* be considered a general partner by virtue of the LLC's disregarded status under the check-the-box regulations.

(g) Under Treas. Reg. § 301.6231(a)(7)-1(b)(1), a partnership may designate a person as the TMP if that person (i) was a general partner in the partnership at some time during the taxable year for which the designation is made, or (ii) is a general partner in the partnership at the time the designation is made. Rev. Rul. 2004-88 states that the check-the-box regulations "do not alter state law, which determines a partner's status as a general partner."

(h) The ruling states that the disregarded entity's owner, A, "does not become a general partner under state law by operation of the check-the-box rules. Although LLC is a disregarded entity for federal tax purposes, LLC remains a partner in P and is the sole general partner authorized to bind the partnership under state law. . . . Accordingly, A cannot step into the shoes of LLC, the disregarded entity."

(i) Under Treas. Reg. § 301.7701-2T, an entity that is otherwise disregarded is treated as an entity separate from its owner for purposes of federal tax liabilities of the entity, and for federal tax liabilities of any other entity for which the entity is liable under state law. The regulation provides the following example (Example 1):

> In 2006, X, a domestic corporation that reports its taxes on a calendar year basis, merges into Z, a domestic LLC wholly owned by Y that is disregarded as an entity separate from Y, in a state law merger. X was not a member of a consolidated group at any time during its taxable year ending in December 2005. *Under the applicable state law*, Z is the successor to X and is liable for all of X's debts. In 2009, the Internal Revenue Service (IRS) seeks to extend the period of limitations on assessment for X's 2005 taxable year. Because Z is the successor to X and is liable for X's 2005 taxes that remain unpaid, Z is the proper party to sign the consent to extend the period of limitations (emphasis added).

(j) The regulation therefore provides that a disregarded entity should (i) be held liable for its own debts, as well as the debts of entities that have merged into it; and (ii) make the decisions that could affect its liabilities under state law, including whether to extend the statute of limitations. The regulation recognizes that it is the disregarded entity (not the parent) that is liable for its own debts where that is the case under state law.

(k) Thus, if the U.S. owner of the disregarded limited-liability foreign entity is not an obligor on that debt it would seem the check-the-box regulations cannot make it an obligor. Section 956 needs an "obligation of a U.S. person" before there can be a § 956 investment.

7. Domestic Partnerships. Proposed Treas. Reg. § 1.956-4(e) also confirms that, for purposes of § 956, an obligation of a domestic partnership is an obligation of a U.S. person, regardless of whether the partners in a partnership are U.S. persons. Under § 956(c)(1)(C), an obligation of a U.S. person generally is U.S. property for purposes of § 956 unless an exception in § 956(c)(2) applies to the obligation. For example, § 956(c)(2)(L) would apply to exclude an obligation of a domestic partnership held by a CFC from the definition of U.S. property if neither the CFC nor a person related to the CFC (within the meaning of § 954(d)(3)) were a partner in the partnership.

8. Proposed Effective/Applicability Dates.

(a) The proposed regulations are to be effective for taxable years of CFCs ending on or after the date of publication in the Federal Register of the Treasury Decision adopting the rules as final regulations, and taxable years of U.S. shareholders in which or with which those taxable years end. Most of these rules are proposed to apply to property acquired, or pledges or guarantees entered into, on or after September 1, 2015, including property considered acquired, or pledges or guarantees considered entered into, on or after September 1, 2015, as a result of a deemed exchange pursuant to § 1001.

(b) Two rules, however, are proposed to apply to obligations held on or after the date of publication in the Federal Register of the Treasury Decision adopting the rules as final regulations. *See* proposed Treas. Reg. §§ 1.956-2(a)(3) and 1.956-4(e) (dealing with obligations of disregarded entities and domestic partnerships).

(c) Finally, proposed Treas. Reg. § 1.956-4(b) (dealing with partnership property indirectly held by a CFC) is proposed to apply to property acquired on or after the date of publication in the Federal Register of the Treasury Decision adopting these rules as final regulations.

(d) No inference is intended as to the application of the provisions proposed to be amended by the proposed regulations under current law, including transactions involving obligations of foreign partnerships. The IRS may, where appropriate, challenge transactions under currently applicable Code or regulatory provisions or judicial doctrines.

D. Active Rents and Royalties Exception: Temporary Regulations.

1. Rents and royalties generally are included in a CFC's foreign personal holding company income ("Subpart F income"). Rents and royalties derived in the active conduct of a trade or business and received from a person that is not a related person, however, are excluded from Subpart F income. The § 954 regulations provide rules for determining whether rents and royalties are derived in the active conduct of a trade or business for purposes of § 954(c)(2)(A).

2. Specifically, Treas. Reg. § 1.954-2(c) provides four alternative ways for rents to be derived in the active conduct of a trade or business, and Treas. Reg. § 1.954-2(d) provides two alternative ways for royalties to be derived in the active conduct of a trade or business. One way for a CFC to derive rents and royalties in the active conduct of a trade or business is to satisfy an "active development" test which, among other things, requires the CFC to be regularly engaged either in the "manufacture or production of, or in the acquisition and addition of substantial value to," certain property (regarding rents); or in the "development, creation or production of, or in the acquisition of an addition of substantial value to," certain property (regarding royalties) (collectively, the active development tests).

3. Although certain of the alternative ways (specifically, the active management and marketing tests) in which a CFC can satisfy the active rents and royalties exception require the relevant activities be performed by the CFC's own offices or staff of employees, the active development tests do not expressly contain this requirement. Treas. Reg. § 1.954-2(d)(3) Example 5, however, does indicate that royalties received by a CFC that financed independent persons in development activities were not considered derived in the active conduct of a trade or business for purposes of § 954(c)(2)(A).

4. In addition to the active development test, another way for a CFC to derive active rents and royalties in the active conduct of a trade or business is to satisfy an "active marketing" test. The test, among other things, requires the CFC to operate in a foreign country an organization that is regularly engaged in the business of marketing, or marketing and servicing, the leased or licensed property, and that is "substantial" in relation to the amount of rents and royalties derived from the leased or licensed property. Pursuant to a safe harbor, an organization is "substantial" if the active leasing or licensing expenses equal or exceed 25% of the adjusted leasing or licensing profits. The regulations generally define active leasing

expenses and active licensing expenses to mean, subject to certain exceptions, deductions that are properly allocable to rental or royalty income and that would be so allowable under § 162 if the CFC were a domestic corporation.

5. The active rents and royalties exception is intended to distinguish between a CFC that passively receives investment income and a CFC that derives income from the active conduct of a trade or business. Accordingly, the policy underlying the active rents and royalties exception requires that the CFC itself actively conduct the business that generates the rents or royalties. Treasury and the IRS have determined that, consistent with this policy, the CFC must perform the relevant activities (that is, activities related to the manufacturing, production, development, or creation of, or, in the case of an acquisition, the addition to substantial value to, the property at issue) through its own officers or staff of employees in order to satisfy the active development test. Thus, new Temp. Treas. Reg. § 1.954-2T(c)(1)(i) and (d)(1)(i) expressly provide that the CFC lessor or licensor must perform the required functions through its own officers or staff of employees.

6. Treasury and the IRS also have concluded that the policy of the active rents and royalties exception allows the relevant activities undertaken by a CFC through its officers or staff of employees to be performed in more than one foreign country. Thus, new Temp. Treas. Reg. § 1.954-2T(c)(1)(iv) and (d)(1)(ii) provide that a CFC's officers or staff of employees may be located in one or more foreign countries, and an organization that meets the requirements of the active marketing test can be maintained and operated by the officers or a staff of employees either in a single foreign country or in multiple foreign countries collectively. An organization also can be in a single foreign country or in multiple foreign countries collectively for purposes of determining the substantiality of the foreign organization.

7. The preamble states that in applying the active development tests and the active marketing tests, questions have arisen as to the treatment of cost sharing arrangements under which a person other than a CFC actually conducts relevant activities. Consistent with the policy underlying the active rents and royalties exception that requires the CFC itself to conduct the relevant activities, the temporary regulations clarify that cost sharing payments and PCT (buy-in) payments made by a CFC will not cause the CFC's officers and employees to be treated as undertaking the activities of the controlled participant to which the payments are made. This clarification applies for purposes of the active development tests and the active marketing tests, including for purposes of determining whether an organization that engages in marketing is substantial.

8. Similarly, the temporary regulations provide that deductions for cost sharing payments and PCT payments are excluded from the definition of active leasing expenses and active licensing expenses. Thus, the cost sharing payments and PCT payments are not active leasing expenses or active licensing expenses for purposes of determining whether an organization is "substantial" under the safe harbor test.

9. The rules relating to the active development test apply to rents and royalties received or accrued during taxable years of CFCs ending on or after September 1, 2015, and to taxable years of U.S. shareholders in which or with which such taxable years end, but only with respect to property manufactured, produced, developed, or created, or, in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015.

10. The rules regarding the active marketing test, as well as the rules regarding cost-sharing arrangements, apply to rents or royalties received or accrued during taxable years of CFCs ending on or after September 1, 2015, and to taxable years of U.S. shareholders in which or with which those taxable years end, to the extent that these rents or royalties are received or accrued on or after September 1, 2015.

IV. PARTNERSHIPS.

A. Transfers of Property to Partnerships with Related Foreign Partners.

1. Notice 2015-54 announced that Treasury and the IRS intend to issue regulations under § 721(c) (transfers to partnerships) to ensure that, when a U.S. person transfers certain property to a partnership that has foreign partners related to the transferor, income or gain attributable to the property will be taken into account by the transferor either immediately or periodically. The Notice also states that Treasury and the IRS intend to issue regulations under §§ 482 and 6662 applicable to controlled transactions involving partnerships to ensure the appropriate valuation of property transferred in these transactions.

2. Under the to-be-issued regulations, § 721(a) will not apply when a U.S. transferor contributes an item of § 721(c) Property to a § 721(c) Partnership (and the transfer thus will be fully taxable), unless the Gain Deferral Method set forth in the Notice is applied with respect to the § 721(c) Property.

3. A de minimis rule of $1 million applies. The de minimis amount is measured as the aggregate of built-in gain with respect to all § 721(c) Property contributed to the § 721 Partnership by related U.S. transferors. The de minimis rule is turned off if the § 721(c) Partnership is applying

the Gain Deferral Method with respect to a prior contribution of § 721(c) Property by the U.S. transferor or a related U.S. transferor.

4. Section 721(c) Property is property, other than Excluded Property, with built-in gain. Excluded Property is (i) cash equivalents, (ii) any asset that is a security within the meaning of § 475(c)(2) without regard to § 475(c)(4), and (iii) any item of tangible property with built-in gain that does not exceed $20,000.

5. A partnership (domestic or foreign) is a § 721(c) Partnership if a U.S. transferor contributes § 721(c) Property to the partnership, and, after the contribution and any transactions related to the contribution, (i) a related foreign person is a direct or indirect partner in the partnership and (ii) the U.S. transferor and one or more related persons own more than 50% of the interest in partnership capital, profits, deductions or losses.

6. The requirements for applying the Gain Deferral Method are as follows:

   (a) The § 721(c) Partnership adopts the Remedial Allocation Method described in Treas. Reg. § 1.704-3(d) for built-in gain with respect to all § 721(c) Property contributed to the § 721(c) Partnership pursuant to the same plan by a U.S. transferor and all other U.S. transferors that are related persons.

   (b) During any taxable year in which there is remaining built-in gain with respect to an item of § 721(c) Property, the § 721(c) Partnership allocates all items of § 704(b) income, gain, loss and deduction with respect to that § 721(c) Property in the same proportion. For example, if income with respect to an item of § 721(c) Property is allocated 60% to the U.S. transferor and 40% to a related foreign person in a taxable year, then gain, deduction and loss with respect to that § 721(c) Property must also be allocated 60% to the U.S. transferor and 40% to the related foreign person.

   (c) The reporting requirements described in the Notice are satisfied.

   (d) The U.S. transferor recognizes built-in gain with respect to any item of § 721(c) Property upon an Acceleration Event, as described in the Notice.

   (e) The Gain Deferral Method is adopted for all § 721(c) Property subsequently contributed to the § 721(c) Partnership by the U.S. transferor and all other U.S. transferors that are related persons until the earlier of: (i) the date that no built-in gain remains with respect to any § 721(c) Property to which the Gain Deferral Method first applied; or (ii) the date that is 60 months after the date of the initial contribution of the § 721(c) Property to which the Gain Deferral Method first applied.

7. An Acceleration Event with respect to an items of § 721(c) Property is any transaction that either would reduce the amount of remaining built-in gain that a U.S. transferor would recognize under the Gain Deferral Method if the transaction had not occurred or could defer the recognition of the built-in gain. In addition, an Acceleration Event is deemed to occur with respect to all § 721(c) Property of a § 721(c) Partnership for the taxable year of the partnership in which any party fails to comply with all of the requirements for applying the Gain Deferral Method.

8. Upon an Acceleration Event with respect to an item of § 721(c) Property, a U.S. transferor must recognize gain in an amount equal to the remaining built-in gain that would have been allocated to the U.S. transferor if the § 721(c) Partnership had sold the item of § 721(c) Property immediately before the Acceleration Event for its fair market value.

9. In an example, USP, a domestic corporation, wholly owns FS, a foreign corporation. USP and FS form a new partnership, PRS. FS contributes cash of $1.5 million to PRS, and USP contributes the following three assets: a patent with an arm's length price of $1.2 M and an adjusted basis of zero; a security with an arm's length price of $100,000 and adjusted basis of $20,000; and machine with an arm's length price of $200,000 and an adjusted basis of $600,000.

10. Because the patent has built-in gain, it is § 721(c) Property. Although the security has built-in gain, it is excluded property because it is an asset described in § 475(c)(2). Section 721(c) Property is property other than excluded property, with built-in gain. Excluded property is cash equivalents, any asset that is a security within the meaning of § 475(c)(2), and any item of tangible property with built-in gain that does not exceed $20,000. The machine has a built-in loss and is therefore not § 721(c) Property.

11. Thus, because USP is a U.S. person and not a domestic partnership, USP is a U.S. transferor that has contributed § 721(c) Property. FS is related to USP under § 267(b) and is not a U.S. person. Accordingly, FS is a related foreign person to USP. USP and FS collectively own more than 50% of the interest in capital, profits, deductions and losses of PRS. Therefore, PRS is a § 721(c) Partnership.

12. The de minimis property rule does not apply because the sum of the built-in gain for all § 721(c) Property is $1.2 million, which exceeds the $1 million de minimis threshold. The built-in loss in the machine does not factor into determining whether the contribution is below the de minimis threshold.

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13. As a result, § 721(a) does not apply to USP's contribution of the patent to PRS unless the Gain Deferral Method is applied.

14. In Example 2, a U.S. transferor contributes § 721 Property to a § 721(c) Partnership in year 1. The property ("Asset 1") has built-in gain of more than $1 million. FS, a related foreign person, also is a partner. The partnership allocates all items of income, gain, deduction and loss with respect to Asset 1, 60% to USP and 40% to FS and adopts the Remedial Allocation Method with respect to Asset 1. The parties comply with the applicable reporting requirements under § 6038, § 6038B and § 6046A and the regulations thereunder. The parties properly apply the Gain Deferral Method with respect to Asset 1 in years 1 through 3.

15. In an unrelated transaction in year 4, USP contributes § 721(c) Property (Asset 2) with a built-in gain of $100,000 to the partnership. The partnership allocates all items of income, gain and loss with respect to Asset 2, 20% to USP and 80% to FS, but allocates deductions with respect to Asset 2, 90% to USP and 10% to FS. The partnership adopts the Remedial Allocation Method with respect to Asset 2.

16. In year 4, although Asset 2 has built-in gain of less than $1 million, the de minimis rule will not apply because the parties are applying the Gain Deferral Method with respect to Asset 1. Because the deductions with respect to Asset 2 are allocated in a different proportion from the other § 704(b) items with respect to Asset 2, the requirements for satisfying the Gain Deferral Method are not met with respect to Asset 2, and USP must recognize the built-in gain with respect to Asset 2.

17. Furthermore, because the Gain Deferral Method does not apply to Asset 2, which was contributed within 60 months of Asset 1, an Acceleration Event is deemed to occur with respect to Asset 1 and USP must recognize any remaining built-in gain with respect to Asset 1.

18. In Example 3, the facts are the same as in Example 2 except that USP does not contribute Asset 2. In year 3, the partners amend the partnership agreement so that all items of income, gain, deduction and loss with respect to Asset 1 are now allocated 30% to USP and 70% to FS. Assume the amendment is accompanied by any consideration required by § 482 and has substantial economic effect as required by § 704(b). Because each § 704(b) item with respect to Asset 1 continues to be allocated in the same proportion to each partner, the Gain Deferral Method will continue to apply so long as the other requirements of the Gain Deferral Method are satisfied.

19. In Example 4, USP, a U.S. transferor, contributes § 721 property (Asset 1) with built-in gain of more than $1 million to a § 721(c) Partnership (PRS) in which FS, a related foreign person and USX, an unrelated U.S. person,

also are partners. The parties properly apply the Gain Deferral Method with respect to Asset 1. In Year 3, USP transfers all of its assets, including its interest in PRS to USS, a domestic corporation, in the transaction to which § 381 applies. In Year 9 (a year in which there is remaining built-in gain with respect to Asset 1), PRS distributes Asset 1 to FS.

20. Although USP will no longer recognize any remaining built-in gain with respect to Asset 1 under the Gain Deferral Method following the transfer to USS, USS is a successor U.S. transferor. Therefore, provided the requirements of the Gain Deferral Method continue to be satisfied, including treating USS as a U.S. transferor, the transfer of USP's interest in PRS to USS is not an Acceleration Event.

21. Although § 704(c)(1)(B) does not apply to the Year 9 distribution, the distribution is an Acceleration Event because USS will not recognize any remaining built-in gain with respect to Asset 1 under the Gain Deferral Method following the distribution. Therefore, USS must recognize gain in an amount equal to the remaining built-in gain that would have been allocated to USS if PRS had sold Asset 1 immediately before the distribution for its fair market value.

22. In Example 5, the facts are the same as in Example 4 except that in Year 3, instead of USP transferring its assets to USS, PRS instead contributes Asset 1 to FC, a foreign corporation, in a transfer described in § 351(a). There is no distribution in Year 9.

23. For purposes of §§ 367(a) and (d), each partner in PRS that is a U.S. person is treated as having transferred its share of the § 721(c) Property directly to FC. An Acceleration Event occurs, but not to the extent of USP's and USX's shares of the § 721(c) Property. The FC stock received by PRS in the transaction is not subject to the Gain Deferral Method.

24. The Treasury Department and IRS intend to issue regulations regarding the application to controlled transactions involving partnerships of certain rules in Treas. Reg. § 1.482-7 that are currently applicable to cost sharing arrangements. In particular, Treasury and the IRS intend to issue regulations to provide specified methods for controlled transactions based on specified methods in Treas. Reg. § 1.482-7(g), as properly adjusted in light of the differences in facts and circumstances between the partnerships and cost sharing arrangements.

25. The regulations will also provide periodic adjustment rules that are based on the principles of Treas. Reg. § 1.482-7(i)(6) for controlled transactions involving partnerships. The regulations will provide that, in the event of a trigger based on a significant divergence of actual returns from projected returns for controlled transactions involving a partnership, the IRS may

make periodic adjustments to the results of those transactions under a method based on Treas. Reg. § 1.482-7(i)(6)(v), as appropriately adjusted, as well as any necessary corresponding adjustments to § 704(b) or § 704(c) allocations.

26. The Notice also states that § 482 and related penalties apply to controlled transactions involving partnerships. For example, when U.S. and foreign persons under common control enter into a partnership, the amounts of their contributions to and distributions from, the partnership are subject to adjustment in order to reflect arm's length results. Partnership allocations, including allocations under § 704(c), also are subject to adjustment.

27. Accordingly, states the Notice, the amount of a remedial allocation under the Notice for controlled taxpayers that choose a Gain Deferral Method, or the amount of gain recognized if § 721(a) does not apply, potentially will be subject to adjustment by the IRS under § 482.

28. The Notice is effective with respect to transfers occurring on or after August 6, 2015, and to transfers occurring before that date resulting from entity classification elections made under the check-the-box rules that are filed on or after August 6, 2015, that are effective on or before August 2015.

29. Finally, the Notice states that no inference is intended regarding the treatment of transactions described in the Notice under current law, and the IRS may challenge those transactions under applicable Code provisions, Treasury regulations, and judicial doctrines. For example, the IRS may challenge a partnership's adopted § 704(c) method under the anti-abuse rule on Treas. Reg. § 1.704-3(c)(a)(10).

B. Section 956 developments regarding partnerships were discussed in the Subpart F section above.

V. SECTION 367.

A. Section 367(d).

1. Treasury and the IRS released important proposed regulations on the treatment of transfers of intangible property by U.S. persons to foreign corporations subject to § 367(d). The proposed regulations eliminate the so-called foreign goodwill exception from the § 367(d) regulations, and limit the § 367(a) active trade or business exception to certain tangible property and financial assets. This would be a huge change,[1] and one with a seriously weak legal underpinning. The new regulation is proposed to be effective immediately, even before a hearing and comments.

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[1] In Andrew Velarde and Amanda Athanasiou's report, they called the proposed regulation "a *monumental* break from previous practice." 2015 TNT 178-2.

2. Background.

(a) The preamble to the newly proposed regulations starts with a discussion of current law regarding § 367(d) and the legislative history of § 367(d). The discussion notes that Temp. Treas. Reg. § 1.367(d)-1T(b) generally provides that § 367(d) applies to the transfer of any intangible property, but not to the transfer of foreign goodwill or going concern value ("foreign goodwill exception"). Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(i) generally defines "intangible property," for purposes of § 367, as knowledge, rights, documents, and other intangible items within the meaning of § 936(h)(3)(B). Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(iii) defines "foreign goodwill or going concern value" as the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued. The value of the right to use a corporate name in a foreign country is treated as foreign goodwill or going concern value.

(b) In amending § 367 in 1984, Congress identified problems as arising when "transferor U.S. companies hope to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible."

(c) The Senate Finance Committee stated that "The committee contemplates that ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business." The House report contains a similar statement. The Senate Finance Committee and the House Ways & Means Committee each noted that it "does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in an abuse of the U.S. tax system."

(d) Treasury and the IRS, however, expressed in the preamble concern regarding how taxpayers interpret § 367 and the regulations thereunder when claiming favorable treatment for foreign goodwill and going concern value.

(e) They say that under one interpretation, taxpayers take the position that goodwill and going concern value are not § 936(h)(3)(B) intangible property and therefore are not subject to § 367(d) because § 367(d) only applies to § 936(h)(3)(B) intangible property. Furthermore, these taxpayers assert that gain realized with respect to the outbound transfer of goodwill or going concern value is not recognized under the general rule of § 367(a) because the goodwill or going concern value is eligible for, and satisfies, the active trade or business exception under § 367(a)(3)(A). This, of course, is stated in the legislative history.

(f) The preamble states that under a second interpretation taxpayers take the position that, although goodwill and going concern value are § 936(h)(3)(B) intangible property, the foreign goodwill exception applies. These taxpayers also assert that § 367(a) does not apply to foreign goodwill or going concern value, either because of § 367(d)(1)(A) (providing that, except as provided in regulations, § 367(d) and not § 367(a) applies to § 936(h)(3)(B) intangible property) or because the active foreign trade or business exception applies.

3. Reasons for Change.

(a) Treasury and the IRS say they are aware that, in the context of outbound transfers, certain taxpayers attempt to avoid recognizing gain or income attributable to high-value intangible property by asserting that an inappropriately large share (in many cases, the majority) of the value of the property transferred is foreign goodwill or going concern value that is eligible for favorable treatment under § 367.

(b) Specifically, Treasury and the IRS say they are aware that some taxpayers value the property transferred in a manner contrary to § 482 in order to minimize the value of the property transferred that they identify as § 936(h)(3)(B) intangible property for which a deemed income inclusion is required under § 367(d) and to maximize the value of the property transferred that they identify as exempt from current tax. Treasury and the IRS say that, for example, some taxpayers (1) use valuation methods that value items of intangible property on an item-by-item basis, when valuing the items on an aggregate basis would achieve a more reliable result under the arm's length standard of § 482, or (2) do not properly perform a full factual and functional analysis of the business in which the intangible property is employed.

(c) This hardly seems to us like something that would support the major change proposed in the regulations.

(d) Treasury and the IRS are also aware that some taxpayers broadly interpret the meaning of foreign goodwill and going concern value for purposes of § 367. Specifically, although the existing regulations under § 367 define foreign goodwill or going concern

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value by reference to a business operation conducted outside of the United States, some taxpayers have asserted that they have transferred significant foreign goodwill or going concern value when a large share of that value was associated with a business operated primarily by employees in the U.S., where the business simply earned income remotely from foreign customers. In addition, some taxpayers take the position that value created through customer-facing activities occurring within the U.S. is foreign goodwill or going concern value.

(e) Treasury and the IRS have concluded that these taxpayer positions and interpretations raise significant policy concerns and are inconsistent with the expectation, expressed in the legislative history, that the transfer of foreign goodwill or going concern value developed by a foreign branch to a foreign corporation is unlikely to result in the abuse of the U.S. tax system. They considered whether the favorable treatment for foreign goodwill and going concern value under current law could be preserved while protecting the U.S. tax base through regulations expressly prescribing perimeters for the portion of the value of a business that qualifies for the favorable treatment.

(f) For example, states the preamble, regulations could require that to be eligible for the favorable treatment, the value must have been created by activities conducted outside the U.S. through an actual foreign branch that had been in operation for a minimum number of years and be attributable to unrelated foreign customers. Treasury and the IRS ultimately determined that such an approach would be impractical to administer.

(g) In particular, while new temporary regulations under § 482 (see below) change the application of § 482 in important respects, the preamble states that there will continue to be challenges in administering the transfer pricing rules whenever the transfer of different types of intangible property gives rise to significantly different tax consequences. The preamble states that as long as foreign goodwill and going concern value are afforded favorable treatment, taxpayers will continue to have incentives to take aggressive transfer pricing positions to inappropriately exploit the favorable treatment of foreign goodwill and going concern value, however defined, and therefore erode the U.S. tax base.

4. <u>Eliminating the Foreign Goodwill Exception and Limiting the Scope of the Active Foreign Trade or Business Exception</u>.

(a) The preamble states that the proposed regulations would eliminate the foreign goodwill exception under Temp. Treas. Reg.

§ 1.367(d)-1T and limit the scope of property that is eligible for the active foreign trade or business exception generally to certain tangible property and financial assets. Accordingly, under the proposed regulations, when there is an outbound transfer of foreign goodwill or going concern value, the U.S. transferor will be subject to either current gain recognition under § 367(a) or the tax treatment provided under § 367(d). This certainly would be a major change in the law, and one that is at odds with the clear legislative history.

(b) Proposed Treas. Reg. § 1.367(d)-1(b) provides that § 367(d) applies to an outbound transfer of intangible property, as defined in proposed Treas. Reg. § 1.367(a)-1(d)(5). Proposed Treas. Reg. § 1.367(d)-1(b) does not provide an exception for any intangible property. Proposed Treas. Reg. § 1.367(a)-1(d)(5) modifies the definition of intangible property. The modified definition facilitates both the elimination of the foreign goodwill exception as well as the addition of a rule under which U.S. transferors may apply § 367(d) with respect to certain other outbound transfers of property that otherwise would be subject to § 367(a) under the U.S. transferor's interpretation of § 936(h)(3)(B). The proposed regulations make certain coordinating changes to Temp. Treas. Reg. § 1.367(d)-1T to take into account the elimination of the foreign goodwill exception and the revised definition of intangible property. The proposed regulations also eliminate the definition of foreign goodwill and going concern value under existing Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(iii) because it no longer will be needed.

(c) In addition, the proposed regulations eliminate the existing rule of Temp. Treas. Reg. § 1.367(d)-1T(c)(3) that limits the useful life of intangible property to 20 years. The preamble states that if the useful life of transferred intangible property exceeds 20 years, the limitation might result in less than all of the income attributable to the property being taken into account by the U.S. transferor. Accordingly, proposed Treas. Reg. § 1.367(d)-1(c)(3) provides that the useful life of intangible property is the entire period during which the exploitation of the intangible is reasonably anticipated to occur, as of the time of the transfer.

(d) For this purpose, exploitation includes use of the intangible property in research and development. Consistent with the guidance for cost sharing arrangements in Treas. Reg. § 1.482-7(g)(2)(ii)(A), if the intangible property is reasonably anticipated to contribute to its own further development or to developing other intangibles, then the period includes the period reasonably anticipated at the time of the transfer, of exploiting (including use in research and development) such further development. Consequently, depending on the facts, the cessation of exploitation activity after a specified period of time may or may not be reasonably anticipated.

5. Modifications Relating to the Active Foreign Trade or Business Exception.

(a) The rules for determining whether property is eligible for the active foreign trade or business exception and whether property satisfies that exception currently are found in numerous regulations under § 367. The proposed regulations combine the active trade or business regulations, other than the depreciation recapture rule, into a single regulation under proposed Treas. Reg. § 1.367(a)-2. The proposed regulations retain a coordination rule to which a transfer of stock or securities in an exchange subject to § 1.367(a)-3 is not subject to Treas. Reg. § 1.367(a)-2. The proposed regulations also make conforming changes to the depreciation recapture rule, and the branch loss recapture rule.

(b) Although minor wording changes have been made to consolidate some aspects of the active trade or business regulations into a single regulation, the proposed regulations are not intended to be interpreted as making substantive changes to the active foreign trade or business regulation except as otherwise provided in the preamble.

(c) Under existing regulations, all property is eligible for the active trade or business exception, unless the property is specifically excluded. Treasury and the IRS say that, under this structure, taxpayers have an incentive to take the position that certain intangible property is not described in § 936(h)(3)(B) and therefore not subject to § 367(d) and is instead subject to § 367(a) but eligible for the active foreign trade or business exception because the intangible property is not specifically excluded from the exception.

(d) Treasury and the IRS believe that providing an exclusive list of property eligible for the active trade or business exception will reduce the incentives for taxpayers to undervalue intangible property subject to § 367(d).

(e) The proposed regulations provide that only certain types of property are eligible for the active foreign trade or business exception. However, in order for the eligible property to satisfy that exception, the property must also be considered transferred for use in the active conduct of a trade or business outside the U.S.

Specifically, proposed Treas. Reg. § 1.367(a)-2(a)(2) provides the general rule that an outbound transfer of property satisfies the active trade or business exception if (1) the property constitutes eligible property, (2) the property is transferred for use by the foreign corporation in the active conduct of a trade or business outside of the U.S., and (3) the reporting requirements under § 6038B are satisfied.

(f) Under proposed Treas. Reg. § 1.367(a)-2(b), eligible property is tangible property, a working interest in oil and gas property, and certain financial assets, unless the property is also described in one of the four categories of ineligible property. Thus, *intangible* property cannot qualify as eligible property.

(g) Proposed Treas. Reg. § 1.367(a)-2(c) lists four categories of property not eligible for the active trade or business exception, which, in general, are (1) inventory or similar property; (2) installment obligations, accounts receivable or similar property; (3) foreign currency or certain other property denominated in foreign currency and (4) certain leased tangible property. These four categories of property not eligible for the active trade or business exception include four of the five categories described in the existing regulations. The category for intangible property is not retained because it will no longer be relevant: intangible property transferred to a foreign corporation pursuant to § 351 or § 361 will not constitute eligible property under proposed Treas. Reg. § 1.367(a)-2(b).

(h) The proposed regulations also eliminate the exception in existing Temp. Treas. Reg. § 1.367(a)-5T(d)(2) that allows certain property denominated in the foreign currency of the country in which the foreign corporation is organized to qualify for the active trade or business exception if that property was acquired in the ordinary course of business of the U.S. transferor that will be carried on by the foreign corporation.

(i) Treasury and the IRS have determined that removing the exception from Temp. Treas. Reg. § 1.367(a)-5T(d)(2) is consistent with the general policy of § 367(a)(3)(B)(iii) to require gain to be recognized in an outbound transfer of foreign currency denominated property. Removing the exception will preserve the character, source, and amount of gain attributable to § 988 transactions that otherwise could be lost or changed if the gain were not immediately recognized but instead were reflected only in the U.S. transferor's basis in the stock of the foreign corporation.

(j) The general rules for determining whether eligible property is transferred for use in the active conduct of a trade or business outside of the U.S. are described in proposed Treas. Reg. § 1.367(a)-2(d). Paragraphs (e) through (h) provide special rules for certain property to be leased after the transfer, a working interest in oil and gas property, property that is re-transferred by the transferee corporation to another person, and certain compulsory transfers of property.

(k) Proposed Treas. Reg. § 1.367(a)-2(g)(2) does not retain the portion of existing Temp. Treas. Reg. § 1.367(a)-4T(d) that applies to certain transfers of stock or securities. Treasury and the IRS have determined that Treas. Reg. §§ 1.367(a)-3 and 1.367(a)-8 (generally requiring U.S. transferors that own five-percent or more of the stock of the foreign corporation to enter into a gain recognition agreement to avoid recognizing gain on the outbound transfer of stock or securities) adequately carry out the policy of § 367(a) with respect to the transfer of stock or securities.

6. <u>Treatment of Certain Property as Subject to § 367(d)</u>.

(a) Treasury and the IRS note that taxpayers take different positions as to whether goodwill and going concern value are § 936(h)(3)(B) intangible property, as discussed above. The proposed regulations do not address this issue. However, the proposed regulations provide that a U.S. transferor may apply § 367(d) to a transfer of property, other than certain property described below, that otherwise would be subject to § 367(a) under the U.S. transferor's interpretation of § 936(h)(3)(B).

(b) Under this rule, a U.S. transferor that takes the position that goodwill and going concern value are not § 936(h)(3)(B) intangible property may nonetheless apply § 367(d) to goodwill and going concern value. Treasury and the IRS say this rule will further sound administration by reducing the consequences of uncertainty regarding whether value is attributable to property subject to § 367(a) or property subject to § 367(d).

(c) The application of § 367(d) in lieu of § 367(a) is available only for property that is not eligible property, as defined in proposed Treas. Reg. § 1.367(a)-2(b) but, for this purpose, determined without regard to proposed Treas. Reg. § 1.367(a)-2(c) (which describes four categories of property explicitly excluded from the active trade or business exception). A U.S. transferor must disclose whether it is applying § 367(a) or (d) to a transfer of this property.

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(d) To implement this new rule under proposed Treas. Reg. § 1.367(a)-1(b)(5) and the removal of the foreign goodwill exception, the proposed regulations revise the definition of the "intangible property" that applies for purposes of §§ 367(a) and (d). As revised, the term means either property described in § 936(h)(3)(B) or property to which a U.S. transferor applies § 367(d) (in lieu of applying § 367(a)). However, for this purpose, and consistent with the existing regulations, intangible property does not include property described in § 1221(a)(3) (generally relating to certain copyrights) or a working interest in oil and gas property.

7. Modifications to Temp. Treas. Reg. § 1.367(a)-1T.

(a) Temp. Treas. Reg. § 1.482-1T(f)(2)(i) (below) applies to the arm's length standard under § 482 when it is used in conjunction with other Code provisions, including § 367, in determining the proper tax treatment of controlled transactions. Proposed Treas. Reg. § 1.367(a)-1(b)(3) provides that, in cases where an outbound transfer of property subject to § 367(a) constitutes a controlled transaction, as defined in Treas. Reg.§ 1.482-1(i)(8), the value of the property transferred is determined in accordance with § 482 and the regulations thereunder.

(b) This rule replaces existing Temp. Treas. Reg. § 1.367(a)-1T(b)(3), which includes three rules. One of these rules refers to the sale of property "if sold individually." Treasury and the IRS are concerned this could be viewed as inconsistent with Temp. Treas. Reg. § 1.482-1T(f)(2)(i)(B), which provides that an aggregate analysis of the transactions may provide the most reliable measure of an arm's length result under certain circumstances. The other two rules are eliminated either because they duplicate language elsewhere or are no longer necessary.

8. Proposed Effective/Applicability Dates. The regulations are proposed to apply to transfers occurring on or after September 14, 2015, and to transfers occurring before that date, resulting from entity classification elections that are filed on or after that date. Removal of the exception currently in Temp. Treas. Reg. § 1.367(a)-5T(d)(2) will apply to transfers occurring on or after the date that the rules proposed are adopted as final regulations. No inferences are intended regarding the application of the provisions proposed to be amended by the proposed regulations under current law. The IRS may, where appropriate, challenge transactions under applicable provisions or judicial doctrines.

9. Comments.

(a) The proposed regulation is impossible to reconcile, and is at odds, with the clear, relevant legislative history, as discussed by Treasury and the IRS in the regulation's preamble. Treasury and the IRS obviously have decided they don't like the foreign goodwill exception.

(b) The Obama Administration has proposed to change the law to include goodwill, going concern value and workforce-in-place in § 936(h)(3)(B). At first, the Administration's description referred to this change as a "clarification." A New York State Bar Association ("NYSBA") report dated October 12, 2010 stated that calling the change a "clarification" was inconsistent with the legislative history of § 367(d). *See* the NYSBA report at p. 8. In the two most recent Administration budgets, the assertion that this change would be a "clarification" was dropped. These proposals were never enacted.

(c) In any event, the new regulation effectively forces taxpayers to treat goodwill and going concern value as § 367(d) assets, and precludes them from qualifying for the active trade or business exception.

(d) The legislative history, as discussed in the regulation's preamble, is clear that "no gain will be recognized on the transfer of goodwill and going concern value for use in an active trade or business." The proposed regulation obviously is contrary to the statute's legislative history.

(e) One of the more interesting things about this proposed regulation is that it was issued so closely in time to the Tax Court's decision in *Altera Corporation v. Commissioner*, 145 T.C. No. 3 (2015), discussed in last month's column. The Tax Court looked to the Administrative Procedure Act ("APA") to test the validity of a regulation. The standard under the APA is "arbitrary, capricious and an abuse of discretion or otherwise not in accordance with the law." The reviewing court must ensure that the agency "engaged in reasoned decision making." There must be "an exchange of views, information and criticism between interested parties and the agency."

(f) The regulation also could have problems under the U.S. Supreme Court's 2014 decision in *Utility Air Regulatory Group v. Environmental Protection Agency*, ___ U.S. ___ (2014), which held that an administrative "agency may not rewrite clear statutory terms to suit its own sense of how the statute should operate."

B. Section 367 GRAs.

1. Treasury and the IRS issued final regulations in November 2014 (generally adopting previously proposed regulations) that amend the rules governing failures to file gain recognition agreements and related documents, or to satisfy other reporting obligations, associated with transfers of property to foreign corporations.

2. The § 367(a) regulations provide exceptions to the general income-recognition rule of § 367(a) for certain transfers by a U.S. transferor of stock or securities to a foreign corporation. These exceptions generally require the U.S. transferor to file a GRA and other related documents. Under the terms of a GRA, the U.S. transferor must agree to include in income the gain realized but not recognized on the initial transfer of stock or securities and to pay interest on any additional tax due if a gain recognition event occurs during the five-year term of the GRA.

3. A failure to comply with the GRA rules can trigger gain recognition. An example is the failure to file an annual certification. The previous regulations provided that if there was a failure to comply with the GRA rules, the U.S. transferor would have to recognize the full amount of gain realized on the initial transfer of stock or securities unless the transferor could demonstrate that the failure was due to reasonable cause and not willful neglect under Treas. Reg. § 1.367(a)-8(p). Similarly, if there was a failure to timely file a GRA in connection with the initial transfer, the U.S. transferor must recognize gain with respect to the transfer unless the reasonable cause exception is satisfied.

4. A domestic target corporation in certain cases also must file statements in connection with the transfer by its shareholders or security holders of stock or securities in a domestic target corporation to a foreign corporation under Treas. Reg. § 1.367(a)-3(c). A domestic target also must file a statement when its assets are transferred to a foreign acquiring corporation in a § 361 exchange and all or a portion of those assets are subsequently transferred to a domestic subsidiary of the foreign acquiring corporation in a transaction treated as an indirect stock transfer under Treas. Reg. § 1.367(a)-3(d).

5. In addition, a U.S. person who transfers property to a foreign corporation in certain nonrecognition transactions also is subject to the reporting requirements of § 6038B. The U.S. transferor generally is required to file IRS Form 926, "Return by a U.S. Transferor of Property to a Foreign Corporation." The form must identify the transferee foreign corporation and describe the property transferred. The penalty for failure to satisfy the § 6038B reporting requirement is equal to 10% of the fair market value of the property at the time of the exchange, but not to exceed $100,000 unless the failure was due to intentional disregard of the reporting

obligations. If the U.S. transferor demonstrates that the failure was due to reasonable cause and not willful neglect, however, no penalty is imposed.

6. Section 367(e)(2) provides that in a liquidation to which § 332 applies, §§ 337(a) and (b)(1) (corporate-level gain exceptions) will not apply when the 80-percent distributee is a foreign corporation unless regulations provide otherwise. As a result, if a domestic liquidating corporation liquidates into a foreign parent corporation (an outbound liquidation), or if a foreign liquidating corporation liquidates into a foreign parent corporation (a foreign-to-foreign liquidation), the liquidating corporation generally must recognize gain or loss on the distribution as if the property were sold to the distributee at its fair market value.

7. Treas. Reg. § 1.367(e)-2(b)(1) provides that a domestic liquidating corporation must recognize gain or loss in an outbound liquidation, subject to an overall loss limitation, except to the extent it satisfies one of the exceptions provided in that regulation. The exceptions are for distributions of (1) property used in the conduct of a trade or business in the U.S.; (2) a U.S. real property interest; or (3) stock of a domestic subsidiary corporation that is at least 80% owned by the domestic liquidating corporation.

8. The regulations also address foreign-to-foreign liquidations and provide that a foreign liquidating corporation generally is not required to recognize gain or loss on the distribution, except in the case of certain distributions of property used in a U.S. trade or business or formerly used in a U.S. trade or business.

9. Other than the exception for distributions of a U.S. real property interest, the exceptions provided under the § 367(e)(2) regulations require the filing of certain statements or schedules by the liquidating corporation and the distributee corporation. A domestic liquidating corporation that distributes property to a foreign corporation in a transaction subject to § 367(e)(2) also must file a Form 926 with respect to the distribution.

10. Under the previous regulations, if a transferor failed to timely file an initial GRA, or failed to comply in any material respect with the § 367(a) GRA regulations with respect to an existing GRA (for example, because it failed to timely file an annual certification), the U.S. transferor was subject to full gain recognition under § 367(a) unless the U.S. transferor later discovered the failure, promptly filed the GRA or other required information with the IRS, and demonstrated that its failure was due to reasonable cause and not willful neglect.

11. Treasury and the IRS were concerned that the previous reasonable cause standard might not be satisfied by U.S. transferors in many common situations even though the failure was not intentional and not due to

willful neglect. Treasury and the IRS believe that full gain recognition under § 367(a) should apply only if a failure to timely file an initial GRA or a failure to comply with a § 367(a) GRA regulations with respect to an existing GRA is willful. They believe that the penalty imposed by § 6038B generally should be sufficient to encourage proper reporting and compliance.

12. The new regulations thus revise the § 367(a) GRA regulations to provide that a U.S. transferor seeking either to (1) avoid recognizing gain under § 367(a) on the initial transfer as a result of a failure to timely file an initial GRA, or (2) avoid triggering gain as a result of a failure to comply in all material respects with the § 367(a) GRA regulations or the terms of an existing GRA, must demonstrate that the failure was not a willful failure.

13. For this purpose, the term "willful" is to be interpreted consistent with the meaning of that term in the context of other civil penalties (for example, § 6672), which would include a failure due to gross negligence, a reckless disregard, or willful neglect.

14. Whether a failure is willful will be determined based on all the relevant facts and circumstances. The regulations illustrate the application of this standard to a series of helpful examples. For example, the § 367(a) GRA regulations require a GRA to include information about the adjusted basis and fair market value of the property transferred. Filing a GRA and intentionally not providing this information, including noting on the GRA that this information is "available upon request," would be a willful failure.

15. The new regulations also provide guidance clarifying when an initial GRA is considered timely filed, and what gives rise to a failure to comply in any material respect with the requirements of the § 367(a) GRA regulations or the terms of an existing GRA. In general, an initial GRA is timely filed only if each document that is required to be filed as part of the initial GRA is timely filed and complete in all material respects. Similarly, in general, there is a failure to comply in a material respect with the § 367 GRA regulations or the terms of an existing GRA if a document (such as an annual certification) that is required to be filed is not timely filed, or is not completed in all material respects.

16. The revised regulations also clarify that the § 6038B penalty will apply to a failure to comply in any material respect with the § 367(a) GRA regulations or the terms of an existing GRA, such as a failure to properly file a GRA document (including an annual certification or new GRA). Under the new regulations, a failure to comply has the same meaning for purposes of the § 367(a) GRA regulations and the § 6038B regulations.

17. However, the previous reasonable cause standard continues to apply to U.S. transferors seeking relief from the § 6038B penalty.

18. The new regulations also modify the information that must be reported with respect to a transfer of stock or securities on Form 926. Specifically, the U.S. transferor must include on Form 926 the basis and fair market value of the property transferred. In addition, the new regulations require that a Form 926 be filed in all cases in which a GRA is filed.

19. The § 367(e)(2) regulations governing liquidating distributions to foreign parent corporations contain several rules that condition nonrecognition treatment upon the filing of statements or other documents, or complying with the requirements of those regulations' documents are functionally similar to GRAs in certain respects. The previous § 367(e)(2) regulations did not provide explicit guidance regarding the treatment of taxpayers who fail to file these documents or report the required information. They also did not provide a mechanism to obtain relief for any failures.

20. Treasury and the IRS believe that the changes made by the new regulations in the case of § 367(a) transfers are also appropriate for failures to file or failures to comply for purposes of the § 367(e)(2) regulations and the related § 6038B regulations. Accordingly, the new regulations provide rules similar to the rules under the § 367(a) GRA regulations and related § 6038B regulations for failures to file the required documents or statements and failures to comply under the § 367(e)(2) regulations and related § 6038B regulations. Finally, the regulations modify the information that must be reported with respect to one or more liquidating distributions of property, including the addition of a requirement to report the basis and fair market value of the property distributed.

21. The previous § 367(a) regulations did not address a taxpayer's failure to file certain other statements required under Treas. Reg. § 1.367(a)-3 in connection with certain transfers of stock or securities. These include statements required to be filed by a domestic target corporation in connection with a transfer of stock or securities of that corporation to a foreign corporation as described in Treas. Reg. §§ 1.367(a)-3(c)(6) and (7), and the statement required to be filed by a domestic target corporation in connection with the transfer of its assets to a foreign corporation in an exchange described in § 361 and the subsequent transfer of those assets to a domestic subsidiary in a transaction described in Treas. Reg. § 1.367(a)-3(d)(2)(vi)(B)(1)(ii).

22. Treasury and the IRS believe that failures to timely file these statements or failures to comply in all material respects with these regulations should be treated similarly to the failures to file or failures to comply with the

§ 367(a) GRA regulations. Accordingly, the new regulations incorporate similar rules with respect to these other filing obligations.

23. The final regulations' examples are helpful, and are the same as or very similar to the examples in the proposed regulations. *See* Treas. Reg. § 1.367(a)-8(p)(3). In Example 1, the taxpayer failed to file a GRA due to an accidental oversight. DC (domestic corporation) filed its tax return for the year of the FS (foreign subsidiary) transfer, reporting no gain with respect to the exchange of the FS stock. DC, through its tax department, was aware of the requirement to file a GRA, and had experience and competency to prepare the GRA. DC had filed many GRAs over the years and had never failed to timely file a GRA. However, although DC prepared the GRA with respect to the FS transfer, it was not filed with DC's return for the relevant tax year due to an accidental oversight. During the preparation of the following year's tax return, DC discovered that the GRA had not been filed and prepared an amended return to file the GRA and comply with the necessary procedures. The example concludes that the failure to timely file was not a willful failure to file.

24. In Example 2, the taxpayer's course of conduct is taken into account in the determination. DC filed its tax return for the year of the FS transfer, reporting no gain with respect to the exchange of the FS stock, but failed to file a GRA. DC, through its tax department, was aware of the requirement to file a GRA in order for DC to avoid recognizing the relevant gain. However, DC had not consistently and in a timely manner filed GRAs in the past, and also had an established history of failing to timely file other tax and information returns for which it had been subject to penalties.

25. At the time of an FS2 transfer, DC was already aware of its failure to file the GRA required for a prior transfer, but had not implemented any safeguards to ensure that it would timely file GRAs for future transactions. DC's course of conduct is taken into account in determining whether its failure to timely file a GRA for the FS2 transfer was willful. Based on the facts in this example, including DC's history of having failed to file required tax and information returns in general, and GRAs in particular, and its failure to implement safeguards to ensure that it would timely file GRAs, the failure to timely a GRA with respect to the FS2 transfer rises to the level of a willful failure to timely file.

26. In Example 3, the GRA was not completed in all material respects. DC timely filed its tax return for the year of the FS transfer, reporting no gain. DC was aware of the requirement to file a GRA to avoid recognizing gain under § 367(a), including the requirement to provide the fair market value of the transferred stock. Instead, the GRA was filed with the statement that the fair market value information was "available upon request." Other than the omission of the fair market value of the FS stock, the GRA

contained all other information required by that section. Because DC knowingly omitted such information, DC's omission is a willful failure to timely file a GRA. The result would be the same if DC knowingly omitted basis information even if fair market value was included.

27. In Example 4, a GRA is filed as a result of hindsight. At the time DC filed its tax return for the year of the FS transfer, DC anticipated selling Business A in the following year, which was expected to produce a capital loss that could be carried back to fully offset the gain recognized on the FS transfer. DC chose not to file a GRA but to recognize gain on the FS transfer under § 367(a), which it reported on its timely filed tax return. However, a large class action lawsuit was filed against Business A at the end of the following year, and DC was unable to sell the business. As a result, DC did not realize the expected capital loss, and was not able to offset the gain from the FS transfer. DC now seeks to file a GRA for the transfer. Because DC knowingly chose not to file a GRA for the FS transfer, its actions constitute a willful failure to timely file a GRA. Accordingly, the GRA is not considered timely filed and DC must recognize the full amount of the gain realized on the FS transfer.

28. <u>Changes From the Proposed Regulation</u>. While the proposed regulations were generally adopted as final, there were some changes. The most significant changes include:

(a) The proposed regulations under § 6038B required a U.S. person that transfers property to a foreign corporation to file Form 926 with respect to the transfer of stock or securities in all cases in which a GRA is filed in order to avoid penalties under § 6038B. The proposed regulations did not require the U.S. transferor to report any specific information regarding the transferred stock or securities. The final regulations require the U.S. transferor to report the fair market value, adjusted basis and gain recognized in the context of the transfer of stock or securities, as well as any other information required by Form 926 and its accompanying instructions or other applicable guidance. This is similar to the information that must be provided for other types of transferred property.

(b) The final regulations extend the relief for failures that are not willful to certain other reporting obligations under § 367(a) that were not covered by the proposed regulations. Accordingly, revisions to Treas. Reg. § 1.367(a)-2 (providing an exception to gain recognition under § 367(a)(1) for assets transferred for use in the active conduct of trade or business outside the U.S.) and § 1.367(a)-7 (regarding the application of § 367(a) to an outbound transfer of assets by a domestic target corporation in an exchange described in § 361) provide that the taxpayer may, solely for purposes of § 367(a), be deemed not to have failed to comply with its reporting obligations by demonstrating that the failure was not willful.

Situations in which relief is sought under Treas. Reg. § 1.367(a)-2 and many situations in which relief is sought under Treas. Reg. § 1.367(a)-7 are also subject to reporting under § 6038B and the regulations thereunder. The preamble to the new regulations states that the penalty imposed under § 6038B for failure to satisfy reporting obligations should generally be sufficient to encourage proper reporting and compliance.

(c) In 2010, the IRS Deputy Commissioner International (LMSB) issued a directive permitting taxpayers to remedy unfiled or deficient GRA documents associated with the timely filed GRA or a timely filed document purporting to be an initial GRA. The directive explained that the means to best ensure compliance with the GRA provisions was under study and that, pending the study, the directive would be effective "until further notice." Because the new regulations provide comprehensive guidance that is designed to ensure compliance with the GRA requirements, the LMSB directive was revoked on the date the final regulations were published as final in the Federal Register.

29. Other Changes.

(a) Under the Prop. Treas. Reg. § 1.367(a)-8(p), the regulations were only to apply to requests for relief submitted on or after the date the proposed regulations were adopted as final regulations. Treasury and the IRS have determined that it would be appropriate to provide relief for certain failures to file or comply that were not willful and that were the subject of requests for relief submitted under Treas. Reg. § 1.861(a)-8(p) of the existing regulations before the finalization of the new regulations. Accordingly, the new regulations provide a procedure under which U.S. transferors may resubmit certain previously filed requests.

(b) Under Prop. Treas. Reg. § 1.367(a)-8(p)(2)(i), a U.S. transferor that seeks relief for a failure to file or failure to comply with the GRA rules must, among other requirements, file an original Form 8838, Consent to Extend the Time to Assess Tax Under § 367 – Gain Recognition Agreement, with an amended return. The final regulations provide that if a U.S. transferor has already filed such a form, it need not file another form with the amended return. Rather, the U.S. transferor must attach a copy of the previously filed Form 8838 to the amended return.

(c) Treas. Reg. § 1.367(a)-8(j)(8) of the existing regulations provides that a failure to comply with the GRA provisions will extend the statute of limitations until the close of the third full taxable year ending after the date on which the Director of Field Operations or Area Director receives actual notice of the failure to comply from the U.S. transferor. The same provision was set forth in the proposed GRA regulations regarding liquidation documents.

(d) According to the preamble to the final regulations, the extended period of limitations should be based on when the taxpayer furnishes to the Director of Field Operations International, Large Business & International (or any successor to the roles and responsibilities of that person) the information that should have been provided under those regulations. Thus, those rules were modified accordingly.

(e) The regulations also were revised to clarify that when a taxpayer files a GRA under Treas. Reg. § 1.367(a)-8 or a liquidation document under Treas. Reg. § 1.367(e)-2, the taxpayer agrees to extend the statute of limitations in the circumstances provided in Treas. Reg. §§ 1.367(a)-8(j)(8) and 1.367(e)-2(e)(4)(ii)(B), as applicable. This agreement is deemed consented to and signed by the IRS for purposes of § 6501(c)(4).

(f) Treas. Reg. § 1.367(a)-3(a) of the existing final regulations provides a general rule that a U.S. person must recognize gain on certain transfers of stock or securities to a foreign corporation. Treas. Reg. § 1.367(a)-3(c) contains an exception for certain transfers of stock and securities of a domestic corporation. That regulation provides that, except as set forth in Treas. Reg. § 1.367(a)-3(e) (providing rules for transfers of stock or securities by a domestic corporation to a foreign corporation pursuant to an exchange described in § 361), a transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation that would otherwise be subject to gain recognition under § 367(a) will not be subject to § 367(a) if certain requirements are satisfied.

(g) In particular, the domestic corporation the stock or securities of which are transferred (referred to as the U.S. target company) must comply with certain reporting requirements and satisfy four specified conditions. The condition in Treas. Reg. § 1.367(a)-3(c)(1)(iv) requires that an active trade or business test be satisfied. To satisfy the active trade or business test, a substantiality test must be satisfied (among other requirements). The test is satisfied if, at the time of the transfer, the fair market value of the transferee foreign corporation is at least equal to the fair market value of the U.S. target company.

(h) Pursuant to the reporting requirements contained in Treas. Reg. § 1.367(a)-3(c)(6)(i)(F)(3), the U.S. target company must submit a statement demonstrating that the value of the transferee foreign corporation exceeds the value of the U.S. target company on the acquisition date. The standard that applies for purposes of that reporting requirement is intended to be the same as the standard that applies for purposes of the substantiality test itself. Accordingly, Treas. Reg. § 1.367(a)-3(c)(6)(i)(F)(3) was revised so that the U.S. target company must submit a statement demonstrating that the value of the transferee corporation equals or exceeds the value of the U.S. target company on the acquisition date.

30. Changes Not Made.

(a) Treasury and the IRS declined to make two changes that were requested by certain commentators. One comment requested that the final regulations excuse Coordinated Industry Case ("CIC") taxpayers from the requirement under Treas. Reg. § 1.367(a)-8(p)(2) of filing an amended return promptly after discovering a failure to file or a failure to comply. The commentator suggested that instead, the final regulations should allow CIC taxpayers to submit the materials required when the taxpayer effects a "qualified amended return" under Rev. Proc. 94-69, 1994-2 C.B. 804. As noted, Treasury and the IRS declined to adopt this comment.

31. Another commentator suggested that the final regulations provide a mechanism under which taxpayers may modify the fair market value of transferred stock or securities reported on a previously filed GRA. According to the commentator, taxpayers often determine the fair market value of stock or securities before the date that the stock or securities are transferred to the foreign corporation and that these determinations are based on projected financial information that may, in some cases, deviate from the actual financial information on the date of the transfer. As noted, Treasury and the IRS also declined to adopt this comment.

VI. OTHER DEVELOPMENTS.

A. International Exam Capacity; New IRS Slides.

1. An IRS official, Douglas O'Donnell, LBI Deputy Commissioner (International), stated that the IRS intends to create a more agile audit function by retraining a portion of its domestic examiners to handle international issues as well. Apparently in connection with this new direction, the IRS made public a number of international training slides developed by its International Practice Networks. O'Donnell mentioned

the slides. The slides describe "best practices" for specific international issues and are among the internal training materials made available to examiners. The slide set is quite lengthy and worth perusing. *See* http://www.irs.gov/Businesses/Corporations/International-Practice-Units.

2. In discussing § 367(d), the slides include a discussion of Chief Counsel Advice 201321018, which is potentially applicable in the context of certain acquisitions that result in a transfer of IP offshore (but curiously the slides do not cite Notice 2012-39, which says the regulations will be revised prospectively to address those transactions). The CCA has been criticized for the IRS's trying to rewrite the current regulations in a CCA and for seeking to apply the 2012 Notice retroactively.

3. The "Intangible Property Transfers W/O Cost Sharing" slides ask in the context of manufacturing "shifted" to a CFC, were the technical workers also moved to the CFC? It continues,

> "as long as the licensed IP has substantial value independent of the services then it is considered intangible property under IRC § 936(h)(3)(B). On the other hand, if the intangible property does not have substantial value independent of the services it must be analyzed as the rendering of services under § 482."

4. The § 482 Fundamentals" slides state that the IRS examiner should consider the "functions performed, assets employed, and risks assumed." It refers to the recent "Transfer Pricing Roadmap." It also states that the arm's length range can be determined "either on a full range or an interquartile range," depending upon the application of certain criteria.

5. Numerous additional "International Practice Units" have since been issued.

B. Integrated Hedging Transactions.[2]

1. In 2012, Treasury and the IRS issued temporary regulations that revised the legging out rules of Treas. Reg. § 1.988-5(a)(6)(ii) applicable to hedging transactions under § 988(d). A public hearing was neither requested nor held. One comment was received, and after consideration of the comment, the temporary regulations were adopted as final without substantive change.

2. The regulation is designed to prevent "legging out" under the § 988(d) integration rules in a manner that would potentially enable taxpayers to recognize a loss with respect to one hedge on a hedged debt instrument

[2] Thanks to Larissa Neumann of Fenwick & West for her helpful comments.

without recognizing the corresponding gain on related hedges and the underlying foreign currency debt instrument.

3. The regulations illustrate the new rule with an example, new Example No. 11. In the example, the taxpayer incurs a foreign currency borrowing and hedges it with a currency swap and an interest rate swap. The taxpayer identifies the borrowing and the swap contracts as a qualified hedging transaction under the § 988(d) rules. Later, the taxpayer terminates the interest rate swap and seeks to claim a loss. Under the new regulation, the remaining components of the hedge that have not been disposed of or otherwise terminated must be treated as sold for their fair market values on the leg out date.

4. The example also illustrates an alternative situation in which the taxpayer terminates the interest rate swap at a gain. If 50% or more of the remaining foreign currency cash flows with respect to the borrowing remain hedged at that time, the gain will be recognized and the remaining components of the hedging transaction will not be recognized. That is, in large measure the rule operates in the context of losses, but not gains.

5. Background and Commentary.

   (a) The New York State Bar Association Tax Section ("NYSBA") prepared an excellent report on the temporary regulation dated November 13, 2012. In the NYSBA's view, the targeted hedging position itself is inconsistent with the purposes of § 988(d) and the economic substance of the transaction. The report also expressed the view that it is unlikely a court would sustain the targeted hedging position as qualifying under § 988(d) even under the previous final regulations.

   (b) The NYSBA also questioned whether the approach taken by the temporary regulations (and by the previous final regulations) is optimal, particularly in light of (1) the meaningfully different approach to similar issues taken by Treas. Reg. § 1.1275-6 and (2) the resulting potential for different tax treatment of economically similar or identical transactions at the option of the taxpayer (or inadvertently by an unwary taxpayer) as a result of these differences.

   (c) In the view of the NYSBA, the approach to leg outs taken by Treas. Reg. § 1.1275-6 as simpler and more consistent with economic reality and recommended that Treasury and the IRS modify the temporary § 988(d) regulations to adopt that approach. (Treas. Reg. § 1.1275-6 also covers the integration of certain hedging transactions.)

(d) An important threshold question is whether it is possible under Treas. Reg. § 1.988-5(a) to integrate a debt instrument denominated in a nonfunctional currency with both a currency swap into dollars and a dollar interest rate swap of that same debt. The NYSBA notes that § 988(d)(1) provides that "the extent provided in regulations, if any § 988 transaction is part of a § 988 hedging transaction, all transactions which are a part of such § 988 hedging transactions shall be integrated and treated as a single transaction or otherwise consistently for purposes of this subtitle." Section 988(d)(2) defines a "section 988 hedging transaction" as a transaction entered into by the taxpayer *primarily* to manage the risk of currency fluctuations.

(e) While Treas. Reg. § 1.988-5(a) does not explicitly require that all or any of the hedge components manage currency risk, the regulation could be viewed as overly broad in this regard. It also raises a number of questions. The NYSBA, for example, stated in 1992 when the § 988(d) regulations were first adopted that the scope of the regulation appeared significantly more broad than the statutory authorization. *See* the NYSBA Tax Section Report on the Final and Proposed Regulations Dated October 21, 1992 (Tax Notes International, November 4, 1992).

(f) Treasury and the IRS, in any event, now seem to have confirmed (in the new regulation) that a non-currency interest rate swap can be integrated with a related foreign currency debt instrument under § 988(d). Arguably, this expansion in Example No. 11, if indeed it is a new expansion, may have created the very problem that the Treasury and the IRS now seek to cure.

(g) The NYSBA asked whether (and what metrics would govern whether) that combination must *primarily* manage the taxpayer's currency risk with respect to the foreign currency debt, a requirement under the statute. The regulations (both the temporary and previous final regulations) are silent on these points, including whether they are even relevant.

(h) In an article published shortly after the new temporary regulations were issued, Mark Leeds of Mayer Brown was quoted as stating that the interest rate swap should be eligible for integration only under Treas. Reg. § 1.1275-6, and not under Treas. Reg. § 1.988-5, *even if* the hedge of which it is a component primarily manages currency risk. *See*, Amy Elliott's report, "Treasury Stops Abusive Foreign Currency Hedging Transactions," Tax Notes International, September 10, 2012.

(i) Leeds states he would have designated the currency swap as a hedge under Treas. Reg. § 1.988-5 and the interest rate swap as a hedge under Treas. Reg. § 1.1275-6. He expressed surprise that Treasury and the IRS did not incorporate Treas. Reg. § 1.1275-6 into its guidance.

(j) In the NYSBA's view, even assuming that a combination of the currency swap and the interest rate swap were properly integratable with the foreign currency debt under Treas. Reg. § 1.988-5(a), the regulations still may not have supported claiming a leg-out loss in the targeted hedging transaction.

(k) Further, even if a termination of the interest rate swap were to trigger a deemed sale of the foreign currency debt instrument and/or the currency swap, this does not necessarily provide for the recognition of any loss by the taxpayer with respect to the foreign currency debt, assuming it was issued by the taxpayer. As a general principle of tax law, the sale of a debt instrument has no tax consequences for the issuer of the instrument. Therefore, under a literal reading of the regulations, the issuer of an instrument such as the taxpayer in Example No. 11, if it continued to be the obligor under foreign currency debt instrument, would recognize no income or loss with respect to the debt instrument as a result of legging out of the integrated transaction.

(l) The NYSBA contrasted this result with Treas. Reg. § 1.1275-6(d)(2)(i)(B) which treats a taxpayer that legs out of an integrated transaction as selling "or otherwise terminating" the synthetic debt instrument. This would seem to trigger the result desired by Treasury and the IRS.

(m) Another issue involves the § 1092 straddle rules. These rules could defer the leg-out loss. The NYSBA, however, believes that it is not entirely clear under the regulations whether the straddle rules would apply to require deferral (or capitalization) of any loss realized on a deemed disposition of the foreign currency debt instrument. Certain ambiguous statements in the § 988(d) regulations cause this lack of clarity.

(n) The question of which regulation must be applied and the ambiguities regarding how to deal with underlying uncertainties in the regulations in the context of a hedge such as the one described in Example No. 11 suggests that Treasury and the IRS ought to simplify the rules. The way things are now, an unwary taxpayer easily could walk down the wrong path, make an incorrect identification, or misjudge the tax consequences in making certain business decisions. And the Service could end up making up the rules as it goes along, perhaps to the surprise of all taxpayers.

6. Discussion in Preamble.

(a) The preamble to the final regulations states that the only comment received (the NYSBA report, discussed above) suggested that promulgation of temporary regulations was unnecessary because the prior regulations did not support the taxpayer reporting position that the temporary regulations were designed to prevent. The preamble states that although the NYSBA thought the temporary regulations ultimately unnecessary, its report acknowledged that the § 988 hedging rules are a complicated area of law and that the prior regulations could be improved to provide greater certainty to taxpayers. Treasury and the IRS thus determined that the temporary regulations are useful in clarifying the § 988(d) integration rules -- as well as preventing unintended approaches to legging out under those rules -- and thus should be adopted as final.

(b) The NYSBA's report recommended that Treasury and the IRS consider aligning the hedge integration regime under § 988 with the approach taken in the regulations under § 1275 on the basis that the § 1275 approach is more consistent with economic reality. Treas. Reg. § 1.1275-6 generally allows the integration of a qualifying debt instrument with a hedge or combination of hedges if the combined cash flows of the components are substantially equivalent to the cash flows on a fixed or variable rate debt instrument. However, states the preamble, a financial instrument that hedges currency risk cannot be integrated as a Treas. Reg. § 1.1275-6 hedge. *See* Treas. Reg. § 1.1275-6(b)(2).

(c) Under the legging out rules of Treas. Reg. § 1.1275-6, a taxpayer that legs out of an integrated transaction is treated as terminating the synthetic debt instrument for its fair market value and recognizing any gain or loss. If the taxpayer remains liable on the qualifying debt instrument after the leg-out, adjustment are made to reflect any difference between the fair market value of the qualifying debt instrument and its adjusted issue price. If the taxpayer remains a party to the Treas. Reg. § 1.1275-6 hedge, the hedge is treated as entered into at its fair market value. By contrast, subject to Temp. Treas. Reg. § 1.988-5T(a)(6)(ii)(F), the legging out rules under Treas. Reg. § 1.985-5 treat a taxpayer that legs out of a synthetic debt instrument under § 988 as having disposed of any remaining hedges, and those hedges cannot be part of a qualifying hedging transaction for any period after the leg-out date.

(d) Treasury and the IRS believe that achieving greater alignment between the hedge integration regimes of §§ 988 and 1275 is beyond the scope of the current project, and unnecessary to achieve the purpose of the temporary regulations. The limited purpose of the new regulation is to clarify the application of the legging out rules under Treas. Reg. § 1.988-5 to a particular fact pattern rather than to undertake a more general revision of those regulations. Continuing to treat the remaining components as integrated, as under the rules of Treas. Reg. § 1.1275-6, would represent a departure from the approach taken in the original Treas. Reg. § 1.988-5 regulations.

(e) As further support for the recommendation to achieve better alignment between Treas. Reg. §§ 1.988-5 and 1.1275-6, the NYSBA's report also suggested that the provision in Temp. Treas. Reg. § 1.988-5T(a)(6)(ii)(F) would be unnecessary if the regulations were modified to conform to Treas. Reg. § 1.1275-6. Under Temp. Treas. Reg. § 1.988-5T(a)(6)(ii)(F), if a taxpayer legs out of a qualified hedging transaction and realizes a gain with respect to the debt instrument or hedge that is disposed of or otherwise terminated, then the taxpayer is not treated as legging out if during the period beginning 30-days before the leg-out date and ending 30-days after that date the taxpayer enters into another transactions that, taken together with any remaining components of the hedge, hedges at least 50% of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualifying hedge transaction.

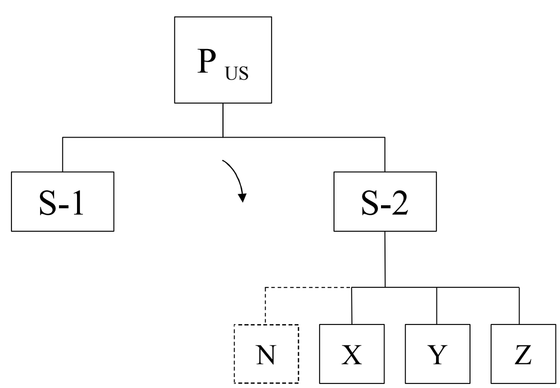
(f) Temp. Treas. Reg. § 1.988-5T(a)(6)(ii)(F) also provides a similar rule where a taxpayer has a qualifying hedge transaction composed of multiple components. In such a case the taxpayer will not be treated as legging out of the qualified hedging transaction if the taxpayer terminates all or a part of one or more components and realizes the net gain with respect to the terminated component, components, or portions thereof, provided that the remaining components of the hedge by themselves hedge at least 50% of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction.

(g) The NYSBA's report suggested that this provision of the § 988 hedging rules is unnecessarily complex, as well incomplete because it does not cover situations in which, upon legging out, the taxpayer recognizes a loss on the debt instrument or hedge that is disposed of or otherwise terminated. However, Treasury and the IRS state they are interested in simply clarifying the § 988 hedging rules and focusing on a particular fact pattern. They do not seek to undertake a more general revision of these rules. Accordingly, they state that modifications to Temp. Treas. Reg. § 1.988-5T(a)(6)(ii)(F) are beyond the scope of this project.

(h) Finally, the NYSBA's report also recommended that, even if the final regulations did not adopt the recommendation of aligning the approach taken in Treas. Reg. § 1.1275-6, the § 988 regulations should be modified to provide that, when an issuer of a qualified debt instrument legs out but continues to be the obligor on the qualifying debt instrument, the issuer should be deemed to repurchase and reissue the debt instrument for its then fair market value. The report noted that the temporary regulations indicated that the debt instrument is "treated as sold for its fair market value." The report said that the sale of a debt instrument has no tax consequences for the issuer of the instrument. Treasury and the IRS agreed that this aspect of the temporary regulations should be modified and, for the sake of consistency, the final regulations adopt the phrase "treated as sold or otherwise terminated by the taxpayer for its fair market value," which is used in Treas. Reg. § 1.988-5(a)(6)(i)(C) (regarding legging in).

C. International Reorganizations: New IRS Ruling.

1. Rev. Rul. 2015-9, I.R.B. 2015-21, revoked Rev. Rul. 78-130, 1978-1 C.B. 114. In the rulings, P, a U.S. company, owns foreign corporations S-1 and S-2. S-1 is an operating company and S-2 is a holding company. S-2 owns foreign subsidiaries, X, Y and Z. In the transaction, P transfers the stock of S-1 to S-2 in exchange for additional S-2 voting stock. In a second pre-arranged step S-1, X, Y and Z transfer their assets to S-2's newly formed foreign subsidiary, N, in exchange for N common stock. Thereafter, S-1, X, Y and Z liquidate.



2. Rev. Rul. 78-130 treated the S-1 transaction as a triangular C reorganization in which S-1 transferred its assets to N in exchange for the

S-2 stock as the steps were all part of a prearranged, integrated plan. The ruling states that the transaction did not qualify as a D reorganization. Subsequently, however, the definition of "control" for purposes of the D reorganization rules was expanded, and the transaction in the ruling could qualify as a D reorganization of S-1 into N. Thus, the transaction appeared to have become a D reorganization.

3. Later (2009), the Service issued § 368 regulations that could change the transaction back to a triangular C reorganization. If neither S-2 nor N issued additional shares of its stock, Treas. Reg. § 1.368-2(l) would appear in the first instance to require the transaction to qualify as a D reorganization of S-1 directly into N. Treas. Reg. § 1.368-2(l) deems the issuance of stock in certain transactions.

4. A D reorganization requires the issuance of acquiring corporation stock pursuant to § 354. It could be argued that the conveyance of the deemed N share or shares would be deemed to happen anyway, even without the § 368 regulation, under the "meaningless gesture" doctrine. This is discussed in the Treasury Decision's discussion regarding the adoption of Treas. Reg. § 1.368-2(l). *See* T.D. 9475 (December 17, 2009). The nominal N share thereafter would then be treated as contributed by P to S-2. *See* Treas. Reg. § 1.368-2(l)(2)(i) and (3) Example No. 3.

5. Treas. Reg. § 1.368-2(l), however, contains an important exception. The deemed stock issuance rule will not apply if the transaction can qualify as a triangular reorganization under Treas. Reg. § 1.358-6. *See* Treas. Reg. § 1.368-2(l)(2)(iv). This could include a triangular C.

6. Rev. Rul. 2015-9, however, does something completely different. It characterizes the transaction as a § 351 transfer by P of the S-1 stock to S-2. The subsequent transactions in which S-1, X, Y and Z transfer their assets to N and then liquidate are treated as D reorganizations.

7. The ruling states that a transfer of property may be respected as a § 351 exchange even if it is followed by subsequent transfers of property as part of a prearranged, integrated plan. However, states the ruling, a transfer of property in an exchange otherwise described in § 351 will not qualify as a § 351 exchange if, for example, a different treatment is warranted to reflect the substance of the transaction as a whole.

8. The ruling also states that even though P's transfer is part of a prearranged, integrated plan involving successive transfers, P's transfer satisfies the formal requirements of § 351. Further, an analysis of the transaction as a whole does not dictate that P's transfer be treated other than in accordance with its form in order to reflect the substance of the transaction.

9. The ruling thus ignores the step-transaction doctrine, substituting in its place a vague new rule.

10. The ruling states that P will enter into a GRA with respect to the transfer of P's S-1 stock to S-2. It also states that P will take into account the application of Treas. Reg. § 1.367(b)-4, which may require shareholders that exchange stock of a foreign corporation in certain nonrecognition exchanges to include in income as a deemed dividend the § 1248 amount attributable to the exchanged stock.

11. Rev. Rul. 2015-9 would seem to continue the elective-characterization nature of the transaction so this cannot be the issue that concerned the Service. If N actually issues a share or shares to P it would seem a D characterization should prevail despite the ruling. The property covered by, and described in, the related § 367 gain recognition agreement would vary according to the characterization.

12. An IRS spokesperson, while discussing the new revenue ruling, was quoted as saying with regard to the application of § 367 that "We couldn't find anything that explained the [Service's § 367] thinking [behind Rev. Rul. 78-130]." Thus, international tax issues apparently were involved in the Service's decision to revoke Rev. Rul. 78-130 and recharacterize the transaction. Perhaps the Service was concerned that, in some cases, only a nominal or deemed share in N is all that would be subject to the gain recognition agreement.

13. The alternative characterizations (discussed above) will cause a difference in what is subject to the related GRA.

    (i) If there's a deemed issuance of N shares to S-1 which are then deemed distributed to P and a deemed contribution of those deemed shares by P to S-2, the GRA should cover the contribution of the deemed shares to S-2

    (ii) If actual N shares are issued to S-1 and then distributed to P, a GRA would be necessary only if P contributes the shares to S-2

    (iii) Under Rev. Rul. 2015-9, a GRA is necessary for the S-1 shares contributed to S-2

    If § 367 was the Service's concern, it might have been better to change the indirect stock transfer rules in the § 367 regulations than to tinker with the substantive reorganization rules. *See* Treas. Reg. § 1.367(a)-3(d).

14. One would hope the IRS has not so broadened the landscape as to place in doubt long-standing applications of the step-transaction doctrine. The IRS also should explain the standards applicable in analyzing a "transaction as a whole," whatever that means.

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REVISITING SECTION 367(d): HOW TREASURY TOOK THE BITE OUT OF SECTION 367(d) AND WHAT SHOULD BE DONE ABOUT IT

by

Bret Wells[*]

Abstract

Section 367(d) seeks to prevent residual profits related to U.S. developed intangible assets from migrating out of the U.S. tax jurisdiction via the outbound contribution or transfer of intangibles to a foreign corporation. There has been a great hue and cry over the outbound migration of intangibles in recent years, which by implication has created significant agitation about whether section 367(d) is effective. For at least a decade, the Treasury Department and IRS have identified section 367(d) as an area in need of regulatory reform, and recent comments by government officials indicate that guidance may be forthcoming in the future. Concurrently, the Obama administration has proposed amendments to section 367(d) and the U.S. subpart F rules to address outbound migration of intangible value.

The debate over the efficacy of section 367(d) to prevent IP migration is being waged along two fronts. As to the first front of this debate, the central question is whether a fatal loophole (a "goodwill loophole") exists within the architecture of section 367(d) that allows the outbound migration of intangible value under the protective cloak of "goodwill" with the consequence that a substantial portion of the ongoing residual profits related to the transferred goodwill items escape the application of section 367(d)'s super royalty obligation. In Subparts II.A. through II.B., this Article addresses why this "goodwill loophole" that has received so much attention is nonexistent. All that is needed is for the courts to correctly apply section 367(d) as it should be applied, and once this is done the "goodwill loophole" should be defrocked of all of its purported cloaking capabilities.

The second front in this ongoing debate about the efficacy of section 367(d) to prevent IP migration concerns the role that cost sharing

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* Associate Professor of Law at the University of Houston Law Center, B.B.A., Southwestern University, 1987, J.D., The University of Texas School of Law, 1989.

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agreements play in facilitating the outbound migration of residual profits away from the U.S. functions that create the high-profit potential intangibles. Section 367(d) is clear on its face as to what should be the correct outcome in these instances, but the Treasury Department's existing cost sharing regulations create a "cost sharing loophole" that provides the means for substantial profit-shifting. In Subpart II.C., infra, this Article sets forth how the Treasury Department should amend its existing Treasury regulations in order to close this inappropriate "costs sharing loophole."

Moreover, as an entirely separate debate, the Treasury Department and IRS have retrofit section 367(a) and (b) as a means to attack the tax-free repatriation of cash from foreign subsidiaries in transactions that utilize the recovery of high stock basis. Part III addresses how section 367(a) and (b) have been substantially altered and how section 367(d) is now being rethought in light of this expanding omnibus strategy that is redefining the contours of all of section 367.

Calm reflection about the contours of section 367(d) is needed because the raging debate about section 367(d) threatens to run it off the road and into a ditch. This Article seeks to provide illumination of the way forward so that section 367(d) achieves its intended purpose.

I. INTRODUCTION

Section 367(d) seeks to prevent residual profits related to U.S. developed intangible assets from migrating out of the U.S. tax jurisdiction via the outbound tax-free contribution or transfer of intangibles to a foreign corporation. There has been a great hue and cry over the outbound migration of intangibles in recent years,[1] which by implication has created significant agitation about whether section 367(d) is effective. For at least a decade, the Treasury Department and IRS have identified section 367(d) as an area in need of regulatory reform,[2] and recent comments by government officials indicate that guidance may be forthcoming in the future.[3] Concurrently, the Obama administration has proposed amendments to section 367(d) and the

1. *See, e.g.*, STAFF OF THE JOINT COMM. ON TAX'N, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2012 BUDGET, JCS-3-11, 197 (2011); STAFF OF THE JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING, JCX-37-10, 75 (2010); U.S. DEP'T OF THE TREASURY, REPORT TO THE CONGRESS ON EARNING STRIPPING, TRANSFER PRICING AND U.S. INCOME TAX TREATIES (2007).

2. The Treasury Department first issued its temporary regulations in 1986. See T.D. 8087, 1986–1 C.B. 175. These regulations have been amended once in 1998 but remained temporary regulations. *See* T.D. 8770, 1998–2 C.B. 3. No further amendments have been made to these temporary regulations even though section 367(d) has been identified off-and-on as an area in need of further regulatory guidance in guidance plans issued over the last decade. *See* DEPARTMENT OF THE TREASURY 2013-2014 PRIORITY GUIDANCE PLAN at 25 (Apr. 21, 2014); DEPARTMENT OF THE TREASURY 2012-2013 PRIORITY GUIDANCE PLAN at 23 (Aug. 9, 2013); DEPARTMENT OF THE TREASURY 2011-2012 PRIORITY GUIDANCE PLAN at 26 (Nov. 19, 2012); DEPARTMENT OF THE TREASURY 2010-2011 PRIORITY GUIDANCE PLAN at 24 (June 30, 2011); DEPARTMENT OF THE TREASURY 2008-2009 PRIORITY GUIDANCE PLAN at 14 (Sept. 10, 2008); DEPARTMENT OF THE TREASURY 2007-2008 PRIORITY GUIDANCE PLAN at 12 (Aug. 13, 2007); DEPARTMENT OF THE TREASURY 2006-2007 PRIORITY GUIDANCE PLAN at 19 (Mar. 12, 2007). It is incredible that the existing temporary regulations have remained in temporary form for almost thirty years and that a significant level of effort has not already been put forward towards improvement of these temporary regulations given the base erosion realities that currently exist.

3. *See International Guidance Update,* 2013 TAX NOTES TODAY 147-1 (July 31, 2013) (quoting source stating that section 367(d) regulatory guidance is forthcoming and the treatment of goodwill will be covered); *IRS Could Update Regs on Transfers of Intangibles to Foreign Corporations,* 2013 TAX NOTES TODAY 109-2 (June 5, 2013) (quoting IRS official who stated that the IRS believes it has authority to deal with intangible migration by closing loopholes under section 367(d) and that the IRS is considering such an update to the existing regulations).

U.S. subpart F rules to address outbound migration of intangible value,[4] presumably believing that section 367(d) is not up to the task by itself.

The debate over the efficacy of section 367(d) is being waged along two fronts. As to the first front of this debate, the central question is whether a fatal loophole (a "goodwill loophole") exists within the architecture of section 367(d) that allows the outbound migration of intangible value under the protective cloak of "goodwill" with the consequence that a substantial portion of the ongoing residual profits related to the transferred goodwill items escape the application of section 367(d)'s super royalty obligation. In Subparts II.A. through II.B., this Article addresses why this "goodwill loophole" that has received so much attention is nonexistent. All that is needed is for the courts to correctly apply section 367(d) as it should be applied, and once this is done, the "goodwill loophole" should be defrocked of all of its purported cloaking capabilities.

The second front in this ongoing debate about the efficacy of section 367(d) to prevent intellectual property migration concerns the role that cost sharing agreements play in facilitating the outbound migration of residual profits away from the U.S. functions that create the high-profit potential intangibles. Section 367(d) is clear on its face as to what should be the correct outcome in these instances, but the Treasury Department's existing cost sharing regulations create a "cost sharing loophole" that provides the means for substantial profit-shifting. In Subpart II.C., this Article sets forth how the Treasury Department should amend its existing Treasury regulations in order to close this inappropriate "costs sharing loophole."

Moreover, as an entirely separate debate, the Treasury Department and IRS have retrofitted section 367(a) and (b) as a means to attack the tax-free repatriation of cash from foreign subsidiaries in transactions that utilize the recovery of high stock basis. Part III addresses how section 367(a) and (b) have been substantially altered and how section 367(d) is now being rethought in light of this expanding omnibus strategy that is redefining the contours of all of section 367.

Finally, in Part IV, this Article provides concluding comments about the way forward in light of the multi-faceted debates that are currently pummeling section 367(d). Calm reflection about the contours of section 367(d) is needed because the raging debate about section 367(d) threatens to

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4. The Obama Administration has proposed legislative changes to section 367(d) that extend its applicability to the outbound transfer of goodwill and also propose to subject the excess intangible returns earned by controlled foreign corporations to taxation under a new category of subpart F income. *See* U.S. TREASURY DEPARTMENT, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS at 45–47 (Mar. 2014) [hereinafter GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS].

run it off the road and into a ditch. This Article seeks to provide illumination of the way forward so that section 367(d) achieves its intended purpose.

II. THE GOODWILL HUNTING EXERCISE CAUSED US TO LOSE FOCUS ON SECTION 367(d)'S OBJECTIVE

To appropriately frame the context for the debate about the "goodwill loophole" that is raging, it is appropriate to review the legislative policy goals of section 367(d) and to posit a specific "goodwill loophole" transaction that illustrates the potential disconnect before specifically analyzing how current law should be applied, so that is where this Part begins.

Prior to the enactment of section 367(d), taxpayers were regularly able to receive favorable rulings under section 367(a) from the IRS that blessed the tax-free outbound contribution of income-producing intangibles to foreign affiliates as long as the intangible was actively utilized by the transferee foreign corporation in foreign markets and the transferee corporation (i) did not utilize the contributed intangible to make products for distribution back in the United States marketplace[5] or (ii) paid a royalty for such distribution.[6] Furthermore, even when the IRS contended that a particular outbound contribution of highly profitable income-producing intangibles was done for tax avoidance reasons, the IRS faced difficulty in sustaining its position in the courts.[7] Concurrently in time, due to press

5. *See* Rev. Proc. 68–23, 1968–1 C.B. 821, § 3.02(1)(b)(iii) and (iv) (stating that favorable rulings would not be issued if the intangible was used for U.S.-destined sales) obsoleted by Rev. Rul. 2003–99, 2003–2 C.B. 388. Taxpayers were regularly able to receive favorable outbound migration of their U.S. intangibles as long as the U.S. affiliate was paid a royalty by the foreign affiliate for the sale of products into the United States. *See, e.g.*, P.L.R. 1984–04–025 (Oct. 21, 1983); P.L.R. 1984–05–004 (Sept. 29 1983); P.L.R. 1984–05–113 (Nov. 4, 1983). Congress has observed this same historical backdrop in its deliberations in its decision to expand the mission of section 367(d). *See* H.R. REP. NO. 98-432(II), at 1312–15 (1984); COMM. ON FINANCE UNITED STATES SENATE, DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 358–61 (Comm. Print 1984).

6. *See* Seagate Tech., Inc. v. Commissioner, 102 T.C. 149, 248–49 (1994) (where the court stipulates that the U.S. taxpayer received a favorable section 367(a) rulings with respect to the outbound contribution of manufacturing and marketing intangibles to a Singapore affiliate that resulted in high profitability outside the United States).

7. Dittler Brothers, Inc. v. Commissioner, 72 T.C. 896, 920 (1979) (IRS asserted that the transfer of the high profit potential intangible to a Netherlands Antilles affiliate had a principal purpose of tax avoidance and thus was taxable under then existing section 367(a); the Tax Court held in favor of the taxpayer, stating that the commercial demands of the joint venture for both parties (the U.S. person and

reports,[8] Congress had become aware that U.S. pharmaceutical companies claimed research and development deductions for developing pharmaceutical intangibles and then had contributed the developed intangibles to a possession corporation to avail themselves of the then applicable section 936 credit for income earned in the transferee possession corporation.[9]

Congress saw all of these events as creating a common problem: tax deductions were allowed to reduce U.S. taxable income[10] even though these

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the non-U.S. investor) to co-contribute intangibles demonstrated that the outbound contribution of the U.S. intangibles did not have a principle purpose of tax avoidance), *aff'd* mem., 642 F.2d 1211 (5th Cir. 1981).

8. *See, e.g.*, Thomas W. Lippman, *Loophole to Puerto Rico Under Fire: Drug Firms Try to Save Puerto Rico Loophole*, THE WASHINGTON POST, Dec. 3, 1981, at C13. This news article was mentioned in the floor debates as one of the factors that galvanized Congressional attention. *See* 128 CONG. REC. S17,235 (1982) (statement of Sen. Dole).

9. *See* H.R. REP. NO. 98-432(II), at 1311–12, 1316 (1984); COMM. ON FINANCE UNITED STATES SENATE, DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 366 (Comm. Print 1984); STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF DEFICIT REDUCTION ACT OF 1984, JCS-41-84, 427 (Comm. Print 1984).

10. *See* I.R.C. §§ 162, 174; Reg. §§ 1.263A-1(e)(3)(iii)(A), (B), and (4)(iv)(N) (allows immediate expensing for marketing, selling, advertising and distribution costs and research and development costs), 1.197-2(k) Ex. (1) (concedes that advertising cost enhances intangible value of a company but even so these costs are not to be capitalized as part of the acquisition cost of an intangible within the meaning of section 197), 1.263A-1(e)(4)(iv)(E) (allows immediate expensing of employee development and training cost even though this can create a valuable workforce in place); Rev. Proc. 2000–50, 2000–2 C.B. 601; Rev. Rul. 92–80, 1992–2 C.B. 57. For criticism of the overly generous expensing under current law, see Calvin H. Johnson, *Measure Tax Expenditures by Internal Rate of Return*, 2013 TAX NOTES TODAY 151-9 (Apr. 15, 2013); Calvin H. Johnson, *Capitalize Costs of Software Development*, 2009 TAX NOTES TODAY 151-9 (Aug. 10, 2009); Ethan Yale, *When Are Capitalization Exceptions Justified?*, 57 TAX L. REV. 549 (2004); Calvin H. Johnson, *Destroying Tax Base: The Proposed INDOPCO Capitalization Regulations*, 2003 TAX NOTES TODAY 106-32 (June 2, 2003). Interestingly, Chairman Baucus has proposed a discussion draft that would require capitalization of a portion of the ongoing research, development, and advertising cost. *See* STAFF OF THE JOINT COMM. ON TAXATION, TECHNICAL EXPLANATION OF THE SENATE COMMITTEE ON FINANCE CHAIRMAN'S STAFF DISCUSSION DRAFT TO REFORM CERTAIN BUSINESS PROVISIONS, JCX-19-13 (Nov. 21, 2013), 2013 TAX NOTES TODAY 226-16. *See also* SENATE FINANCE COMM., SUMMARY OF STAFF DISCUSSION DRAFT: COST RECOVERY AND ACCOUNTING (Nov. 21, 2013), 2013 TAX NOTES TODAY 226-35. For a review of this proposal, *see* Calvin H. Johnson, *First Do No Harm: The Senate Staff Discussion Draft on Cost Recovery*, 2014 TAX NOTES TODAY 25-11 (Feb. 6, 2014).

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expenses created intangible property which (once developed) was transferred from the intangible developer to a non-U.S. entity that was not subject to full U.S. taxation (either because it was a possession corporation entitled to claim a section 936 credit or because income of the transferee foreign corporation was nonsubpart F income and thus escaped current U.S. taxation). The profit-shifting problem was clear, and in Congress's view the resulting erosion of the U.S. tax base was unacceptable. Cases such as *Dittler Brothers*, *Inc. v. Commissioner*[11] demonstrated that section 367(a), as interpreted by the courts, was insufficient to protect the U.S. tax base from erosion via these intangible migration strategies.[12]

As a result, Congress began systematically addressing the migration of U.S. developed intangibles. In 1982, Congress enacted section 936(h), which required the shareholders of a possession corporation to include in income any income earned by the possession corporation attributable to a contributed intangible that was described in section 936(h)(3)(B),[13] and the legislative history indicates that the statute was meant to define "intangible assets broadly."[14] Section 936(h)(3)(B) seeks to identify all intangibles that could create future revenue-generating opportunities, and for good order's sake Congress included a "catch-all" category in section 936(h)(3)(B)(vi) including all other "similar items" in section 936(h)(3)(B)'s definition as well.[15] The intent was clear: if an intangible is capable of producing a nonroutine return, then the income of that intangible cannot be assigned to a possession corporation even if the underlying intangible asset is assigned to the possession corporation. Instead, the income derived from the transferred intangible will be allocated back to the U.S. person that transferred the

11. Dittler Brothers, Inc. v. Commissioner, 72 T.C. 896 (1979).

12. *See* H.R. REP. NO. 98-432(II) at 1317 (1984) (so stating and then emphatically stating that this committee has no intention of condoning such a result); COMM. ON FINANCE UNITED STATES SENATE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 360 (Comm. Print 1984) (so stating); STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84, 427 (1984) (same).

13. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 213, 96 Stat. 324 (1982).

14. *See* S. REP. NO. 97-494(I), at 161 (1982).

15. This term other "similar item" is incorporated in section 482 regulations and states that an intangible is similar if it derives its value not from its physical attributes but from its intellectual content or other intangible properties. *See* Reg. § 1.482-4(b)(6). Thus, if an item or function has value due to its revenue generating capabilities related to its intangible properties, then it is a "similar item" to all of the other intangibles enumerated in section 936(h)(3)(B) and thus is subject to section 367(d)'s super royalty. Again, this definition is attempting to encompass all contributing factors to nonroutine returns. This analysis is more fully explored in Part II.B., *infra*.

intangible to the possession corporation. Section 936(h) thus represented a statutory expansion of the assignment of income doctrine beyond its historic norm. After the enactment of section 936(h), the possession corporation would be able to earn routine manufacturing returns, but it would not be entitled to earn nonroutine returns because section 936(h) reassigned any intangible returns ("residual profits") arising from that transferred intangible back to the U.S. transferor.[16]

The floor debates at that time indicate that Congress understood that section 936(h)(3)(B) was intended to apply generally to all income-generating intangibles, and legislative amendments that would have curtailed this expansive definition were rebuffed.[17] In the legislative history, Congress was categorical in its concerns, stating that "no legitimate policy is served by permitting tax-free generation of income related to intangibles created, developed or acquired in the United States or elsewhere outside of the possession" and that "ending the availability of the possession credit for income from such intangibles is justified."[18] Congress simultaneously recognized that some taxpayers had stated that they would transfer intangibles out of their possession corporation and into a foreign corporation incorporated in a low-tax jurisdiction as a means of side-stepping the consequences of the expected enactment of section 936(h).[19] For this reason, Congress concurrently amended section 367 by enacting section 367(d) to provide that any transfer of an intangible enumerated in section 936(h)(3)(B) from a possession corporation to any foreign corporation would be taxable under section 367(d).[20]

In 1984, the scope of section 367(d) was expanded to apply to outbound contributions of any intangible described in section 936(h)(3)(B) from any U.S. person to any foreign corporation, and the Treasury Department was given broad regulatory authority to adopt regulations that would implement the objectives of this expanded base protection goal of section 367(d).[21] In addition to expanding the mission of section 367(d), the 1984 amendments made clear that the transfer of intangible property subject to section 367(d) would be treated as a sale of the subject intangible by the U.S. transferor in exchange for ongoing annual contingent payments that are deemed to be received by the U.S. transferor over the useful life of the

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16. The implications of the cost sharing arrangements that historically could be employed by possession corporations are beyond the scope of this Article. Similar results are achievable by foreign corporations under the existing cost sharing regulations, and those issues are discussed in Part II.C., *infra*.

17. *See* 128 CONG. REC. S17,235 (1982) (statement of Sen. Dole).

18. *See* S. REP. NO. 97-494(I), at 159 (1982).

19. *See* H.R. REP. NO. 97-760, at 512 (1982) (Conf. Rep.).

20. *See* H.R. REP. NO. 97-760, at 512 (1982) (Conf. Rep.).

21. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 131(b), 98 Stat. 494 (1984).

transferred intangible (within the nomenclature of section 367(d), these deemed ongoing annual contingent payments came to be known as a section 367(d) “super royalty”).[22]

Seen in its historical context, section 367(d) codifies the applicability of the assignment of income doctrine to any section 351 transfer of intangible property to a foreign corporation. Prior to section 367(d), the scope of the judicially created assignment of income doctrine had a limited application. In this regard, the assignment of income doctrine prevented the true earner of income from assigning that income to others.[23] Furthermore, the assignment of income doctrine prevented income from property from being deflected away from the person who maintained ownership control over the underlying property.[24] And, the assignment of income doctrine could apply if a property transfer did not have a substantial nontax business purpose.[25] The IRS in litigation had argued that the judicially created assignment of income doctrine also should apply to reassign intangible income away from the owner of a contributed intangible and instead should assign such income back to the original developer of the income-generating property.[26] But, this argument took the courts further than they were willing to go,[27] as the case law prior to section 367(d) generally refused to apply that

22. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

23. *See* Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Eubank, 311 U.S. 122 (1940).

24. *See* Helvering v. Horst, 311 U.S. 112 (1940).

25. The Tax Court asserted such a view in UPS v. Commissioner, 78 T.C.M. (CCH) 262, 1999 T.C.M. (RIA) ¶ 99268 (holding that the assignment of income doctrine and sham transaction doctrines serve to reallocate income from a foreign subsidiary back to the U.S. affiliate whose income explains those profits). The Eleventh Circuit reversed the Tax Court decision, finding that the UPS restructuring had a business purpose. *See* UPS v. Commissioner, 254 F.3d 1014 (11th Cir. 2001) (finding that UPS restructuring had a business purpose and remanded for determining whether section 482 required a reallocation of income among the related parties). For the view that the UPS case would be decided differently today and that the assignment of income principles would be applicable given the codification of the economic substance doctrine in section 7701(o), see *Caterpillar’s Offshore Tax Strategy: Hearing Before the S. Permanent Subcomm. on Investigations of the S. Comm. on Homeland Security and Governmental Affairs* (2014) (statement of Reuven S. Avi-Yonah) [hereinafter *Caterpillar Hearing*].

26. *See* Eli Lily & Co. v. Commissioner, 84 T.C. 996, 1109 (1985) (“Although respondent concedes that Lilly P.R. acquired legal title to the patents and know-how in 1966 in a valid section 351 transfer, he maintains that for purposes of section 482, legal ownership of the intangibles can be disregarded and all income attributable to them reallocated from Lilly P.R. to petitioner.”), *aff’d in part and rev’d in part*, 856 F.2d 855 (7th Cir. 1988).

27. *See, e.g.*, *Eli Lily & Co.*, 84 T.C. at 1123 (“Respondent’s reallocations conflict with a fundamental principle of Federal income tax law: that income from

doctrine in instances where the future income derived from the exploitation of income-producing intangible property was earned by the true owner of the underlying income-producing property.[28]

With this backdrop in mind, section 367(d) is best seen as an effort to statutorily expand the applicability of the assignment of income doctrine past its historic scope, providing in effect that no transfer of intangible property (whether the fruit, the tree, or the tree with its fruit) will serve to deflect the income from that intangible property away from the U.S. developer. Thus, rightly viewed, section 367(d) is a repudiation of the ability to transfer the ongoing intangible returns generated by U.S. developed income-producing intangibles away from the U.S. developer to a foreign corporation by means of an outbound section 351 transfer of the income-producing intangible as was allowed in cases such as *E.I. Dupont de Nemours & Co. v. United States*,[29] *Eli Lily & Co. v. Commissioner*,[30] *G.D. Searle & Co. v. Commissioner*,[31] and *Bausch & Lomb, Inc. v. Commissioner*.[32] Section 367(d) assigns the income derived from the transferred intangible back to the U.S. developer even when ownership of the underlying "tree" (i.e., the income-producing intangible asset) has been transferred to a foreign corporation.

In 1986, concurrent with the addition of the "commensurate with income" standard to section 482, Congress incorporated this same standard into section 367(d), providing that the amount of the ongoing annual section 367(d) super royalty payment must be commensurate with the income generated by the transferred intangible.[33] Said differently, this commensurate with income standard was intended to make clear that where taxpayers

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property is earned by the owner of the property. *See* Helvering v. Horst, 311 U.S. 112 (1940); Blair v. Commissioner, 300 U.S. 5 (1937)").

28. Heim v. Fitzpatrick, 262 F.2d 887 (2d Cir. 1959). In the context of a section 351 transfer, see Hempt Bros., Inc. v. U.S., 490 F.2d 1172 (3rd Cir. 1974) (held that cash basis taxpayer's assignment of accounts receivable as part of a transfer of the entire business to a controlled corporation is not assailable under assignment of income principles); *Eli Lily & Co.*, 84 T.C. at 1116–27 (1985), *aff'd in part and rev'd in part*, 856 F.2d 855 (7th Cir. 1988).

29. *See* E.I. Dupont de Nemours & Co. v. United States, 471 F.2d 1211 (Ct. Cl. 1973) (stating that the grant of a non-exclusive license with respect to a patent constituted a "transfer of property" within the meaning of section 351).

30. Eli Lily & Co., 84 T.C. 996, 1116–27 (1985), *aff'd in part and rev'd in part*, 856 F.2d 855 (7th Cir. 1988) (manufacturing intangibles transferred to Puerto Rican subsidiary).

31. G.D. Searle & Co. v. Commissioner, 88 T.C. 252 (1987) (manufacturing intangibles transferred to Puerto Rican subsidiary).

32. Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991) (manufacturing intangibles transferred to Irish subsidiary).

33. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1231(e), 100 Stat. 2085 (1986).

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transfer an enumerated intangible with high-profit potential, the ongoing super royalty cannot be benchmarked with generic industry data. Instead, it must be valued based upon the actual ongoing profit experience of the transferred intangible.[34] This commensurate with income standard accomplishes its objective by deeming the foreign transferee corporation as paying a super royalty to the U.S. transferor that is determined in amount by the actual income generated from the exploitation of the transferred intangible.[35] Thus, the addition of the commensurate with income standard to section 367(d)(2) in 1986 was an important step towards harmonizing section 367(d)'s super royalty amount with Congress's underlying goal of codifying the assignment of income doctrine because it made clear that all income arising from the contributed intangible would be assigned back to the original U.S. transferor by reason of the fact that the super royalty must always remain commensurate in amount with the amount of the income actually generated by the transferred intangible. Thus, whereas the government had failed to convince the courts to expand their judicially created assignment of income doctrine to assign the income attributable to transferred income-generating intangible property back to the U.S. developer–transferor,[36] Congress by 1986 had statutorily codified this doctrine, thus preventing the deflection of intangible returns away from the U.S. developer via the technique of transferring income-generating intangibles to a foreign corporation.

In 1997, Congress modified section 367(d) again to provide that the super royalty would be considered foreign source income to the extent that section 482 would have so sourced an actual ongoing royalty if one had been paid between the parties,[37] thus allowing the tax results afforded under

34. *See* JOINT COMM. ON TAX'N, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1016 (Comm. Print 1987).

35. *See* Reg. § 1.367(d)-1T(c)(1) (states super royalty amount is determined consistently with section 482); Reg. § 1.482-6(c)(3)(i)(B) (residual profits allocated to those functions that make a nonroutine contribution and only those functions); Reg. § 1.482-4(f)(2)(ii)(C)(4), -4(f)(2)(iii) Ex. (2) (specifies proposition in text and then demonstrates via example that the allocation of residual profits must approximate the actual profit experience to meet the commensurate with income standard).

36. *See, e.g.*, Eli Lily & Co. v. Commissioner, 84 T.C. 996, 1123 ("Respondent's reallocations conflict with a fundamental principle of Federal income tax law: that income from property is earned by the owner of the property. *See* Helvering v. Horst, 311 U.S. 112 (1940); Blair v. Commissioner, 300 U.S. 5 (1937)").

37. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

section 367(d) to better approximate the results achievable under section 482.[38]

As an important asterisk to this systemic legislative effort, Congress contemplated that a transfer solely categorized as goodwill would not be subjected to section 367(d)'s super royalty obligation,[39] and existing

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38. H.R. REP. NO. 105-220, at 629 (1997) (Conf. Rep.). Although beyond the scope of this Article, it is worth noting in passing that the change in the sourcing result represents a significant effort to prevent section 367(d)'s deemed super royalty from creating international double taxation. In this regard, consider the facts set forth in the ILLUSTRATION CASE, *infra* but now posit that the income-producing intangible assets of the Target's business owned by the risk-taker entrepreneurial entity includes a Country A trademark and Country A brand names and that Country A imposes its own taxes on the risk-taker entrepreneurial entity for the sale into Country A using those intangible assets. These Country A foreign tax levies in all likelihood would allow the U.S. transferor to claim deemed U.S. foreign tax credit under section 902 when dividends are paid by the risk-taker entrepreneurial entity. *See* Reg. § 1.901-2(b)(1)–(4). The effect of section 367(d)(2)(C)'s sourcing rule is to cause the super royalty attributable to intangibles used outside of the U.S. to generate foreign source income to the U.S. transferor, thus providing the U.S. transferor the foreign tax credit limitation in which to utilize deemed section 902 foreign tax credits from Country A. *See* I.R.C. § 904(a), (d). Thus, the U.S. government has done much to unilaterally address potential double taxation problems arising from section 367(d)'s efforts to assert U.S. taxing jurisdiction over the income generated by foreign-owned intangibles in the ILLUSTRATION CASE, but even so Congress remained committed to preserving the right to tax on a residual basis the U.S. developer on the intangible returns of U.S. developed income-producing intangible assets even when the ownership of those intangible asset are transferred away to a foreign corporation.

39. *See* COMM. ON FINANCE UNITED STATES SENATE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 362, 365 (Comm. Print 1984); H.R. REP. NO. 98-432(II), at 1320 (1984) (stating that the committee contemplates that the transfer of goodwill or going concern value developed by a foreign branch will be treated under this exception [section 367(a)(3)] rather than a separate rule applicable to intangibles [section 367(d)]); a possible explanation for the distinction between goodwill and all other intangibles is indicated in the below excerpt from the Blue Book:

> Except in the case of an incorporation of a foreign loss branch, the Congress did not believe that transfers of goodwill, going concern value, or certain marketing intangibles should be subject to tax. Goodwill and going concern value are generated by earning income, not by incurring deductions. Thus, ordinarily, the transfer of these (or similar) intangibles does not result in avoidance of Federal income taxes.

STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84, 428,

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Treasury regulations implement that policy—at least with respect to foreign goodwill.[40] Does this "goodwill" carve-out represent a fatal "goodwill loophole" to section 367(d) that frustrates Congress's efforts to statutorily codify the assignment of income doctrine?

The following ILLUSTRATION CASE provides a useful mechanism to clearly frame the relevant policy analysis:

> ILLUSTRATION CASE: USP acquires U.S. Target Corporation with a purchase price of $1,000. The U.S. parent corporation engages an expert to make a purchase price allocation. The expert identifies tangible assets of the Target Corporation and separately values them at $100. The expert also identifies manufacturing intangibles of the Target Corporation and values them at $100. The expert identifies marketing-based intangibles, valuable foreign brands, and a workforce-in-place that provides systemic ongoing nonroutine returns, but these assets are not separately valued and are instead included as components of foreign goodwill. The expert report therefore produces the following purchase price allocation:

Purchase Price Allocation	
Tangibles	$ 100
Manufacturing Intangibles	$ 100
Foreign Goodwill	$ 800
	$1,000

> The plan is to have the tangible assets acquired by a corporation incorporated in the country where

(Comm. Print 1984). *See also* H.R. REP. NO. 98-432(II), at 1317 (1984) ("The committee does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in abuse of the U.S. tax system."); COMM. ON FINANCE UNITED STATES SENATE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 362 (Comm. Print 1984) (same). This policy rationale is nonsensical on its face. As pointed out by Professor Johnson in the debate leading up to the Supreme Court's decision in Newark Morning Ledger, the advertising and marketing costs are immediately deducted even though these costs can have value long into the future and create goodwill. *See* Calvin H. Johnson, *The Mass Asset Rule Reflects Income and Amortization Does Not,* 56 TAX NOTES 629 (Aug. 3, 1992). The Congressional statement that foreign goodwill was not the subject of expenditures that reduced the U.S. tax base is factually inaccurate.

40. Temp. Reg. § 1.367(d)-1T(b).

> manufacturing is performed. The manufacturing intangibles and foreign goodwill are to be acquired by an offshore entity (a so-called "risk-taker entrepeneur entity") incorporated in a low-tax jurisdiction. Key personnel of the workforce-in-place are employed by the risk-taker entrepreneur entity so that it can claim to have "real substance."
>
> In future years, the offshore risk-taker entrepreneur entity earns $90 of residual profits in excess of the routine profits generated by the routine functions performed by the various affiliates. The taxpayer claims that 1/9th of the residual profits relate to the manufacturing intangible and is subject to section 367(d)'s super royalty but that 8/9ths of the residual profits fall within the protective cloak of the "goodwill loophole" because the $80 of residual profits relate to the transfer of foreign goodwill and the fantastic entrepeneurship of the risk-taker entrepreneur entity and as such are outside the scope of section 367(d)'s super royalty obligation.

What portion of the intangibles set forth in the ILLUSTRATION CASE are subject to section 367(d)'s super royalty obligation and what amount of super royalty is commensurate with the income generated by those covered intangibles?

Respected tax organizations have urged the Treasury Department to clarify that intangible income assigned to the exploitation of contributed goodwill ($800 of value in the initial transfer and $80 of ongoing residual profits in the above example) should not be subjected to section 367(d)'s super royalty provisions.[41] The Obama administration has proposed legislation that would treat all $900 as subject to section 367(d)'s super

41. *See* New York State Bar Association, *Report on Section 367(d)*, at 51–58 (Oct. 12, 2010), 2010 TAX NOTES TODAY 198-20; *see also* Andrew Velarde, *Legislative History Could Prevent U.S. Taxation of Some Intangible Transfers*, 2014 TAX NOTES TODAY 57-9 (Mar. 25, 2014) (quoting James P. Fuller of Fenwick & West for statement that IRS "'shouldn't, and under the legislative history maybe couldn't' include under section 367(d) guidance things such as workforce in place, going concern value, and goodwill"); Thomas M. Zollo, *Clarification or Modification? The Tax Treatment of the Outbound Transfer of Goodwill, Going Concern Value, and Workforce in Place to a Foreign Corporation*, 39 TAX MGM'T INT'L J. 71 (Feb. 12, 2010); James P. Fuller, *U.S. Tax Review*, 54 TAX NOTES INT'L 773 (June 1, 2009); David N. Bowen, *Full-Value Methods: Has the IRS Finally Hurled the Holy Hand Grenade? A Critical Analysis of the Scope of §§ 482, 367(d), and 936(h)(3)(B) in Relation to Goodwill, Going Concern Value, and Workforce in Place*, 37 TAX MGM'T INT'L J. 3 (Jan. 11, 2008).

royalty obligation as a matter of law.[42] The staff of the Joint Committee on Taxation has identified the essence of this ILLUSTRATION CASE as a source for profit shifting under current law.[43] According to public documents, Caterpillar, Inc. engaged in a supply chain restructuring exercise where sophisticated logistics systems, business methods, foreign goodwill, and the opportunity to sell Caterpillar, Inc. specialty parts (a franchise)[44] was transferred to a Swiss risk-taker entrepreneur entity that substantively performed no significant function other than as a limited-risk distributor (an internal "commissionaire"). But even so, approximately 85 percent of the residual profits (approximately $8 billion of profits over a twelve year period) was retained by the Swiss risk-taker entrepreneurial entity notwithstanding that the functions responsible for the generation of these residual profits resided with Caterpillar, Inc. and its independent foreign dealers.[45] The IRS has identified IP migration strategies premised on the "goodwill loophole" as an area of concern[46] and is now belatedly contesting these goodwill loophole cases in court.[47]

42. *See* GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS, *supra* note 4, at 47.

43. SEE STAFF OF THE JOINT COMM. ON TAXATION, PRESENT LAW AND BACKGROUND RELATED TO POSSIBLE INCOME SHIFTING AND TRANSFER PRICING (JCX-37-10), at 73–76 (July 20, 2010) (the Charlie Company scenario posits a migration of intangible assets through a strategy where over $15 billion of intangible value was transferred and almost all of the transferred value was designated as foreign goodwill).

44. Jefferson-Pilot Corp. v. Commissioner, 98 T.C. 435, 441 (1992) (stating that "we read the world "franchise," as used in section 1253, broadly to mean 'franchises' as that term is commonly understood, including any agreement which gives one party the right to distribute, sell, or provide goods, services, or facilities within a specified area"), *aff'd*, 995 F.2d 530 (4th Cir. 1993); Int'l Multifoods v. Commissioner, 108 T.C. 25 (1997) (applies same broad definition found in section 1253 case law to section 865(d)(1)); TAM 2009–070–24 (Nov. 10, 2008) (applies same broad definition to section 936(h)(3)(B)(iv) and thus section 367(d)).

45. *See Caterpillar Hearing*, *supra* note 25 (statement of Bret Wells) (statement of Reuven S. Avi-Yonah). Reuven S. Avi-Yonah, *Just Say No: Corporate Taxation and Social Responsibility* (U. of Michigan Public Law Research Paper No. 402; U. of Michigan Law & Econ. Research Paper No. 14-010), http://ssrn.com /abstract=2423045. At the hearing, Caterpillar claimed that the IRS had accepted the company's position. However, subsequent to this hearing, Caterpillar stated that in fact the IRS was contesting these prior positions. *See* Filing on Form 10-Q with the Securities and Exchange Commission at 27 (May 2, 2014); Richard Rubin, *IRS Probing Caterpillar Parts Deal Examined by Senators*, BLOOMBERG NEWS (May 3, 2014) http://www.bloomberg.com/news/2014-05-02/irs-probing-caterpillar-parts-deals-examined-by-senators.html.

46. *See* T.A.M. 2009–07–024 (Feb. 13, 2009) (stating that 97 percent of section 351 outbound intangible contribution was designated by the taxpayer as "goodwill" whereas IRS asserted that the transfer represented intangibles such as a

The debate about the correct result in the ILLUSTRATION CASE is fierce. But, seen in its historic context, the correct policy answer to the ILLUSTRATION CASE is straightforward: all $90 of the residual profits should be assigned back to the original U.S. transferor via section 367(d). That is what Congress intended when it enacted and amended section 367(d), but whether a "goodwill loophole" exists that prevents this result is a critical question that goes to the efficacy of section 367(d).

For the reasons explored in Subparts II.A. and II.B., taxpayers are mistaken when they claim that a "goodwill loophole" exists within section 367(d) that allows residual profits to remain in the risk-taker entrepreneur entity. A correct application of existing law to the facts set forth in the ILLUSTRATION CASE requires that all $90 of the residual profits be assigned back to the U.S. transferor as a super royalty. There are at least two separate (albeit related) lines of reasoning that lead to this conclusion, and the rationale related to each are set forth below.

A. The "Goodwill Loophole" Does Not Provide a Protective Cloak Against Section 367(d)'s Super Royalty Obligation for Assets that Generate Residual Profits

In order to evaluate the ineffectiveness of the "goodwill loophole," the scope of the term goodwill must be understood as the evolution of the meaning of goodwill provides important insight and context for the current debate. Early case law consistently defined goodwill as the financial benefits

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dealer network and network of foreign agents that were subject to section 367(d)'s super royalty obligation); *see, e.g.*, IRS, *Coordinated Issue Paper Addresses Cost-Sharing Arrangement Buy-In Adjustments*, LMSB-04-0907-62 (Sept. 27, 2007), 2007 TAX NOTES TODAY 190-38; IRS Industry Specialization Program Papers, withdrawn in 2012 (see LB&I-04-0812-010 (Aug. 17, 2012)), 2012 TAX NOTES TODAY 161-51; *Audit Guidelines Related to Section 936 Conversion Issues, Attachment to Industry Directive on Section 936 Exit Strategies Audit Guidelines Related to Section 936 Conversion Issues*, LMSB-04-0107-002 (Feb. 2, 2007), 2007 TAX NOTES TODAY 25-39; *LMSB Procedures for Program Action Cases (PACs) on Tax Return Preparers*, LMSB-04-0108-001 (Feb. 13, 2008) ("The definition of foreign goodwill or going concern value requires a business operation conducted outside of the United States."), 2008 TAX NOTES TODAY 36-42 [hereinafter *LMSB Procedures for Program Action Cases*]; *see also*, *Coordinated Issue Paper Addresses Cost-sharing Arrangement Buy-In Adjustments*, section III.E.1., LMSB-0400907-62 (Sept. 27, 2007), 2007 TAX NOTES TODAY 190-38; *Coordinated Issue Paper Addressing Transfer of Intangibles Offshore/Section 482 Cost Sharing Buy-In Payment*, LMSB-0400307-027 (Apr. 5, 2007), 2007 TAX NOTES TODAY 67-3.

47. Petition for Redetermination of Deficiency in Tax, Medtronic v. Commissioner, No. 6944-11 (2011) 2011 WL 1373498; Petition for Redetermination of Deficiency in Tax, Amazon v. Commissioner, No. 31197-12 (2012) 2012 WL 11860896.

attributable to customer patronage that existed for whatever reason.[48] From the earliest years of the income tax until 1993, Treasury regulations provided that goodwill was not amortizable because it had an indefinite useful life,[49] and this strict prohibition on the amortization of goodwill had been consistently upheld in the case law.[50] Faced with the prospect that any purchase price allocated to goodwill would be nonamortizable, taxpayers in the domestic tax context attempted to minimize the amount of purchase price that would be categorized as goodwill by claiming that the purchase price should instead be allocated to separate and distinct customer-based intangible assets that were independent of goodwill, capable of being valued, and had an ascertainable useful life.[51] In response, the government regularly argued

48. *See* Boe v. Commissioner, 307 F.2d 339 (9th Cir. 1962) (denying depreciation or loss deduction for terminable-at-will medical service contracts on mass asset grounds). The notion that goodwill is the "expectancy that old customers will resort to the old place" was first espoused, not in a tax case, but by Lord Eldon in the 1810 British decision of *Cruttwell v. Lye*, 17 Ves. 335, 346 (1810). In Metropolitan Bank v. St. Louis Dispatch Co., 149 U.S. 436, 446 (1893), the Court stated that goodwill is the benefit from the general public patronage arising "from constant or habitual customers on account of its local position, or common celebrity, or reputation for skill or affluence or punctuality, or from other accidental circumstances or necessity, or even from ancient partialities or prejudices." Existing regulations continue this definition. *See* Reg. § 1.197-2(b)(1) (stating that "[g]oodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor.").

49. The Revenue Act of 1913 allowed taxpayers a reasonable deduction for the exhaustion, wear and tear of property. Tariff Act of 1913, Pub. L. No. 62-16, II(B), 38 Stat. 114, 167 (1913). Regulations were issued in 1914, and those regulations explicitly stated that goodwill was not entitled to a depreciation/amortization deduction. *See* Reg. 33, art. 162 (1914). Congress, in 1918, enacted legislation that allowed amortization of intangibles. *See* Revenue Act of 1918, Pub. L. No. 65-254, 234(a)(7), 40 Stat. 1057, 1078 (1919). But, the IRS issued regulations the next year that reconfirmed that no amortization was allowed with respect to goodwill because goodwill had no definite useful life. *See* Reg. 45, art. 163, (1919). During Prohibition, in order to allow distillers to amortize goodwill made obsolete due to the passage of the Eighteenth Amendment, Treasury regulations were amended to allow amortization of goodwill. *See* Regs. 45, art. 163 (1920). In 1927, Treasury regulations were amended to state that goodwill is nonamortizable. *See* Regs. 45, art. 163 (1927). This prohibition on amortization of goodwill has been continued in Reg. § 1.167(a)-3(a) until the enactment of section 197.

50. The Supreme Court upheld the general prohibition of amortization of goodwill in Haberle Crystal Springs Brewing Co. v. Clarke, 280 U.S. 384 (1930).

51. *See Report on Proposed Legislation on Amortization of Intangibles (H.R. 3035)*, 53 TAX NOTES 943, 944 (Nov. 25, 1991) [hereinafter *Report on*

that the customer-based intangibles identified by the taxpayer were in reality so interrelated with goodwill that the identified intangibles and goodwill were in reality a single, indivisible asset that could not be disaggregated.[52] The indivisibility of customer-based intangibles from the underlying goodwill of the business came to be known as the "mass asset" rule[53] and was summarized as follows:

> [The taxpayer seeks] an implausible separation of customer lists from goodwill, one a mirror reflection of the other, for

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Proposed Legislation]; Michael J. Douglass, *Tangible Results For Intangible Assets: An Analysis of New Code Section 197*, 47 TAX LAW. 713 (1994).

52. *See* PHILIP F. POSTLEWAITE, DAVID L. CAMERON & THOMAS KITTLE-KAMP, FEDERAL INCOME TAXATION OF INTELLECTUAL PROPERTIES AND INTANGIBLES at ¶ 10.01[2] (Thompson Reuters/WG&L updated Nov. 2013) [hereinafter POSTLEWAITE, CAMERON & KITTLE-KAMP]. For authorities that so hold, *see* Commissioner v. Killian, 314 F.2d 852, 855 (5th Cir. 1963) (purchase of tradename ensured that customers would continue to resort to the same old place of business which is the essence of goodwill); Vaaler Inc. v. United States, 68-1 U.S.T.C ¶ 9183, 21 A.F.T.R. 2d 558 (D.N.D. 1968) (court allowed amortization but only after it was stated that the seller's tradename was never used by the taxpayer); *but see* Donrey, Inc. v. United States, 809 F.2d 534, 536 (8th Cir. 1987) (court upheld jury verdict that allowed amortization even though taxpayer acquired customer-based intangibles with the seller's tradename, but the district court judge commented that if it had been the trier of fact it would have found the subscription list to be nondepreciable. and the Eight Circuit affirmed).

53. The mass asset rule appears to have been first applied in Danville Press, Inc. v. Commissioner, 1 B.T.A. 1171, 1172 (1925) (applying mass asset rule to disallow amortization of newspaper customer subscription list because this was inextricably linked to goodwill). The mass asset rule was applied as a rule of law for decades thereafter. See, e.g., Hillside Dairy Co. v. Commissioner, 3 T.C.M. 174 (CCH), T.C.M. (RIA) ¶ 44,055 at 193 (1944) (no loss deduction for a customer list acquired as part of the acquisition of a dairy business); Anchor Cleaning Service, Inc. v. Commissioner, 22 T.C. 1029 (1954) (disallowed amortization deductions for customer lists acquired as part of the purchase of a cleaning business); Westinghouse Broadcasting Co. v. Commissioner, 36 T.C. 912 (1961) (no amortization deduction for spot announcement contracts because they were inseparable from goodwill); Thoms v. Commissioner, 50 T.C. 247 (1968) (denying depreciation deduction with respect to list of insurance contracts under mass asset doctrine); Marsh & McLennan, Inc. v. Commissioner, 51 T.C. 56 (1968), *aff'd* 420 F.2d 667 (3d Cir. 1969) (same); Commissioner v. Seaboard Fin. Co., 367 F.2d 646, 652 (9th Cir. 1966) (same); Richard S. Miller & Sons, Inc. v. Commissioner, 537 F.2d 446, 45 (Ct. Cl. 1976) ("The rationale and purpose of the mass asset rule is to prevent taxpayers from increasing the value of depreciable property to offset the amount paid in excess of book value of assets purchased. This doctrine makes it possible to strike down depreciation deductions for amounts which should be properly allocated to goodwill" (internal quotation marks omitted)).

> goodwill = expectancy of continued patronage = customer lists = goodwill. At least, if goodwill and customer lists are not mutually coextensive, the former includes the latter, and the lesser is inextricable from the greater. In the vernacular, goodwill is a customer list with trimmings. . . . [A] purchased terminable-at-will type of customer list is an indivisible business property with an indefinite, nondepreciable life, indistinguishable from—and the principal element of—goodwill, whose ultimate value lies in the expectancy of continued patronage through public acceptance. It is subject to temporary attrition as well as expansion through departure of some customers, acquisition of others, and increase or decrease in the requirements of individual customers. A normal turnover of customers represents merely the ebb and flow of a continuing property status in this species, and does not within ordinary limits give rise to the right to deduct for tax purposes the loss of individual customers. The whole is equal to the sum of its fluctuating parts at any given time, but each individual part enjoys no separate capital standing independent of the whole, for its disappearance affects but does not interrupt or destroy the continued existence of the whole.[54]

Based on the mass asset rule, if a customer-based or marketing-based intangible was identifiable but it was acquired as part of the acquisition of the seller's entire operating business, taxpayers could expect that the government would argue that the customer-based intangible was subsumed within the definition of goodwill as a matter of law because any effort to separately identify an intangible was merely an effort to disaggregate what was better viewed as a mass asset (goodwill). Accordingly, instead of goodwill representing a residual category, prior to 1973, goodwill represented a substantively pre-defined category that trumped the ability to separately identify income-producing customer-based intangibles. Thus, returning to the ILLUSTRATION CASE, the import of the mass asset rule would be to prevent the separate classification of marketing-based or customer-based intangibles, thus allowing the foreign goodwill classification to trump all other possible classifications for income-producing intangibles linked to goodwill. If our understanding of goodwill had stopped at this juncture, the "goodwill loophole" would have had the capability to cloak substantial income-producing intangible assets within its scope.

54. Golden State Towel and Linen Services, Ltd. v. United States, 373 F.2d 938, 942–44 (Ct. Cl. 1967) (citations omitted).

However, this expansive view of goodwill was significantly undercut in 1973 by the Fifth Circuit's decision in *Houston Chronicle Publishing Company v. United States*[55] in which the taxpayer acquired newspaper subscription lists as part of the acquisition of a newspaper publishing company. The taxpayer had no intention of continuing to operate the acquired newspaper and maintained that the acquired subscription lists represented separate and distinct assets with a limited and ascertainable life.[56] The government argued that while the subscription list may have a limited useful life that was ascertainable, the acquired subscription lists nevertheless were nonamortizable as a matter of law since they were in the nature of goodwill.[57]

The Fifth Circuit observed that goodwill was nonamortizable as a matter of law, but even so, neither the prohibition against its amortization nor the mass asset rule prevented the taxpayer from properly claiming amortization deductions when the taxpayer could factually prove that: (1) an intangible had an ascertainable value separate and distinct from goodwill, and (2) the separately identified customer-based intangible had a limited useful life.[58] The Fifth Circuit then reconciled its decision to prior case law by stating that "most of the cases purporting to apply the 'mass asset' rule involved evidentiary failures on the part of the taxpayer to meet the dual burden of proof."[59] In the view of the Fifth Circuit, the determination of whether a customer-based intangible asset was separately identifiable and had an ascertainable useful life were simply factual questions, the resolution of which depended on whether the taxpayer could carry its burden of proof.[60] If so, then the identified intangible would be defrocked from the cloak of "goodwill."

In the following year, the IRS issued Revenue Ruling 74-456 where it reconsidered two earlier revenue rulings[61] that had asserted that the "mass asset" rule was a rule of law and instead now asserted that whether customer-based intangibles were separate and distinct intangibles that existed apart

55. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129 (1974). For an excellent discussion of this case law evolution, *see* POSTLEWAITE, CAMERON & KITTLE-KAMP, *supra* note 52, ¶ 10.01[2].

56. *See Houston Chronicle Publishing Co.*, 481 F.2d at 1244–45.

57. *See id.* at 1245.

58. *See id.* at 1250.

59. *See id.* at 1249.

60. *See id.* at 1247–53. The Eighth Circuit followed the rejection of the mass asset rule announced in *Houston Chronicle* by asserting that the burden to prove that an asset qualified for tax amortization is cast upon the taxpayer. *See* Donrey, Inc. v. United States, 809 F.2d 534 (8th Cir. 1987).

61. Rev. Rul. 74–456, 1974–2 C.B. 65, modifying Rev. Rul. 65–175, 1965–2 C.B. 41, and Rev. Rul. 65–180, 1965–2 C.B. 279.

from goodwill was a factual inquiry.[62] Although the IRS asserted that the taxpayer's burden of proof was likely to be met only in the "unusual situation,"[63] it clearly contemplated that the mass asset rule was no longer a rule of law that barred such a factual inquiry. After *Houston Chronicle Publishing* and Revenue Ruling 74-456, commentators asserted that the mass asset rule, as a rule of law, was dead.[64] Emboldened by the inherently factual nature of the inquiry contemplated by these authorities, taxpayers aggressively sought to identify amortizable nongoodwill intangibles (such as marketing-based intangibles, workforce-in-place, and customer-based intangibles), and the efficacy of such efforts rested on the sophistication of the taxpayer's proof; as a result, even if one taxpayer lost a case, another taxpayer was motivated to try again with better proof.[65]

In 1989, the General Accounting Office gathered data with respect to unresolved tax cases from 1979 to 1987 that had arisen in the wake of *Houston Chronicle Publishing* and found that taxpayers had identified 175 different types of customer-based intangible assets that were separate and distinct from goodwill, and these identified assets had a cumulative value (according to taxpayers) of $23.5 billion.[66] In 70 percent of the contested

62. In Revenue Ruling 74–456, the Service modified two previous Revenue Rulings to reflect the Fifth Circuit's *Houston Chronicle* decision. Under Revenue Ruling 74–456, customer-related intangibles were no longer automatically characterized as a mass asset and "indistinguishable from goodwill." *See* Rev. Rul. 74–465, 1974–2 C.B. 65.

63. *See* Rev. Rul. 74–456, 1974–2 C.B. 65 ("Generally, customer and subscription lists, location contracts, insurance expirations, etc., represent the customer structure of a business, their value lasting until an indeterminate time in the future. These lists, contracts, insurance expirations, etc., are in the nature of goodwill or otherwise have indeterminable lives and, therefore, are not subject to depreciation. . . . However, if in an unusual case the asset or a portion thereof does not possess the characteristics of goodwill, is susceptible of valuation, and is of use to the taxpayer in its trade or business for only a limited period of time, a depreciation deduction is allowable.").

64. *See* Gregory M. Beil, *Internal Revenue Code Section 197: A Cure for the Controversy over the Amortization of Acquired Intangible Assets*, 49 U. MIAMI L. REV. 731, 749–51 (1995); Amy J. Bokinsky, *Note: Section 197: Taxpayer Relief and Questions of Asymmetry*, 14 VA. TAX REV. 211, 220–22 (1994).

65. *See Report on Proposed Legislation*, *supra* note 51, at 946; Allen Walburn, *Depreciation of Intangibles: An Area of the Tax Law in Need of Change*, 30 SAN DIEGO L. REV. 453, 466 (1993).

66. See GENERAL ACCOUNTING OFFICE, REPORT TO THE JOINT COMMITTEE ON TAXATION: ISSUES AND POLICY PROPOSALS REGARDING TAX TREATMENT OF INTANGIBLE ASSETS at 3 (Aug. 1991) [hereinafter ISSUES AND POLICY PROPOSALS REGARDING TAX TREATMENT OF INTANGIBLE ASSETS]. The GAO report further indicated that the identified intangibles fell into the following categories:

cases of this period, the government asserted that the taxpayer had not met its burden of proof to demonstrate that the identified intangible was independent of goodwill.[67] As a further complication, the Tax Court appeared to hold onto the belief that the mass asset rule had continued vitality,[68] and so in 1991 the IRS again resurrected the mass asset rule as a rule of law in its audit strategy.[69]

Category #1	Customer- or Market-based Assets ($10.5 billion)
Category #2	Contract-based assets ($3.7 billion)
Category #3	Technology-based assets ($2.2 billion)
Category #4	Statutory-based assets ($3.5 billion)
Category #5	Workforce-based intangibles ($1.1 billion)
Category #6	Corporation organization/financial intangibles ($1.3 billion)
Category #7	Unidentified assets ($1.2 billion)

67. *See* ISSUES AND POLICY PROPOSALS REGARDING TAX TREATMENT OF INTANGIBLE ASSETS, *supra* note 66, at 4.

68. *See* Ithaca Industries v. Commissioner, 97 T.C. 253 (1991) (utilizing the mass asset rule as a basis to conclude that the assembled workforce in place was not amortizable), *aff'd in result*, 17 F.3d 684, 687 (4th Cir. 1994) (Although the Fourth Circuit affirmed the Tax Court decision on the grounds that the factual record did not demonstrate that the workforce-in-place had an ascertainable life in this particular case, the Fourth Circuit rejected the Tax Court's reliance on the "mass asset rule" and the inability of workforce-in-place to have a separate and distinct intangible asset, stating that after the decision in Newark Morning Ledger, "it is no longer appropriate to classify an intangible asset based on its resemblance to the classic conception of goodwill or going-concern value, and Ithaca's deduction cannot be denied on that basis.").

69. *IRS Media/Communications Industry Specialization Program, Coordinated Issue Paper, Customer Subscription List* (Oct. 31, 1991), *reprinted in Complete Text of the Internal Revenue Service's Industry Specialization Program Coordinated Issue Papers*, TAX NOTES SPECIAL SUPP. 705, 706 (June 8, 1992). *See also IRS Retail Industry Specialization Program, Coordinated Issue Paper, Customer-Based Intangibles* (Oct. 31, 1991), *reprinted in Complete Text of the Internal Revenue Service's Industry Specialization Program Coordinated Issue Papers*, TAX NOTES SPECIAL SUPP. 746 (June 8, 1992) (IRS position is that when an ongoing business is acquired with the expectation of continued patronage of the seller's customers such that the purchaser merely steps into the shoes of the seller; the two-prong factual test announced in *Houston Chronicle* and followed in Revenue Ruling 74–456 cannot be met.); *IRS LBO Industry Specialization Program, Coordinated Issue Paper, Amortization of Market Based Intangibles* (Oct. 31, 1991), *reprinted in Complete Text of the Internal Revenue Service's Industry Specialization Program Coordinated Issue Papers*, TAX NOTES SPECIAL SUPP. 687 (June 8, 1992) (an intangible asset based on the benefit derived from a competitive market position is nonamortizable). As Newark Morning Ledger was making its way through the

Another front in this ongoing battle of how much intangible value should be assigned to the category called goodwill involved whether the use of the capitalization of excess earnings method was an appropriate purchase price allocation methodology. This method was supported by the Ninth Circuit decision in *Commissioner v. Seaboard Financial Co.*[70] and by Revenue Ruling 68-609.[71] Under this method, goodwill was not considered a residual category; instead, taxpayers separately identified an initial value for all assets (including goodwill) and then allocated any "excess purchase price" pro rata among all of the identified assets (including goodwill). Thus, under the capitalization of excess earnings methodology, depreciable assets could receive an allocation of purchase price in an amount in excess of their fair market value. In contrast to the capitalization of excess earnings methodology, the residual allocation methodology sought to allocate purchase price to all identified assets up to their fair market value and then any remaining difference was simply allocated entirely to goodwill.[72] To resolve this split in the circuits and create conformity, Congress enacted section 1060 in 1986 to require the residual allocation methodology be employed for acquisitions.[73] Thus, after the enactment of section 1060, goodwill was considered a *residual category*.[74] While the residual allocation methodology became the means to determine value assigned to goodwill, Congress again left unaddressed the question of whether "goodwill" included

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courts and the IRS's audit position became well known, a spirited debate about the continued viability of the mass asset rule was had in Tax Notes. *See* Reuven S. Avi-Yonah, *Newark Morning Ledger: A Threat to the Amortizability of Acquired Intangibles,* 55 TAX NOTES 981, 983 (May 18, 1992); Calvin H. Johnson, *The Mass Asset Rule Reflects Income and Amortization Does Not,* 56 TAX NOTES 629 (Aug. 3, 1992); Reuven S. Avi-Yonah, *Getting Out of the 'Silly Quagmire,'* 57 TAX NOTES 427 (Oct. 19, 1992); Calvin H. Johnson, *Newark Morning Ledger:* Intangibles Are Not Amortizable, 57 TAX NOTES 691 (Nov. 2, 1992); Reuven S. Avi-Yonah, *Newark Morning Ledger: Striking a Blow for Tax Equity,* 57 TAX NOTES 819 (Nov. 9, 1992); Calvin H. Johnson, *The Argument over Newark Morning Ledger*, 57 TAX NOTES 1090, 1091 (Nov. 16, 1992); Calvin H. Johnson, *Sowing Mass Confusion*, 57 Tax Notes 1087 (Nov. 16, 1992); Calvin H. Johnson, *The Mass Asset Rule Is Not the Blob That Ate Los Angeles,* 57 TAX NOTES 1603 (Dec. 14, 1992); Calvin H. Johnson, *Once More into the Mass Assets*, 58 TAX NOTES 369 (Jan. 18, 1993); Reuven S. Avi-Yonah, *Newark Morning Ledger: A Post-Litem and Some Implications*, 59 TAX NOTES 813, 816 (May 10, 1993).

70. Commissioner v. Seaboard Fin. Co., 367 F.2d 646 (9th Cir. 1966).

71. Rev. Rul. 68–609, 1968–2 C.B. 327.

72. *See* R.M. Smith, Inc. v. Commissioner, 591 F.2d 248, 252 (3d Cir. 1979); *cert. denied*, 444 U.S. 828 (1979); Banc One Corp. v. Commissioner, 84 T.C. 476, 506 (1985).

73. *See* Tax Reform Act of 1986, P.L. 99-514, § 641; H.R. REP. No. 99-841(II), at 209 (Conf. Rep. 1986).

74. *See* S. REP. NO. 99-313, at 252–55 (1986).

all customer-based and marketing-based intangibles as a matter of law (under the mass asset rule) or whether goodwill excluded all intangibles that were capable of separate identification.

Thus, in the 1980s, it is fair to say that significant controversy existed over the separate and distinct identity of marketing-based and customer-based intangibles. In the midst of this raging debate, Congress defined intangibles in broad terms in section 936(h)(3)(B) but omitted "goodwill" from the list of intangibles, and the legislative history provides support for excluding goodwill from section 367(d)'s super royalty obligation. But, Congress did not legislatively resolve the debate about the contours of the term "goodwill."

Ambiguity over the scope of what was meant by the term goodwill eventually was definitively resolved by the Supreme Court in 1993 in its landmark decision in *Newark Morning Ledger v. United States.*[75] In *Newark Morning Ledger*, the Supreme Court subordinated the category of "goodwill and going concern value" to all other separately identifiable intangible assets that are capable of separate identification, thus making "goodwill" an ephemeral category that deferred to other separately identifiable categories of intangibles.[76] Specifically, in *Newark Morning Ledger*, the taxpayer was the successor to The Herald Company (Herald).[77] In a prior year, Herald had purchased Booth Newspapers (Booth) and was required to determine its basis for the Booth assets by allocating its stock purchase price to the various Booth assets. After allocating $234 million to financial and tangible assets,

75. Newark Morning Ledger v. United States, 507 U.S. 546 (1993). After the Supreme Court opinion was issued on April 20, 1993, Congress understood that the effort to separately identify intangibles would continue in light of the Supreme Court's decision in *Newark Morning Ledger* and that a significant backlog of cases existed. *See* H.R. REP. NO. 103-213, at 690 (Conf. Rep. 1993). So, Congress enacted section 197 within four months of the Supreme Court's decision in *Newark Morning Ledger* as a means to simplify the law. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-166, 107 Stat 312 (Aug. 10, 1993). Under section 197, taxpayers generally are allowed to amortize all purchased intangible property, including goodwill, over a fifteen year period. Final regulations under section 197 were issued shortly thereafter. T.D. 8865, 2000-1 C.B. 589. For purposes of section 197, the regulations provide that goodwill means "the value of a trade or business attributable to the expectancy of continued customer patronage" and "may be due to the name or reputation of a trade or business or any other factor." Reg. § 1.197-2(b)(1). The regulations go on to distinguish goodwill from other intangible property including going concern value, customer based intangibles, trademarks and trade names, and workforce in place. Reg. § 1.197-2(b)(2)–(12). *See* I.R.C. § 197(d)(1)–(3). However, for purposes of amortization, section 197 makes no significant distinction between these various intangible assets. I.R.C. § 197(d)(1). *See* Reg. § 1.197-2(d)(1).

76. *Newark Morning Ledger*, 507 U.S. at 546.

77. *Id.*

Herald allocated approximately $68 million of its purchase price to "paid subscribers lists" and then determined the ascertainable life for each of them.[78] Herald allocated the $26 million remaining balance to goodwill and going concern value.[79]

The Supreme Court stated that goodwill can be defined as the expectancy of continued patronage[80] and that goodwill is nonamortizable,[81] but the Court pointed out that the regulatory test for whether an asset is amortizable depends upon whether the asset is separately identifiable, has a limited useful life, and has a reasonably ascertainable value.[82] If such an asset exists, then by definition such an intangible is *no longer part of goodwill because goodwill is what is left-over after all other intangible assets have been identified*.[83] The effect of the Supreme Court's holding was to dismember goodwill and require that all separately identifiable aspects of customer patronage be segregated from goodwill.[84] Consequently, even if customer-based or marketing-based intangibles were inextricably linked to the common understanding of what goodwill is (i.e., the expectancy of continued patronage), the value assigned to that customer patronage would

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78. *Id.*

79. *Id.* at 550.

80. *Id.* at 556.

81. *Id.* at 565 n.13.

82. *Newark Morning Ledger*, 507 U.S. at 565–66 n.13.

83. The Court stated as follows:

> The dissent's mistake is to assume that because the "paid subscribers" asset looks and smells like the "expectancy of continued patronage," it is, ipso facto, nondepreciable. In our view, however, whether or not an asset is depreciable is not a question to be settled by definition. "Goodwill" remains nondepreciable under applicable regulations, and we do not purport to change that fact. In interpreting those regulations, however, we have concluded that because the "paid subscribers" is an asset found to have a limited useful life and an ascertainable value which may be determined with reasonable accuracy, it is depreciable. *By definition, therefore, it is not "goodwill."*

Id. at 565 n.13 (emphasis added).

84. The dissenting opinion in *Newark Morning Ledger* seems particularly prescient on this point when its stated:

> [The taxpayer] would have us scrap the accepted and substantive definition of "goodwill" as an expectation of continued patronage, in favor of a concept of goodwill as a residual asset of ineffable quality, whose existence and value would be represented by any portion of a business's purchase price not attributable to identifiable assets with determinate lives. Goodwill would shrink to an accounting leftover.

Id. at 574. The dissent's prophecy has come true.

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be allocated to a separate and distinct asset that was not part of goodwill if the asset could be shown to have an ascertainable useful life and was able to be separately identified and valued.[85]

In view of section 1060's and *Newark Morning Ledger's* endorsement of the residual allocation methodology, goodwill has no preset definition and is displaced whenever income-producing intangibles are capable of separate identification,[86] and so any allocation to goodwill is at best provisional. In the context of the ILLUSTRATION CASE, an effort to use the "goodwill loophole" as a cloak to cover income-producing intangibles is ineffective. The case law indicates that all intangibles that can be identified are no longer "goodwill" for tax purposes. In the context of the ILLUSTRATION CASE, the allocation of $800 to goodwill would be unsupportable after *Newark Morning Ledger* if the value assigned to goodwill included income-producing intangible assets. Any value that remains as residual goodwill is only the left-over residual value that remains after all income-producing intangibles have been valued. Said differently, any allocation of intangible value to goodwill remains in goodwill only if that value has no discrete income-generating capability; otherwise the value should be segregated out of goodwill whenever it does have income-producing potential and assigned to the identifiable income-producing asset that generates the annual residual profits.[87]

In the context of the ILLUSTRATION CASE, taxpayers have argued that only the residual profits attributable to the $100 of manufacturing intangibles are subject to section 367(d) and that the residual profits of $80 that are attributable to the $800 of foreign goodwill are not.[88] The legislative

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85. *See* Brian R. Greenstein, *The Depreciation of Customer-Based Intangible Assets After* Newark Morning Ledger, 20 J. CORP. TAX'N 315, 324–25 (1994).

86. *See* Christian M. McBurney, *Goodwill in Like-Kind Exchanges of Newspapers—IRS is Inconsistent With Other Areas,* 108 J. TAX'N 147 (Mar. 2008).

87. *See* authorities cited *supra* note 35.

88. The IRS has stated as follows:

> The existence of this [foreign goodwill exception to section 367(d)] exception often leads US transferors to contend that a significant portion of the intangibles transferred in a section 351 or 361 exchange, particularly marketing intangibles and workforce in place, should be treated as foreign goodwill and going concern value. Such claims should be carefully scrutinized, and the nature of all transferred intangibles should be examined to determine whether it would be more appropriate to treat the claimed foreign goodwill and going concern value as intangibles subject to section 367(d). Likewise, in the case of section 936 conversions, it may be appropriate to consider whether claimed foreign goodwill and going concern value is really foreign. It may be that these

history to section 367(d) indicates that Congress did not intend for section 367(d) to apply to an outbound contribution of solely goodwill,[89] and several practitioners have argued that "goodwill" should have some static meaning and should not be eroded by the opportunity to separately identify specific marketing-based or customer-based intangibles,[90] thus harkening back to the mass asset rule that was the subject of the litigation in *Newark Morning Ledger*. However, the legislative history indicates that this goodwill exception should not allow separate and distinct intangibles to escape section 367(d)'s super royalty obligation.[91]

Arguments based on the legislative history that claim that "goodwill" provides a safe haven categorization for significant income-producing intangibles that are marketing-based or based on a workforce-in-place are overdone.[92] Nowhere did Congress evidence an intent to affirmatively define

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> intangibles are goodwill and going concern value, but are not foreign and thus are subject to tax.

See IRS Directive LMSB-04-0107-002, transmitted by memorandum dated Feb. 2, 2007, from John Risacher, Industry Director for Retailers, Food, Pharmaceuticals and Healthcare Division.

89. *See* authorities cited *supra* note 39.

90. *See* authorities cited *supra* note 41.

91. The conference report indicates that all intangibles, whether or not otherwise subject to a nonrecognition transaction, are intended to be subject to section 367(d)'s super royalty provision. *See* H.R. REP. NO. 98-861, at 953–55 (Conf. Rep. 1984). The House Ways and Means Committee report indicates that section 367(d) should apply to intangibles regardless of whether an otherwise applicable nonrecognition exception existed. *See* H.R. REP. NO. 98-432(II), at 1323 (1984); COMM. ON FINANCE UNITED STATES SENATE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 362, 367–68 (Comm. Print 1984) (same); H.R. REP. NO. 98-861, at 953 (Conf. Rep. 1984) (same); *see also* STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84, at 432–35, (Comm. Print 1984) (stating that the special rule for transfers of intangibles preempts the rule for tainted assets where property is described in both provisions).

92. Those who attempt to provide a carve-out point to the discussion of marketing intangibles that occurred within the context of section 367(a)(3)'s exception, which provided that:

> It is expected that regulations will provide that gain will not be recognized on transfers of marketing intangibles (such as trademarks or trade names) in appropriate cases.

COMM. ON FINANCE UNITED STATES SENATE, 98TH CONG., DEFICIT REDUCTION ACT OF 1984 STATUTORY LANGUAGE OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 362, 365 (Comm. Print 1984); *see also* STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84, at 435, (Comm. Print 1984) (same). Trade names and trademarks are explicitly enumerated in section 936(h)(3)(B), so goodwill in any way other than in its generally understood meaning, and that generally understood meaning was significantly clarified by the Supreme Court in 1993. As the Supreme Court stated in *Newark Morning Ledger*, if an intangible asset is separately identifiable and valuable, then it is by definition no longer goodwill even though one might recognize that it represents aspects of customer patronage.

Thus, in the context of the ILLUSTRATION CASE, a court should understand that if an intangible (individually or collectively) actually creates ongoing annual residual profits, then the underlying asset that generates those residual profits is no longer part of goodwill and should be separately identified. The existence of the full $90 of annual intangible profits requires a court to engage in a fact-finding exercise to determine the underlying intangibles that generated those intangible returns, and once this is done then the identified intangibles that generated the intangible returns (the full $90 of residual profits in the ILLUSTRATION CASE) are no longer goodwill but in fact are attributable to separate and distinct intangibles. Once those identified intangibles are excluded from goodwill, then section 367(d) causes the full $90 of residual profits attributable to those identified intangibles to be assigned back to the U.S. transferor if the U.S. transferor is the one that contributed those income-generating intangible assets to the foreign corporation. A court that allows residual profits to remain in goodwill without associating them to the specific intangible that created them fails to apply section 367(d) in a manner that achieves Congress's goals. The system is watertight, and purposefully so because Congress intended to statutorily codify the judicially created assignment of income doctrine so that residual profits would stay with the developer of the intangible and would not follow the transferred income-producing intangible to the risk-taker entrepreneurial entity in the facts set forth in the ILLUSTRATION CASE.

Regardless of how one reads the legislative history and common law on these points, it is clear that the Treasury Department was given broad

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this legislative history needs to be read as solely describing the applicability of section 367(a)(3) and not a broad articulation that these intangibles can be transferred in avoidance of section 367(d). In addition, as mentioned in *supra* note 91, the legislative history goes on to state that section 367(d)'s super royalty provision preempts other results including otherwise nontaxable results achieved under section 367(a). Furthermore, other statements in the legislative history make clear that section 367(d) applies to both marketing and manufacturing exceptions. *See* H.R. REP. NO. 98-432(II), at 1316 (1984) (referring to both marketing and manufacturing intangibles as transactions that motivated the enactment of section 367(d)). The conference report summarily states that an outbound transfer of an intangible is subject to section 367(d) and then states that certain marketing intangibles may simultaneously be taxable under section 367(a). *See* H.R. REP. NO. 98-861, at 955 (Conf. Rep. 1984).

regulatory authority to define the scope of section 367(d),[93] and it is also clear that Congress wanted to stop the migration of residual profits away from the U.S. developer via the contribution of income-producing intangibles to a foreign corporation.[94] The Treasury Department exercised its regulatory authority to provide that section 367(d)'s super royalty provisions apply equally to both manufacturing intangibles and to marketing intangibles,[95] and these regulations distinguish and define goodwill as "*the residual value* of a business operation conducted outside of the United States *after all other* tangible and *intangible assets have been identified and valued*."[96] This definition of goodwill in the section 367(d) regulations incorporates the approach articulated in *Newark Morning Ledger*. If the intangible assets that

93. In this regard, section 367(d) includes the lead-in clause, "[e]xcept as provided in regulations," thus leaving Treasury and the IRS with abundant authority to carry out the congressional intent to interpret scope of section 367(d) in a manner that prevents the migration of residual profits out of the U.S. tax base.

94. *See* legislative history discussed *supra* note 91.

95. *See* Temp. Reg. § 1.367(a)-1T(d)(5)(i) (second sentence), cross-referenced by Temp. Reg. § 1.367(d)-1T(b) (first sentence). Others have attempted to infer that the Treasury and the IRS clearly understood that they were not acting consistently with the intent of Congress because the section 367 regulations include a special transition rule under which foreign trademarks, trade names, brand names, and similar marketing intangibles developed by a foreign branch are treated as foreign goodwill or going concern value. *See* Temp. Reg. § 1.367(a)-1T(d)(5)(iv). Note, however, that this provision is not cross-referenced by Temporary Regulation section 1.367(d)-1T(b). Such treatment effectively allowed such transfers to be excluded from the scope of section 367(d). This special rule is effective, however, only for transfers occurring after December 31, 1984 (the effective date of section 367(d)), and before May 16, 1986 (the date of publication of the regulations). No explanation is given as to why certain marketing intangibles developed by a foreign branch are effectively excluded from the scope of section 367(d) (by their treatment as foreign goodwill or going concern value) only on a transitional basis. *See* Davis, 920-3rd T.M., *Other Transfers Subject to Section 367* at III.B.1.a(3).

96. Temp. Reg. § 1.367(d)-1T(b) (second sentence) (emphasis added). The section 482 White Paper states:

> A particularly difficult aspect of valuing intangibles has been determining what part of an intangible profit is due to manufacturing intangibles and what part is due to marketing intangibles. This problem has particular significance in section 936, since the possessions corporation is generally entitled to a return only on manufacturing intangibles when it elects the cost sharing method under section 936(h).

See Notice 88–123, 1988–2 C.B. 458, 463 (TREASURY DEP'T & INTERNAL REVENUE SERVICE, A STUDY OF INTERCOMPANY PRICING 20–21 (1988)) [hereinafter 1988 White Paper]. The inclusion of both marketing intangibles and manufacturing intangibles within the scope of section 367(d) avoids difficult allocations of value between these types of identified intangibles.

generated the $90 of residual profits have not been identified, then they must be identified and doing so requires that the identified items be removed from goodwill, thus defrocking them of the "goodwill loophole."

Furthermore, it is equally clear under the section 367 regulations that section 367(d)'s super royalty provisions apply to intangibles that are owned by a U.S. person without regard to whether those items are used or developed in the United States or in a foreign country.[97] A taxpayer attempting to assign significant value to a residual category called "goodwill" with an eye towards resisting efforts to separately identify the underlying intangibles that generate annual residual profits frustrates the policy goals that are behind section 367(d) and ignores *Newark Morning Ledger*. If significant ongoing residual profits exist in an enterprise, then the ongoing residual profits must be explained in terms of the specific income-producing intangibles that generate those nonroutine returns.[98] Congress made it clear that annual and ongoing residual profits cannot be transferred away from the U.S. developer via the transfer of the underlying income-producing intangible asset in an outbound section 351 transfer, and Congress made this air tight by stating that intangibles that generate intangible returns are subject to section 367(d)'s super royalty and that the amount of the section 367(d) super royalty must be commensurate in amount to the actual residual income that is generated by those transferred income-producing intangibles.[99] A section 351 transfer that is designated as goodwill is not an effective loophole for migrating residual profits to a foreign corporation because the goodwill cloak is defrocked of all income-producing intangibles that generate residual profits. When faced with the "goodwill loophole" cases, courts should decide those cases in a manner that achieves section 367(d)'s fundamental goals, and the common law along with existing Treasury regulations provide the courts with ample means to do so.

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97. *See* Reg. § 1.367(a)-1T(d)(5)(i); Reg. § 1.367(a)-7(f)(11).

98. *See* Reg. § 1.482-6(c)(3)(i)(B) (residual profits allocated to those functions that make a nonroutine contribution and only those functions); Reg. § 1.482-4(b)(6) (defines "intangible" to include an item that exhibits intangible property characteristics which presumably is met if the asset is capable of generating intangible returns).

99. *See* authorities cited *supra* note 35.

B. Section 936(h)(3)(B) Uses a Purposefully Circular Definition to Ensure that Residual Profits Arising from a Contributed Business are Always Subject to Section 367(d)'s Super Royalty Obligation

An objector may claim that intangible property must be described in section 936(h)(3)(B) before that intangible asset is subjected to section 367(d)'s super royalty obligation and that important intangibles, such as workforce-in-place or marketing intangibles, were not enumerated within section 936(h)(3)(B). The proponent of that argument would then say that failing to be specified in section 936(h)(3)(B) prevents the application of section 367(d)'s super royalty obligation.[100] Thus, even if the $90 of residual profits are all associated with income-producing intangibles that are not goodwill, the objector would still argue that the income-producing intangibles must still be described in section 936(h)(3)(B) before the income from the contributed income-producing intangibles is subjected to section 367(d)'s super royalty obligation. As facially plausible as this argument may seem based on the statutory language, it is patently erroneous.

Section 936(h)(3)(B) contains an extensive list of twenty-eight specifically enumerated items[101] that are explicitly enumerated as "intangibles." This list is extremely broad in its scope in that it utilizes traditional indicia of customer patronage (such as trademarks, trade names, brand names) but then the statute provides in section 936(h)(3)(B) (iv) and (v) that an intangible also includes any "franchise, license, contract, method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list or technical data." These categories are extremely broad and would capture almost any aspect of an intangible business asset that generates residual profits.

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100. *See* I.R.C. § 367(d)(1) (cross-references section 936(h)(3)(B)'s definition of intangibles for the list of intangibles that are subject to section 367(d)'s super royalty).

101. Section 936(h)(3)(B) states that the term "intangible property" means any—

> (i) patent, invention, formula, process, design, pattern, or know-how;
> (ii) copyright, literary, musical, or artistic composition;
> (iii) trademark, trade name, or brand name;
> (iv) franchise, license, or contract;
> (v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
> (vi) any similar item,

which has substantial value independent of the services of any individual.

However, assume for the sake of argument that some aspect of workforce-in-place or of a marketing intangible defies ready categorization within the twenty-eight enumerated terms set forth under section 936(h)(3)(B)(i) through (v) and yet represents an intangible that generates ongoing intangible returns. If this were the procedural posture of the case before a court, would this cause a court to conclude that the intangible profits associated with this unspecified transferred intangible escapes section 367(d)'s super royalty obligation? The answer is a categorical "no" because of the purposeful circularity employed for the definition of a "similar item" in section 936(h)(3)(B)(vi).

In this regard, section 936(h)(3)(B)(vi) provides a final "catch-all category," stating that an intangible within the meaning of section 936(h)(3)(B) also includes any "similar item." For this purpose, the section 367(d) regulations incorporate the regulations under section 482,[102] and those section 482 regulations state that an intangible is a "similar item" if it derives value from its "other intangible properties."[103] What is a characteristic of an intangible property? The answer a court should reach is that a characteristic of an intangible property is that it generates intangible returns. Thus, if an internal function has the characteristic that it creates intangible returns (i.e., creates residual profits), then it is a "similar item." If a particular workforce-in-place creates intangible returns (i.e., residual profits), then that particular workforce-in-place has properties that are characteristic of an intangible and is therefore a "similar item" under section 936(h)(3)(B)(vi). If another workforce-in-place makes no contribution towards creating residual profits, then that other workforce-in-place does not exhibit the characteristic of an intangible asset in this alternative scenario.

One should not miss the results-oriented, purposeful circularity of this definition: if residual profits exist as a result of a transferred asset, then that transferred asset exhibits properties that are characteristic of an intangible asset, and it is that fact alone that causes the asset to be including within the definition of section 936(h)(3)(B)(vi). The circularity is purposeful: ongoing residual profits must be grounded to some "item," and once that item is identified then it is covered under section 936(h)(3)(B)(vi) exactly because it generates intangible returns. The circularity is inexplicable until one remembers the rationale for section 367(d): Congress wanted to codify the assignment of income doctrine so that residual profits from contributed businesses are assigned back to the U.S. transferor who developed the transferred assets that generate intangible returns. Furthermore, the addition of the commensurate with income requirement now means that the super royalty is determined by looking to the actual

102. *See* Temp. Reg. § 1.367(d)-1T(c)(1).

103. *See* Reg. § 1.482-4(b)(6); *see also* T.D. 8552, 1994–2 C.B. 93 (stating that this definition of a "similar item" was merely a clarification of existing law).

annual residual profits that are generated so that the amount assigned back to the U.S. transferor as a super royalty is the full amount of the residual profits attributable to the underlying business that was transferred away.[104] The circularity achieves the fundamental goal of the statutorily codified assignment of income doctrine.

Interestingly, the government has already adopted in its audit and litigating positions that those things that create residual profits represent separate and distinct customer-based and marketing-based intangibles (such as workforce-in-place,[105] long-term supply agreements,[106] and foreign marketing and distribution networks)[107] and as such are described within the defined categories enumerated in section 936(h)(3)(B), thus excluding them from the definition of goodwill.[108] Conceptually, the IRS position is that

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104. *See* Temp. Reg. § 1.367(d)-1T(c)(1) (states super royalty amount is determined consistently with section 482); Reg. § 1.482-6(c)(3)(i)(B) (residual profits allocated to those functions that make a nonroutine contribution and only those functions); Reg. § 1.482-4(f)(2)(ii)(C)(4) and -4(f)(2)(iii) Ex. (2) (specifies and then demonstrates via example that the allocation of residual profits must approximate the actual profit experience to meet the commensurate with income standard).

105. The IRS has stated as follows with respect to taxpayer efforts to categorize intangible value associated with workforce-in-place as part of foreign goodwill:

> Workforce-in-place is properly treated as an intangible under § 936(h)(3)(B), and is therefore taxable under § 367(d). Some taxpayers have argued that the workforce-in-place is a part of going concern value that transfers tax free to the foreign corporation. However, to the extent that workforce-in-place can be identified and valued as a distinct asset, workforce-in-place should not be viewed as part of foreign goodwill or going concern value.

See IRS, LMSB-04-0108-001 (Feb. 13, 2008). The issue of whether workforce in place is a section 936(h)(3)(B) intangible that is subject to section 367(d)'s super royalty is an issue in controversy in Petition for Redetermination of Deficiency in Tax, Medtronic v. Commissioner, (2011) (No. 6944-11), 2011 WL 1373498.

106. *See* F.S.A. 2001–28–040 (Apr. 16, 2001) (wherein the Chief Counsel's Office treated a long-term supply agreement as a section 367(d) intangible property that was separate and distinct from foreign goodwill).

107. *See* authorities cited *supra* notes 46 and 47. A fact pattern substantially similar to the one posited in T.A.M. 2009–07–024 was presented in the docketed case of First Data Corp. v. Commissioner, but the taxpayer conceded this issue in its entirety prior to trial. *See* Fourth Stipulation of Settled Issues, First Data Corp. v. Commissioner, (2011) (No. 7042-09), 2011 WL 9160637.

108. The staff of the Joint Committee on Taxation has a different view, believing that the IRS is arguing that outright goodwill is a "similar item" to those set forth in section 936(h)(3)(B)(i) through (v). *See* STAFF OF THE JOINT COMM. ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2013 BUDGET PROPOSALS, JCS-2-12, at 364 (2012). However, that is

identified intangibles are either intangibles that are contained within the explicitly enumerated twenty-eight identified intangibles[109] or such intangibles represent an unspecified intangible that is a "similar item" within the meaning of section 936(h)(3)(B)(vi) because the item has ongoing income-generating intangible property value. In the context of section 482, the case law has recognized that marketing intangibles exist as a separate and distinct asset,[110] and cases where the government has failed in its arguments to find a marketing intangible can be viewed as failures to sustain a factual finding and not as articulating a rule of law.[111] Thus, the government's

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not what the IRS has been saying in the publicly available audit guidelines. *See, e.g.*, *LMSB Procedures for Program Action Cases*, *supra* note 46. In any event, if aspects of customer patronage or workforce-in-place provide significant value, then a separately identified and valuable intangible asset exists apart form goodwill and as such workforce-in-place is simply no longer goodwill but is instead an intangible asset that is similar within the meaning of section 936(h)(3)(B)(vi) to the enumerated intangibles set forth in section 936(h)(3)(B)(i) through (v).

109. Either the intangible is explicitly so named or it is an intangible that is functionally the same as an intangible that is explicitly named in section 936(h)(3)(B)(i) through (v).

110. *See, e.g.,* Clarke v. Haberle Crystal Springs Brewing Co., 280 U.S. 384 (1930) (goodwill in the nature of trademarks, trade names, and trade brands); J.C. Cornillie Co. v. United States, 298 F. Supp. 887 (E.D. Mich. 1968) (goodwill in the form of customer lists); F.W. Drybrough v. Commissioner, 45 T.C. 424 (1966), *aff'd*, 384 F.2d 715 (6th Cir. 1967) (goodwill consisting of agency's file of uncollected claims). *See also* P.L. R. 1981–34–193 (May 29, 1981) ("marketing intangibles" defined as the right to use tradename, trademark, and related goodwill).

111. In *Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009) (nonacq.), A.O.D. 2010–5, 2010 WL 4531284, the Tax Court primarily addressed a cost sharing buy-in payment in the context where the court found that there was no evidence to support a finding that the transfer of access to U.S.-based R&D and marketing teams was the transfer of an intangible. As part of this discussion, the court included the following footnote 31:

> Even if such evidence existed, these items would not be taken into account in calculating the requisite buy-in payment because they do not have "substantial value independent of the services of any individual" and thus do not meet the requirements of sec. 936(h)(3)(B) or sec. 1.482-4(b), Income Tax Regs. "Access to research and development team" and "access to marketing team" are not set forth in sec. 936(h)(3)(B) or sec. 1.482-4(b), Income Tax Regs. Therefore, to be considered intangible property for sec. 482 purposes, each item must meet the definition of a "similar item" and have "substantial value independent of the services of any individual." Sec. 936(h)(3)(B); sec. 1.482-4(b), Income Tax Regs. The value, if any, of access to VERITAS US' R&D and marketing teams is based primarily on the services of individuals (i.e., the work, knowledge, and skills of team members).

arguments are laudable, but they are incomplete and are making the "goodwill loophole" case more difficult for the court than need be.

The government, courts, and taxpayers need to recognize that if a business is transferred to a foreign corporation and residual profits are generated annually thereafter from the contributed business, then the underlying assets that generate those annual residual profits exhibit properties that are characteristic of an intangible and as such are included within the scope of section 936(h)(3)(B)(vi) due to that fact alone. The mere existence of residual profits arising from an outbound transfer of assets implicates section 367(d). The underlying assets that explain those residual profits are either explicitly enumerated, or the residual profits relate to an unspecified intangible that from this fact alone causes them to be a "similar item" under the "catch-all category" of section 936(h)(3)(B)(vi) due to the sole fact that it generates residual profits. The existence of residual profits creates the definition. Thus, in the end, the government is not required to demonstrate what business asset created the residual profits. It need only show that annual residual profits exist with respect to a business that was the subject of an outbound transfer and so *a priori* those residual profits relate to intangibles that fall within the scope of section 367(d)'s super royalty obligation. There is no space in this rubric for a "goodwill loophole." Furthermore, the addition of the commensurate with income requirement

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> Nevertheless, respondent in support of his contention cites Newark Morning Ledger Co. v. United States, 507 U.S. 546 [71 AFTR 2d 93-1380] (1993), and Ithaca Indus., Inc. v. Commissioner, 97 T.C. 253 (1991), affd. 17 F.3d 684 [73 AFTR 2d 94-1323] (4th Cir. 1994). These cases, however, do not suggest that access to an R & D or marketing team has substantial value independent of the services of an individual, do not define intangibles for sec. 482 purposes, and do not even reference sec. 482. We note that in December 2008, the Secretary promulgated temporary regulations (i.e., secs. 1.482-1T through 1.482-9T, Temporary Income Tax Regs., *supra*) which reference "assembled workforce." In addition, the Administration, in 2009, proposed to change the law to include "workforce in place" in the sec. 482 definition of intangible.

The author harmonizes this dicta with the synthesis of the law set forth in this article by simply noting that the Tax Court did not find a separate and distinct intangible in *Veritas* as a factual matter and as a factual matter believed solely goodwill existed. Under that finding of fact, it is entirely consistent to say that any remaining value was therefore allocable to residual goodwill. However, if the taxpayer asserts that workforce-in-place possesses nonroutine functions that contribute towards the generation of nonroutine profits, then that workforce-in-place represents an intangible that is subject to section 367(d)'s super royalty because it is a "similar item" within the meaning of section 936(h)(3)(B)(vi). *See* Reg. § 1.482-4(b)(6) (defines "similar item" as an intangible that has value due to its intangible property characteristics).

ensures that all of the $90 of residual profits in the ILLUSTRATION CASE must be assigned as a super royalty to the U.S. person who transferred the nonroutine intangible that generated those residual profits.[112]

The breadth of section 936(h)(3)(B) places the taxpayer in the ILLUSTRATION CASE on the horns of a dilemma. If the taxpayer says that the $800 of value assigned to goodwill actually creates future intangible property returns, then to that extent the value so designated represents an other "similar item" and thus is carved-out of goodwill and is subject to section 367(d)'s super royalty obligation. Alternatively, the taxpayer could claim that none of the $800 assigned to goodwill has any ongoing income-producing value to the controlled foreign corporation and thus is not an intangible that is valuable due to its intangible property characteristics. However, having made that argument, the taxpayer cannot then claim that any of the $90 of residual profits in the ILLUSTRATION CASE remain with the risk-taker entrepreneur entity, because the amount of the section 367(d) super royalty (in order to be commensurate in amount to the residual profits actually generated) must be $90 as the residual profits are to be allocated only to the income-producing intangibles that generate those residual profits[113] and then assigned back to the U.S. transferor under section 367(d). What cannot be true is that goodwill cloaks some intangible that creates ongoing residual profits. Section 936(h)(3)(B) is drafted to defrock goodwill of all intangibles that create ongoing intangible property returns and leaves it as a hollow shell. If there is any value left-over in the residual category called goodwill, it has no claim to share in the ongoing future residual profits.

The only pathway out of section 367(d)'s super royalty obligation for the full $90 of residual profits is for the risk-taker entrepreneur entity to show that the annual residual profits arise from a function that was not part of the outbound contribution. However, now the taxpayer is required to prove what function made a nonroutine contribution towards the creation of those residual profits[114] and must also show that the identified function was not part of the outbound section 351 transfer. As has been argued elsewhere, risk-taking by itself is not a "nonroutine function" that affords an entity the right to share in residual profits.[115]

Seen in this light, the decision by the Tax Court in *International Multifoods v. Commissioner*[116] is in harmony with this evolution in the law.

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112. *See* authorities cited *supra* note 35.

113. *See* Reg. §§ 1.482-6(c)(3), 1.482-4(b)(6).

114. *See* Reg. § 1.482-6(c)(3)(i)(B).

115. *See* Bret Wells & Cym Lowell, *Tax Base Erosion: Reformation of Section 482's Arm's Length Standard*, 15 FLA. TAX REV. 737 (2014) [hereinafter Wells & Lowell, *Tax Base Erosion*].

116. Int'l Multifoods v. Commissioner, 108 T.C. 25 (1997).

In *International Multifoods*, the Tax Court held that a U.S. corporate seller's goodwill inherent in its doughnut business in Asia and the Pacific was embodied in, and not severable from, its franchisor's interest and trademark that were conveyed to the buyer. Accordingly, the court held that the gain from the sale of the taxpayer's franchisor's interest and trademarks (including any goodwill inherent therein) was U.S.-source income for foreign tax credit limit purposes under the residence-of-the seller rule in section 865(a) and (d)(1) since the subject matter of the sale was a trademark. In the court's view, the special source rule in section 865(d)(3) for gain from the sale of goodwill applies only where goodwill is separate from the other intangible assets that are specifically listed in section 865(d)(1). Since an identified asset (namely a tradename) apart from goodwill was identified that coterminously explained the intangible value of the doughnut business, the allocation of that intangible value to the identified trademark supplanted any opportunity to source the gain under the specialized sourcing rule of section 865(d)(3). Thus, the Tax Court in *International Multifoods* rejected prior case law that goodwill, trademarks, and tradenames were inextricably linked and were thus sourced as goodwill under section 865(d)(3).[117] These earlier decisions harken back to the now defunct mass asset rule, but since 1993 goodwill is considered a left-over or residual allocation that only receives an allocation for sourcing purposes after the other identifiable intangibles specified in section 865(d)(1) are valued, thus causing goodwill to have an ephemeral and contingent status.

C. Section 367(d)'s Purpose is Frustrated by the Existing Cost Sharing Regulations

The ability to assign residual profits to a risk-taker entrepreneur entity and away from the affiliate whose functions created the income-producing intangible is a theme that has been clearly played out through the use of cost sharing arrangements (CSAs) entered into among MNE affiliates.[118] Essentially, CSAs allow two or more controlled parties to share the costs and risks of a research and development project for an agreed upon scope in exchange for a specified interest in the results of the project. As the participants jointly own the developed technology, there is typically no royalty obligation with respect to the use of the technology by any participant. Consideration for use of intangibles developed in a CSA is paid

117. For cases articulating that trademarks and tradenames are the embodiment of goodwill, see Canterbury v. Commissioner, 99 T.C. 223, 252 (1992); Philip Morris, Inc., 96 T.C. 606, 634 (1991).

118. The views expressed by the author with respect to cost sharing agreements was originally set forth in Wells & Lowell, *Tax Base Erosion*, *supra* note 115.

in advance during the course of development as opposed to after the development (typically as royalties) where the intangibles are developed by another person. In effect, a CSA involves multiple developers.

The IRS has struggled with the cost sharing regulations from a U.S. tax base defense standpoint since the mid-1960s.[119] In the pre-1986 cases, courts typically sided with taxpayers.[120] While the Tax Reform Act of 1986 Act did not specifically address CSAs, the legislative history indicates that the commensurate-with-income provisions of sections 367(d) and 482 were not intended to prevent appropriate use of such arrangements.[121] The

119. Administrative guidance was initially provided in the 1966 proposed regulations. Prop. Reg. § 1.482-2(d)(4)(i), 31 Fed. Reg. 10,394, 10,398 (1966). When the section 482 regulations were finalized in 1968, the provisions applicable to cost sharing were considerably reduced and simplified, with the content compressed from several pages to only one paragraph. T.D. 6952, 1968–1 C.B. 218.

120. The first significant cost-sharing case was Seagate Technology, Inc. v. Commissioner, 102 T.C. 149 (1994), *acq.* 1995-2 C.B. 1. A U.S. MNE, "S," established a Singapore subsidiary (SSing) to manufacture disk drives. The IRS asserted that the cost share of SSing should be increased to reflect relative production. The evidence indicated that by 1987 the preponderance of manufacturing in SSing suggested that a sharing ratio of 75 percent and 25 percent as between SSing and S was reasonable. Experts testifying for the IRS stated that shares should be based on the relative production of disks, which over the three years in question would have resulted in an 84 percent and 16 percent split. The court found that the record did not contain any uncontrolled cost-sharing arrangements that could be consulted for guidance and used its "best judgment" to conclude that 75 percent of the costs should be allocated to SSing and 25 percent to S. *See also* Altama Delta Corp. v. Commissioner, 104 T.C. 424, 463–72 (1995) (applying the cost-sharing method in the context of the possession corporation cost-sharing provisions); Ciba-Geigy Corp. v. Commissioner 85 T.C. 172, 222 (1985) (rejecting IRS's position that a generalized facts and circumstances approach should be applied to an arrangement similar to a CSA in favor of the provisions of the intangibles section 482 regulations).

121. Specifically, the legislative history to the Tax Reform Act of 1986 indicated that Congress did not intend to preclude the use of certain bona fide research and development cost-sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, if and to the extent that the income allocated among the parties reasonably reflects the actual economic activity undertaken by each. The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085. *See* STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1017 (Comm. Print 1987). In order for cost-sharing arrangements to produce results consistent with the commensurate with income provisions of the 1986 Act, it was envisioned that cost allocations should generally be proportionate to profits determined before deduction for research and development costs. In addition, to the extent that one party actually contributes funds at a significantly earlier point in time than the other, or is otherwise effectively putting its funds at risk to a greater extent than the other, it would be

regulatory experience of the succeeding decades has been that the cost sharing regulations have become more and more complicated.[122]

For the purposes of this Article, the fundamental principle behind the existing and previous cost sharing regulations is that they explicitly allocate residual profits based on anticipated future benefits,[123] whereas the profit-split methodologies of section 482 seek to allocate residual profits based on the relative functional contribution towards the creation of the nonroutine intangible generating those residual profits.[124]

Where a CSA is put into place among parties that both contribute nonroutine intangibles and where their cost shares (i.e., their expected future benefits) are equivalent to their relative contribution of the nonroutine functions creating the developed intangible, then those results achieved under the cost sharing regulations should mirror the results provided by a two-sided transfer pricing methodology conducted under the rubric of Regulation section 1.482-6. Thus, in such a fact pattern, the CSA formalizes an arrangement that harmonizes with the results achieved under the profit-split approaches. On the other hand, when a CSA allows an MNE to choose a risk-taker entrepreneurial affiliate to fund the intangible development for an amount in excess of its functional contribution towards the creation of that developed intangible, then the cost sharing regulations allow the residual profits to be stripped away from the functions that created those residual

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expected that an appropriate return would be provided to such party to reflect the time value of this investment.

122. *See* 1988 White Paper, *supra* note 96. The 1988 White Paper provided a detailed analysis of how those provisions of the 1986 Act should be applied to CSAs. The 1988 White Paper seemed generally to take a rather restrictive approach. *Id.* at 495. The stringent requirements of the 1988 White Paper were roundly criticized by commentators, and a more lenient set of provisions was proposed in 1992. Prop. Reg. § 1.482-2(g)(1)(i), 57 Fed. Reg. 3571, 3575 (1992). The IRS issued final cost-sharing regulations on December 20, 1995. T.D. 8632, 1996–1 C.B. 85. The final regulations largely followed the 1992 proposed regulations, but made several important alterations. *Id*. The IRS issued proposed regulations restating the CSA regulations in August 2005. *See* 70 Fed. Reg. 51,116 (2005). On December 31, 2008, final and temporary regulations were issued. T.D. 9441, 2009–7 I.R.B. 460. These regulations had been proposed in 2005 to replace the 1995 regulations. The 1995 regulations were controversial, reflecting the conflicting interests of MNEs and the public fisc with respect to the cross-border use or transfer of intangible property. In 2011, final, temporary, and proposed regulations were released. T.D. 9569, 76 Fed. Reg. 80,249 (Dec. 23, 2011), finalizing the 2009 version with relatively modest substantive change.

123. *See* Reg. § 1.482-7(a)(1).

124. *Compare* Reg. § 1482-6(a), *with* Reg. § 1.482-7(b)(1)(i), *and* (e)(1). The appropriate transfer pricing results under section 482 are dealt with extensively by the authors in a separate work. *See* Wells & Lowell, *Tax Base Erosion*, *supra* note 115.

profits and given to the offshore "risk-taker."[125] From the standpoint of devising a solution to this profit shifting problem, Regulation section 1.482-7 should be amended to provide that all allocations of residual profits via a CSA (whether a pre-existing CSA or a new CSA) will be respected in future years only to the extent that the CSA allocates residual profits in the same manner as would occur under a straightforward application of a two-sided transfer pricing methodology set forth in Regulation section 1.482-6. To the extent that a foreign corporation is able to fund a cost sharing arrangement to develop intangibles above their functional contribution (apart from funding), section 367(d) should treat the transfer of this excess ownership interest in the developed intangible as an outbound contribution of an intangible to a foreign corporation that is subject to section 367(d)'s super royalty provisions. Stated differently, the excess funding should be viewed as a prepayment of the ongoing section 367(d) super royalty obligation.

Section 367(d) provides the IRS with authority to require all transfer pricing arrangements, including CSAs, to comply with the commensurate with income requirements regardless of which entity owns the intangible. Some have argued that the Treasury Department should explicitly state that section 367(d) has no application to value transfers that occur via qualified

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125. *See* Reg. § 1.482-7(a)(1), (b)(1)(i), and (e)(1). The problem of how to source intangible income has been explored by others without academic agreement. *See* Michael J. Graetz & Rachael Doud, *Technological Innovation, International Competition, and the Challenges of International Income Taxation*, 113 COLUM. L. REV. 347 (2013) (discussing and cataloging several possible policy options); Ilan Benshalom, *Sourcing the "Unsourceable:" The Cost Sharing Regulations and the Sourcing of Affiliated Intangible-Related Transactions*, 26 VA. TAX REV. 631 (2007) (proposing that manufacturing intangibles be sourced according to where their value was created whereas marketing intangibles should be sourced to where they were created based on sales); Lawrence Lokken, *The Sources of Income from International Uses and Dispositions of Intellectual Property*, 36 TAX L. REV. 235 (1981) (discussing sourcing intangible income to the place where the intangible value is sold or where manufactured); Erin L. Guruli, *International Taxation: Application of Source Rules to Income From Intangible Property*, 5 HOUS. BUS. & TAX L.J. 204 (2005) (sourcing intangible income to where intangible value is sold); David G. Noren, *The U.S. National Interest in International Tax Policy*, 54 TAX L. REV. 337 (2001) (sourcing intangible income to where sale is made). The OECD released a draft proposing that intangibles should be sourced to the functions that created them. *See* OECD, *Revision of the Special Considerations for Intangibles in Chapter VI of the OECD Transfer Pricing Guidelines and Related Provisions*, 2012 TAX NOTES TODAY 110-37 (June 6, 2012). The view taken by the OECD is that to solve the base erosion and profit shifting phenomenon the residual profits must be sourced to the functions that contributed to their creation, not based on the entity that will benefit from them.

cost sharing arrangements,[126] so in response the Treasury Department should clarify in forthcoming section 367(d) regulations that a CSA's assignment of residual profits to a risk-taker satisfies the commensurate-with-income requirements only if the results are in accord with the results achieved with a two-sided transfer pricing methodology.[127] The IRS is on record as having asserted authority under section 367(d) to require pre-existing CSAs to comply with the commensurate-with-income standard, and it should now follow-through on that authority.[128] Instead of exercising that authority to

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126. *See* NEW YORK STATE BAR ASSOCIATION, REPORT ON SECTION 367(D) 62–64 (Oct. 12, 2010) 2010 TAX NOTES TODAY 198-20.

127. *See* Reg. § 1.482-6(c). For a detailed analysis of how the profit-split methodologies better align the residual profits with the substantive functions that create those residual profits, see Wells & Lowell, *Tax Base Erosion*, *supra* note 115.

128. *See* 1988 White Paper, *supra* note 96, at Chapter 13(J). The White Paper states as follows:

> It is unlikely that there will be preexisting cost sharing agreements that will meet all of the standards described above. If such agreements are not recognized, the Service and taxpayers will encounter significant problems in determining ownership of preexisting intangibles and the treatment of the payments that have been made pursuant to the preexisting agreements. Some type of grandfather treatment would therefore appear to be appropriate. One possibility would be to permit any cost sharing agreement that conforms to the requirements of the existing regulations, and that has been in existence for more than 5 years prior to 1987, to be recognized fully if conformed within a certain period after the promulgation of the new rules with respect to matters other than the buy-ins that occurred prior to June 6, 1984 (the effective date of section 367(d)). If the cost sharing agreement has been in effect for less than 5 years and the agreement does not conform substantially to the new rules, then the old agreement would not be recognized. If a new agreement that conforms to the new rules is adopted, then all payments pursuant to the old agreement would be taken into account as an adjustment to any required buy-in payments relating to the new agreement.

Id.

Consistent with the above methodology, the IRS could require that all CSAs conform their tax results to those resulting from two-sided transfer pricing methodologies of Regulations section 1.482-6 regardless of which affiliate is the tax owner of the nonroutine intangible if the ownership was acquired by a CSA entered into after the effective date of section 367(d). This regulatory requirement would ensure that the affiliate that created the nonroutine intangible was in fact allocated the residual profits commensurate with that residual income under the principles of section 367(d). The IRS could provide a short transition rule (two years or less) for having taxpayers subject their existing CSAs to a two-sided transfer pricing

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harmonize the residual profit allocations afforded under the cost sharing regulations to the residual profit allocations afforded under Regulation section 1.482-6, the IRS has instead limited its policing of CSAs to contesting (1) the buy-in payment amount for pre-existing intangibles[129] and (2) whether the MNE had included all of the intangible development costs as part of the cost shares.[130] But in each of these factual settings, the IRS has faced a significant factual determination challenge. Furthermore, the existing cost sharing regulations grandfathered even more lenient CSAs entered before the issuance of the current regulations.[131] Thus, existing Regulation section 1.482-7 provides significant opportunities for an MNE to utilize a CSA to assign a foreign risk-taker entrepreneur affiliate the right to residual profits for intangible property created by other affiliates without the need to provide any further significant contribution towards their creation other than internal funding.

In the legislative hearings relating to profit shifting, CSAs have played a prominent role.[132] If public statements are to be believed, in the case of Apple, Inc.,[133] its tax-haven affiliate funded $5 billion of its research and

methodology as a confirming check to the results achieved under Regulation section 1.482-7.

129. *See* Veritas Software Corp. v. Commissioner, 133 T.C. 297 (2009) (where the IRS unsuccessfully argued that the buy-in payment should have been 1000 percent higher than the one utilized by the taxpayer, and the Tax Court sustained the taxpayer's valuation of the buy-in payment); A.O.D. 2010–005, 2010–49 I.R.B. 803.

130. *See* Xilinx, Inc. v. Commissioner, 567 F.3d 482 (9th Cir. 2009) (rejecting IRS position that stock option costs should be included in the cost to be shared among the parties), *withdrawn*, 592 F.3d 1017 (9th Cir. 2010).

131. *See* Reg. § 1.482-7(m)(1).

132. *See Offshore Profit Shifting and the U.S. Tax Code – Part 2 (Apple Inc.): Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs,* 112th Cong. 6 (2013), http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code_-part-2 [hereinafter *Offshore Profit Shifting Hearing (Apple, Inc.)*]; *Offshore Profit Shifting and the U.S. Tax Code – Part 1 (Microsoft & Hewlett Packard): Hearing Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs*, 112th Cong. 2 (2012), (Ex. 1.a. Memorandum from Permanent Subcommittee on Investigations (May 21, 2013)) [hereinafter *Offshore Profit Shifting Hearing (Microsoft & Hewlett Packard)*].

133. The author has no personal knowledge of the Apple tax situation, and as a general rule would not comment on a particular taxpayer situation in my writings outside the context of decided cases. However, Apple has explicitly invited the public to consider its tax structure as part of the ongoing comprehensive tax reform debate. See *Offshore Profit Shifting Hearing (Apple, Inc.)*, *supra* note 132, (statement of Tim Cook, Chief Executive Office of Apple, Inc.). Mr. Cook stated that Apple welcomes an objective evaluation of the U.S. corporate tax system, that

development expenditures and in return was allocated $79 billion of income or $74 billion in residual profits (net of the research expenditures).[134] If section 367(d) were faithfully implemented, Apple's tax-haven subsidiary would not be entitled to share in the residual profits unless it met the functional standard. As a general rule, an entity whose sole function is that of a risk-taker funding party is not providing a "function" that creates residual profits.[135] Instead, the Treasury Department should amend its cost sharing regulations to make clear that the residual profits would be allocated to the affiliate whose functions contributed to the creation of the valuable intangible. If all functions that contributed to the creation of the developed intangible were located in the United States, then all of Apple's residual profits should be allocated to the United States. If, however, a significant nonroutine European marketing intangible existed in the Apple fact pattern and that European marketing intangible contributed towards the generation of the combined residual profits, then the residual profits should be split based on the relative contribution of the offshore marketing intangible's contribution versus the contribution of the other intangibles that contributed to Apple's combined residual profits. If the Irish risk-taker subsidiary is receiving a share of nonroutine intangibles that is in excess of its functional contribution towards their creation (apart from funding),[136] then this arrangement represents an outbound contribution of an intangible that ought

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Apple provided its information as a means to provide information "critical to any objective evaluation of its tax practices," and that Apple supports comprehensive U.S. corporate tax reform "even though it would result in Apple paying more U.S. corporate tax." *Id.* This article comments on the publicly-disclosed facts for the purpose of answering the question of whether section 367(d) can be reformed to prevent inappropriate shifting of profits to tax havens via CSAs.

134. *See Offshore Profit Shifting Hearing (Apple, Inc.)*, *supra* note 132, at 4, n.6 (Statement of Richard Harvey, Jr., Villanova University School of Law).

135. *See* Bausch & Lomb, Inc. v. Commissioner, 92 T.C. 525, 611 (1989), *aff'd*, 933 F.2d 1084 (2d Cir. 1991). In fact, in this case, the party funding the research was entitled to receive a 27 percent return on its funding investment and then residual profits were split based on the relative contribution of the functions. The Tax Court stated as follows as to the return that the risk-taker should take: "[w]e can assume that the 12-percent rate used to discount future cash-flows in the SEA projections constituted petitioner's estimate of the acceptable rate of return on a relatively riskless venture. The additional 15 percentage points earned by the investor can thus be viewed as compensation for assuming the risks involved in the venture." *Id.* This aspect of the Tax Court's holding in *Bausch & Lomb* recognizes that the funding function was a routine function that did not deserve to share in residual profits, and this aspect of the court's holding could be adopted in regulations.

136. *See Offshore Profit Shifting Hearing (Microsoft & Hewlett Packard)*, *supra* note 132, (Staff Memorandum to the Members of the Senate Permanent Subcommittee on Investigations (May 21, 2013)).

to be subject to section 367(d)'s super royalty obligation, and existing Treasury regulations should be amended to require this result.

D. *Specific Reform Proposals to Prevent Intangible Migration Are Administratively Available*

The discussion throughout this Part II leads to a consistent conclusion, namely that if significant intangible profits can be transferred via the transfer of the underlying intangible property, then the U.S. tax base is left unprotected and base erosion and profit shifting will be the result. Courts were unwilling to extend their own judicially created assignment of income doctrine to prevent the profit shifting occasioned by the transfer of intangibles away from the U.S. developer, but Congress statutorily did so. When one considers the evolution of the U.S. case law definition of goodwill, the adoption of section 367(d), the expansive definition contained in section 936(h)(3)(B), and the commensurate with income standard, the clear statutory purpose of section 367(d) is expressed, and it is the following: whenever significant annual residual profits exist in a risk-taker entrepreneur entity that obtained its business in a supply chain restructuring, an outbound transfer of an active foreign business, or via a cost sharing agreement, the specific and distinct intangibles that generate those intangible returns must be identified and if those income-generating intangibles originated from a U.S. person then section 367(d) requires the profits from those income-generating items to be reassigned back to the U.S. developer whose functions created those income-producing items.

The legislative goals for section 367(d) dictate that significant residual value generated by U.S. developed intangibles should not migrate out of the U.S. tax base, and Congress carefully crafted a statute that effectively codified the judicially created assignment of income doctrine to achieve that purpose. Thus, if the Treasury Department and IRS want to ensure that it faithfully implements the legislative intent that Congress had in mind when it enacted section 367(d), then it needs to do two things:

> **Action #1: Clearly assert in litigation of these so-called "goodwill loophole" cases that Section 367(d) does not allow the annual residual profits to remain in the foreign risk-taker entrepreneur when those residual profits are attributable to items contributed as goodwill.** If there are aspects of goodwill that are capable of providing intangible property returns, then those aspects of goodwill are described in section 936(h)(3)(B) to that extent and thus are to that extent subject to section 367(d)'s super royalty obligation. All income-producing intangibles that contribute towards the generation of annual residual profits should be

> separately identified, and under today's modern valuation techniques it should be possible to determine the business functions, processes, methods, and systems that comprise the items that contribute towards the creation of an enterprise's ongoing residual profits. Those identified intangibles then should be subjected to section 367(d)'s super royalty provisions if they are the subject of an outbound section 351 transfer to a foreign corporation, and the amount of the super royalty obligation should be determined so that all the residual profits arising from the transferred income-producing intangibles are assigned back as a super royalty to the U.S. person who transferred the income-producing intangible property.
>
> **Action #2: Amend the existing cost sharing regulations to not allow a party to share in residual profits from a developed intangible simply because they funded the development of the intangible.** Tax base erosion occurs as a result of the transparent "assignment of residual income" planning that is achievable under the cost sharing regulations. CSAs, under current law, allow residual profits to be migrated to a risk-taker entrepreneur entity in an amount above its functional contribution, and thus the current regulations allow annual residual profits to be segregated away from the functions that created the residual income. CSAs should not be sanctioned except to the extent that they provide allocations of residual profits in accordance with the functional contribution of the contributing entities towards the creation of the income-producing intangible. The Treasury Department has evolved the cost sharing regulations over time, but the fundamental mistake of allowing a taxpayer to simply assign residual profits away from the affiliates that create the nonroutine intangible remains an important avenue for accomplishing IP migration strategies under current law. The Treasury Department's regulations that implement section 367(d) should be amended to say that any assignment of residual rights under a qualified CSA to a funding party in excess of its functional contribution represents an outbound contribution of intangibles subject to section 367(d)'s super royalty provisions.

In combination, the above recommendations address much of the mischief currently in play under section 367(d) and would serve to fulfill Congress's goal of assigning intangible income back to the U.S. developer whose nonroutine functions created the income-producing intangible.

III. SYNTHESIS OF SECTION 367(d) WITH § 367'S NEVER-ENDING STORY OF POLICING TAX-FREE CASH REPATRIATION STRATEGIES

Although Part II dealt with the historical objectives of section 367(d) and how section 367(d) should be interpreted in terms of the challenges posed by the ILLUSTRATION CASE, the reality is that the Treasury Department has enlisted section 367 to achieve a variety of other tax policy objectives, and section 367(d) is now being impacted by those other objectives. Thus, in Part III, this Article addresses how section 367(d) needs to be reformed in light of the other policy goals that are reformulating section 367 generally.

Before commencing this analysis, however, it is important to recognize that the historical goals of section 367(a) and (b) were premised on preserving the U.S. tax jurisdiction over the built-in gain inherent in assets that are contributed to a foreign subsidiary (section 367(a)'s historic concern) and subjecting any unrepatriated section 1248 earnings of a controlled foreign corporation to immediate taxation if a corporate adjustment causes those earnings and profits to move into a non-CFC environment (section 367(b)'s historic concern).[137] However, although the above twin goals provide a framework for understanding the original goals of section 367(a) and (b), they are not sufficient in and of themselves to understand section 367 as it has been implemented because Congress granted broad regulatory authority to the Treasury Department, and the Treasury Department in recent years has utilized that authority to achieve other goals. It is these other goals to which the existing section 367(d) regulations are in conflict and where reform is thus needed. In Subpart III.A., this Article explores the additional goals that have been grafted into section 367(a) and (b). In Subpart III.B., this Article discusses how these changes to section 367(a) and (b) now require changes to the existing Treasury regulations under section 367(d).

A. Policing Cash Repatriation Section 367(a) and Section 367(b)

The starting point for analysis is with the Treasury Department's efforts to utilize its regulatory authority under section 367(a) to attack corporate inversion transactions prior to the enactment of section 7874.[138] In

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137. *See* JOSEPH ISENBERG, INTERNATIONAL TAXATION at 208 (Foundation Press 3d Ed. 2010).

138. In the well-known outbound transfer of Helen of Troy's stock in 1994, shares of Helen of Troy (U.S.) were exchanged for shares of Helen of Troy

general, under the anti-inversion regulations enacted under section 367(a), U.S. shareholders that transfer stock in a U.S. corporation to a foreign transferee corporation and receive 50 percent or more of the transferee foreign corporation stock are immediately taxable on their stock gain.[139] Through its adoption of these anti-inversion regulations, the Treasury Department signaled that other goals apart from the historic goals of section 367(a) and (b) would guide future regulatory reform.

After its anti-inversion foray, the Treasury Department again signaled that it would use its regulatory authority under section 367 to prevent nontaxable repatriations of cash from foreign subsidiaries even though the built-in gain in foreign subsidiary stock was preserved and the

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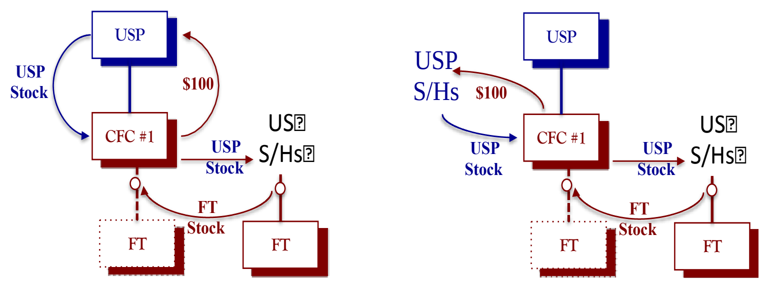
(Bermuda), and the U.S. company became a wholly owned subsidiary of the Bermuda corporation. The nuances of how this form of expatriating transaction was accomplished under the old section 367 regulations have been adequately addressed by other commentators. *See generally* David R. Tillinghast, *Recent Developments in International Mergers, Acquisitions, and Restructurings,* 72 TAXES 1061, 1063–68 (1994); *see also* Benjamin G. Wells, *Section 367(a) Revisited,* 71 TAX NOTES 1511 (June 10, 1996). The purpose of the transaction was to rearrange the ownership of the companies so that Helen of Troy (Bermuda) could make further international investments outside the reach of the U.S. extra-territorial tax regime. The IRS responded to this expatriation transaction by issuing Notice 94–46, 1994–1 C.B. 356, which announced that such inversion transactions would be attacked under the government's authority in section 367. The Treasury Department then issued regulations in 1996 that required the transfer of stock in a U.S. corporation to a foreign corporation to be taxable unless the premerger foreign corporation was more valuable than the U.S. corporation and other requirements were met. *See* Reg. § 1.367(a)-3(c)(1). The stated purpose for the rule was to address Treasury's concern that outbound reorganizations could provide corporations an opportunity to avoid the U.S. extraterritorial taxation regime, so the government amended its regulations under § 367(a) to require immediate recognition of all built-in gain when the outbound reorganization was being used as a means to effectuate a corporate inversion. *See, e.g.*, T.D. 8770, 1998–2 C.B. 3. (explaining purpose of the anti-inversion regulations and the government's desire to update them to stop inversions). However, these regulations did not stop inversion transactions. For a thorough review of expatriations from 1996 through 2002, see Willard B. Taylor, *Corporate Expatriations—Why Not?*, 78 TAXES 146 (2002). Congress would later respond by adopting section 7874 in an effort to further attack the corporate inversion phenomenon, but section 7874 has also not stopped inversions. *See* Bret Wells, *Cant and the Inconvenient Truth About Corporate Inversions,* 136 TAX NOTES 429 (July 23, 2012) [hereinafter Wells, *Cant and the Inconvenient Truth*]. Nevertheless, Regulation section 1.367(a)-3(c) has remained a permanent fixture of the section 367(a) regulations and as such has fundamentally modified the application of section 367(a).

139. *See* Reg. § 1.367(a)-3(c). An important exception to this general taxable result is provided for certain triangular reorganizations, and this exception is more fully discussed *infra* text accompanying notes 152–68.

U.S. parent company had not altered its position with respect to unrepatriated section 1248 earnings and profits of its controlled foreign corporations. The first expression of this emerging anti-repatriation goal was in 2006 when the Treasury Department stated that it had become concerned about transactions where a controlled foreign corporation purchased the stock of its U.S. parent and then used the U.S. parent stock to acquire a foreign target corporation in a transaction that was intended to qualify as a tax-free reorganization under section 368(a)(1)(B). If successful, the U.S. parent corporation's receipt of cash in exchange for its own shares would be nontaxable by reason of section 1032,[140] and the controlled foreign corporation obtained a cost basis in the parent shares by reason of section 1012. The transaction, under this construct, did not require the U.S. parent to incur an income inclusion with respect to the foreign subsidiary's unrepatriated section 1248 earnings and profits.[141] These repatriation techniques came to be known as "Killer B Transactions," and two common variations of these Killer B Transactions are graphically depicted in the below diagram.

"<u>Killer B Transaction</u>"

Notice 2006-85 **Notice 2007-48**



In two notices, the Treasury Department announced that these Killer B Transactions raise significant policy concerns because they allow the U.S. parent corporation to repatriate or access foreign subsidiary cash ($100 in the above diagrams) or both while avoiding any income inclusion with respect to the unrepatriated section 1248 earnings and profits of the controlled foreign corporation. In Notice 2006-85,[142] the Treasury Department stated that it intended to issue regulations under section 367(b) that would treat the $100

140. *See* Reg. § 1.1032-1(a).

141. *See* Reg. § 1.367(b)-4(b)(1)(ii). The U.S. parent stock was disposed of before the close of a quarter-end in order to avoid an income inclusion by reason of having an investment in U.S. property. *See* I.R.C. § 956(a).

142. Notice 2006–85, 2006–2 C.B. 677, *obsoleted by* T.D. 9400, 2008–1 C.B. 1139, *adopted with modification by* T.D. 9626, 76 Fed. Reg. 28,890 (May 19, 2011).

payment from CFC #1 to USP in the above left diagram as a separate transaction that for tax purposes is bifurcated from the overall exchange, thus in effect treating CFC #1's payment of the $100 of cash in the Notice 2006-85 diagram as a stand-alone taxable section 301 dividend in much the same manner as section 304 would have done if it had been applicable.[143] In Notice 2007-48,[144] the Treasury Department expanded the deemed section 301 dividend treatment of Notice 2006-85 to include transactions where a subsidiary acquires stock of its U.S. parent from the open market in order to use such stock as part of a larger acquisitive reorganization.[145] Subsequently, the Treasury Department issued temporary[146] and eventually final regulations[147] to implement this reform.

No built-in gain property was transferred in these Killer B Transactions, and the section 1248 earnings of CFC #1 remain within a controlled foreign corporation environment.[148] Yet, section 367(b) was amended to create an immediate income inclusion to the U.S. parent in the context of Killer B Transactions. Why? The reason is that the use of the CFC #1 cash to purchase U.S. parent stock was seen as a de facto repatriation event and thus represented an appropriate occasion to subject to U.S. taxation a corresponding amount of unrepatriated section 1248 earnings of CFC #1. Thus, seen in its larger context, the IRS and Treasury Department utilized its

143. The IRS agrees that "section 304, by its terms, does not apply to the transfer by a shareholder of its own stock to a controlled corporation in exchange for property, even though the economic effect of that transaction is essentially identical," but then the IRS went on to state that "a triangular reorganization involving a foreign corporation is described in section 367(b) and, therefore, may be subject to regulations issued under the broad regulatory authority granted therein" and that it was "on this basis that regulations will be issued to address the triangular reorganizations covered by this notice." *See* Notice 2006–85, 2006–2 C.B. 677, § 3.03 & § 4.

144. Notice 2007–48, 2007–1 C.B. 1428, *obsoleted by* T.D. 9400, 2008–1 C.B. 1139, *adopted with modification by* T.D. 9526, 76 Fed. Reg. 28,890 (May 19, 2011).

145. This result reversed longstanding case law and IRS administrative guidance that had concluded in the non-section 367 context that a subsidiary's acquisition of its parent stock in the open market for cash was not a deemed dividend to the shareholder. *See* Broadview Lumber Co. v. U.S., 561 F.2d 698 (7th Cir. 1977); Virginia Materials Corp. v. Commissioner, 67 T.C. 372 (1976), *aff'd* 577 F.2d 739 (4th Cir. 1978); Webb v. Commissioner, 67 T.C. 293 (1976), *aff'd* 572 F.2d 135 (5th Cir. 1978); Rev. Rul. 80–189, 1980–2 C.B. 106.

146. *See* Temp. Reg. § 1.367(b)-14T, 73 Fed. Reg. 30,301 (May 27, 2008).

147. Reg. § 1.367(b)-10.

148. *See* Joseph Calianno & Kagney Petersen, *IRS Issues Notice on 'Killer B' Transactions: Curbing Repatriation or Overreaching?*, 18 J. INT'L TAX'N 52, 55 (Jan. 2007) (making this observation) [hereinafter Calianno & Petersen, *Curbing Repatriation or Overreaching?*].

authority under section 367(b) to create tax results that were analogous to the results afforded under section 304 without the benefit of section 304's direct applicability.[149] Respected practitioners questioned whether the Treasury Department had exceeded its authority,[150] but the government ignored these concerns[151] and finalized its regulations,[152] thus utilizing its section 367(b) regulatory authority to attack repatriation strategies even when the section 1248 amount had been preserved in the transaction.

Although the government's goal was to stop Killer B Transactions, the amendments made to section 367 that effectuated the anti-repatriation goals unexpectedly provided taxpayers with the means to implement an inversion that avoided the anti-inversion regulations contained in Regulation section 1.367(a)-3(c). The relevant planning opportunity is set forth in the

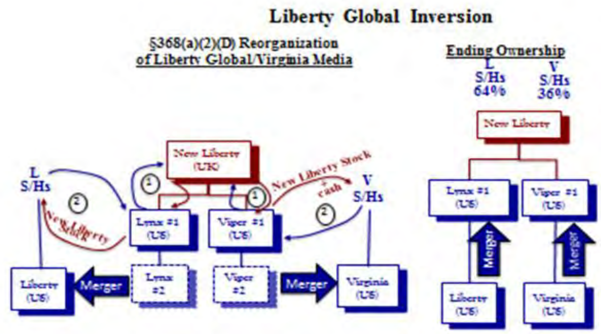
149. Section 304 on its face is inapplicable to this transaction because section 304(a)(2) applies to a subsidiary's purchase of its parent's stock from an entity other than the parent corporation. *See* Reg. § 1.1032-1(a) (disposal of parent stock for cash is not taxable to parent); Rev. Rul. 80–189, 1980–2 C.B. 106 (subsidiary purchases parent stock from sole parent shareholder not a section 304 transaction); Rev. Rul. 69–261, 1961–1 C.B. 94 (subsidiary's purchase of parent stock from open market is not a section 304 transaction); Joseph Calianno & Kagney Petersen, *Have the IRS and Treasury Overextended Their Reach?*, 34 J. CORP. TAX'N 11 (Sept.-Oct. 2007) [hereinafter Calianno & Petersen, *Have the IRS and Treasury Overextended Their Reach?*].

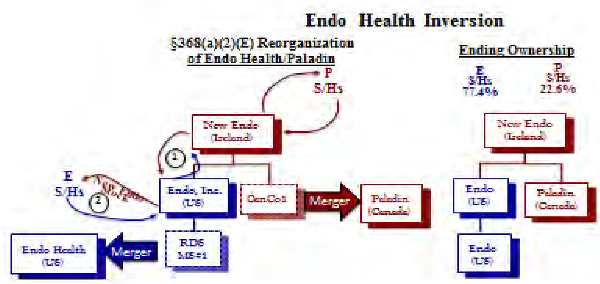
150. *See* Robert Willens, *Service Rejects 'Killer Bees' Technique for Repatriating Earnings of Foreign Subsidiary but Courts May Reject Move for Lack of Authority*, Daily Tax Rep. (BNA) No. 193, at J-1 (Oct. 5, 2006); Calianno & Petersen, *Curbing Repatriation or Overreaching?*, *supra* note 148; Calianno & Petersen, *Have the IRS and Treasury Overextended Their Reach?*, *supra* note 149; Joseph M. Calianno & Kagney Petersen, *Notice 2007–48: A Further Attack on the 'Killer B' and Similar Transactions,* 18 J. INT'L TAX'N 18 (Aug. 2007); Joseph M. Calianno & Kagney Petersen, *The 'Killer B' Saga Continues—IRS Issues New Regulations*, 19 J. INT'L TAX'N 34 (Sept. 2008); Jeffrey L. Rubinger, *Final 'Killer B' Regulations Further Expand Likelihood of Gain Recognition by Taxpayers,* 114 J. TAX'N 365 (June 2011); William R. Pauls & H. Carl Zeswitz, Jr., *A Gambit Vanquished: The Rise and Fall of the "Killer B,"* 52 TAX MGM'T MEM. (BNA) 419 (Oct. 2011).

151. *See* T.D. 9400, 73 Fed. Reg. 30,301 (May 27, 2008) (to justify its regulatory attack on the Killer B Transaction, the preamble to the temporary regulations stated that Congress granted the Secretary authority to provide regulations "necessary or appropriate to prevent the avoidance of Federal income taxes" and identified "transfers constituting a repatriation of foreign earnings" as a type of transfer to be covered in regulations to be promulgated by the Secretary); *See* T.D. 9526, 76 Fed. Reg. 28,890 (May 19, 2011) (stating that the government was not adopting comments that section 304 concepts should not apply to a subsidiary's use of cash to purchase parent stock in the open market).

152. *See* Reg. § 1.367(b)-10.

below two diagrams that are based on two recently announced inversion transactions:[153]





In both the Endo Health diagram (top) and the Liberty Global diagram (bottom), a U.S. subsidiary (Endo, Inc. (U.S.) in the top diagram and

153. The below diagrams are based on two recent high profile deals where respected tax counsel advised shareholders that the legacy U.S. shareholders potentially would receive tax-free treatment on their exchange of U.S. target stock for the foreign acquirer stock even though the legacy U.S. target shareholders owned more than 50 percent of the vote and value of the combined entity. *See* Proxy Statement of Endo Health Solutions, Inc. filed on Schedule 14A at 108–09 (Jan. 24, 2014) [hereinafter Proxy Statement of Endo Health Solutions, Inc.]; Proxy Statement of Liberty Global, Inc. filed on Schedule 14A at 170–72 (May 1, 2013) [hereinafter Proxy Statement of Liberty Global, Inc.].

Lynx #1 and Viper #1 in the bottom diagram) purchased stock of a newly created inverted parent entity by issuing its own promissory note and stock to the inverted parent entity (New Endo in the top diagram and New Liberty in the bottom diagram). Under general corporate tax principles, this transaction would have been treated as a purchase transaction, but the changes to the section 367(b) regulations designed to attack the "Killer B Transactions" supplant this result and treat the transfer of the subsidiary's promissory note as a section 301 distribution in an amount equal to the full value of the note.[154] The transfer of the parent stock is treated as a separate transaction that occurs after the distribution of the subsidiary's promissory note and is treated as a contribution in an amount equal to the fair market value of the contributed parent stock.[155] Because the subsidiary that issued its promissory note was also newly created, the amount of its earnings and profits and the basis in its stock (apart from the later-in-time basis increase occasioned by the subsequent contribution of the parent stock) was insignificant, and so the distribution of the subsidiary's promissory note created a substantial amount of section 301(c)(3) gain in the hands of the inverted parent company.[156] However, this section 301(c)(3) gain escapes any actual U.S. taxation by reason of the applicable U.S. tax treaty.[157] In addition, even though this section 301(c)(3) gain was not subject to any actual U.S. taxation, its existence causes section 367(a) to become inapplicable. In this regard, under a coordination rule contained in Regulation section 1.367(a)-3(a)(2)(iv), the Treasury regulations provide that section 367(a) is inapplicable to any triangular reorganization where the total amount of the income recognized by the inverted parent under section 301(c)(1) or (c)(3) is greater than the aggregate built-in gain of the target U.S. shareholders in their U.S. target stock.[158] Furthermore, section 367(b) provides a similar rule, stating that

154. *See* Reg. § 1.367(b)-10(b)(1).

155. This result was explicitly clear in the temporary regulations that contained an example. *See* T.D. 9400, 73 Fed. Reg. 30,301 (May 27, 2008). The final regulations modified this example but state that the distribution and contribution are separate transactions and the distribution is listed first, so presumably it occurs first-in-time consistent with the temporary regulations. *See* Reg. § 1.367(b)-10(b)(1)–(3).

156. *See* I.R.C. §§ 301, 316; Prop. Reg. § 1.301-2. The later-in-time contribution then provided the inverted parent with a basis increase in its subsidiary stock in an amount equal to the fair market value of the parent stock that was transferred to the subsidiary. *See* Reg. § 1.367(b)-10(b)(2).

157. Taxpayers claimed that the minor dividend amount would be entitled to reduced withholding taxes under U.S. tax treaties and that the section 301(c)(3) gain would be exempt from all U.S. taxation pursuant to treaty. *See* Proxy Statement of Endo Health Solutions, Inc., *supra* note 153, at 37, 106–10.

158. In this regard, Regulation section 1.367(a)-3(a)(2)(iv) provides that neither section 367(a) generally nor the anti-inversion provisions of Regulation

section 367(b) is inapplicable to any triangular reorganization if the total amount of the income recognized by the inverted parent under section 301(c)(1) or (c)(3) is greater than the aggregate built-in gain of the target U.S. shareholders in their U.S. target stock.[159]

The irony of this result is striking: the U.S. subsidiary issues a promissory note, and this promissory note along with the acquisitive reorganization accomplishes a leveraged corporate inversion that affords significant earnings stripping advantages (a flashpoint for Congress and the Treasury Department),[160] and yet it is the addition of this promissory note into the triangular reorganization rubric that affords the opportunity to avoid the applicability of the anti-inversion regulations of Regulation section 1.367(a)-3(c). From a policy perspective, one would have thought that an inversion that is combined with earnings stripping attributes would be the poster child for when the anti-inversion regulations of section 367(a) should apply, and yet it is this transaction that is excluded from their application as a result of the amendments to the section 367 regulations that were made in order to stop the Killer B Transactions.

What is more, inversion benefits arising from these transactions are not assailable under section 7874.[161] In the Endo Health inversion, the

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section 1.367-3(a) apply to triangular reorganization if the requirements of Regulation section 1.367(b)-10(a)(2)(iv) are met. Regulation section 1.367(b)-10(a)(2)(iv) provides that this provision is met if the amount of gain in the U.S. target corporation's stock or securities that would otherwise be recognized under section 367(a)(1) is less than the sum of the amount of the deemed distribution under section 301(c)(1) and the amount of such deemed distribution treated as gain from the sale or exchange of property under section 301(c)(3).

159. *See* Reg. § 1.367(b)-10(a)(2)(iii).

160. The earnings stripping opportunities afforded by inversion debt has been well documented. *See* S. REP. NO. 108-192, at 142 (Nov. 7, 2003); *see also* STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS, at 343 (Comm. Print 2005), 2005 TAX NOTES TODAY 108-16; TREASURY DEPARTMENT OFFICE OF TAX POLICY, REPORT TO THE CONGRESS ON EARNINGS STRIPPING, TRANSFER PRICING, AND U.S. TAX TREATIES, at 8 (Nov. 2007), 2007 TAX NOTES TODAY 230-17.

161. The recent round of inversions has spurred further Congressional calls for further tightening section 7874. *See* Stop Corporate Inversions Act of 2014 (draft released May 20, 2014), H.R. 4679, 113th Cong. 2nd Sess., 2014 TAX NOTES TODAY 98-25; Andrew Velarde & Lindsey McPherson, *Inversion Rule Tightening to Wait for Tax Reform, Wyden Says*, 2014 TAX NOTES TODAY 98-1 (May 21, 2014). The author has stated elsewhere that such efforts, although commendable, are unlikely to be effective because what is needed is to address the base erosion opportunities afforded to all foreign-owned multinational corporations; simply attacking inversion transactions without addressing the underlying financial incentives that make inversion transactions financially attractive ensures that efforts to effectuate inversions will continue. *See* Wells, *Cant and the Inconvenient Truth*, *supra* note

foreign parent is not treated as a surrogate foreign parent under section 7874 because the legacy U.S. shareholders of the U.S. target corporation own less than 80 percent of the foreign parent.[162] Likewise, in the Liberty Global inversion, the foreign parent is not a surrogate foreign parent under section 7874 because the foreign parent possesses a substantial foreign business presence conducted in the country of the inverted parent's incorporation.[163]

In what can be understood as an "uh-oh moment" for the government, the IRS issued Notice 2014–32.[164] In this notice, the IRS stated that forthcoming amendments to its existing regulations will provide that only dividend income and section 301(c)(3) gain that is actually subject to U.S. taxation should be considered for purposes of applying the coordination rule of Regulation section 1.367(a)-3(a)(2)(iv). This change effectively means that section 301(c)(3) gain that escapes any U.S. taxation will be excluded for purposes of determining whether the inverted parent receives a taxable section 301 distribution in an amount that exceeds the aggregate built-in gain of the U.S. shareholders.[165] Once that section 301(c)(3) gain is excluded from the analysis, the inversion transactions depicted in the above diagram will not be able to meet the exception to the anti-inversion regulations that is contained in Regulation section 1.367(a)-3(a)(2)(iv) because the inverted parent's gain is likely to be less than the aggregate built-in gain of the U.S. shareholders of the U.S. target corporation. Notice 2014-32 further provides that section 367(a) and (b) will apply to triangular reorganizations even if the inverted parent's total income exceeds the aggregate built-in gain of the U.S. shareholders in the scenario where the inverted parent receives a dividend from a U.S. subsidiary that is not subject to any actual U.S. taxation or where no actual dividend exists in the transaction.[166] The above regulatory modifications, once effective, will cause

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138; Bret Wells, *What Corporate Inversions Teach About International Tax Reform,* 127 TAX NOTES 1345 (June 21, 2010).

162. See I.R.C. § 7874(b); *see also* Proxy Statement of Endo Health Solutions, Inc., *supra* note 153, at 105.

163. *See* I.R.C. § 7874(a)(2); Temp. Reg. § 1.7874-3T; *see also* Proxy Statement of Liberty Global, Inc., *supra* note 153, at 167–68.

164. *See* Notice 2014–32, 2014–20 I.R.B. 1006.

165. Notice 2014–32, 2014–20 I.R.B. 1006, § 4.01.

166. *See* Notice 2014–32, 2014–20 I.R.B. 1006, § 4.02 (stating that "the regulations will clarify that the no-U.S.-tax exception [in Reg. § 1.367(b)-10(a)(2)(ii)] will apply if the deemed distribution that would result from application of § 1.367(b)-10 to the triangular reorganization would not be treated as a dividend under section 301(c)(1) that would be subject to U.S. tax (for example, by reason of an applicable treaty or by reason of an absence of earnings and profits)"). Furthermore, for good order's sake, this notice states that Regulation section 1.367(b)-10(b)(4) will be modified to provide that the parent corporation (New Endo in the topt diagram and New Liberty in the bottom diagram) must treat the transfer of

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the U.S. shareholders in the above diagrams to recognize their built-in gain in their U.S. target stock by reason of Regulation section 1.367(a)-3(c) because the exception to that result afforded by Regulation section 1.367(a)-3(a)(2)(iv) is no longer available. With this said, these proposed amendments to the existing regulations would only apply prospectively.[167] Thus, the transactions contemplated for Liberty Global and Endo Health appear to be grandfathered.[168] This episode has caused many to believe that the Treasury Department has experienced significant growing pains in its efforts to implement its new anti-repatriation goals under section 367 alongside its already existing anti-inversion goals.[169]

Nevertheless, notwithstanding these growing pains, the Treasury Department remains committed to expanding its anti-repatriation goals to more and more analogous fact patterns. In this regard, shortly after the first two Killer B notices were issued, the Treasury Department identified another technique to repatriate cash from a controlled foreign corporation without triggering an income inclusion—this time with reorganizations described in section 368(a)(1)(D). Two variations of the "all-cash D reorganizations" or

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the parent stock to its subsidiary as being part of the later-in-time triangular reorganization with the consequence that the inverted parent company's basis in its subsidiary stock is increased in an amount equal to the exchanging U.S. shareholders' aggregate basis in their stock, which could well be less than the fair market value of the parent stock used in the exchange. *See* Reg. § 1.358-6. Finally, the anti-abuse rules in the regulations will be clarified to take into account the earnings and profits of other corporations (even if unrelated) for purposes of determining the application of these rules. *See* Notice 2014–32, 2014–20 I.R.B. 1006, § 4.03.

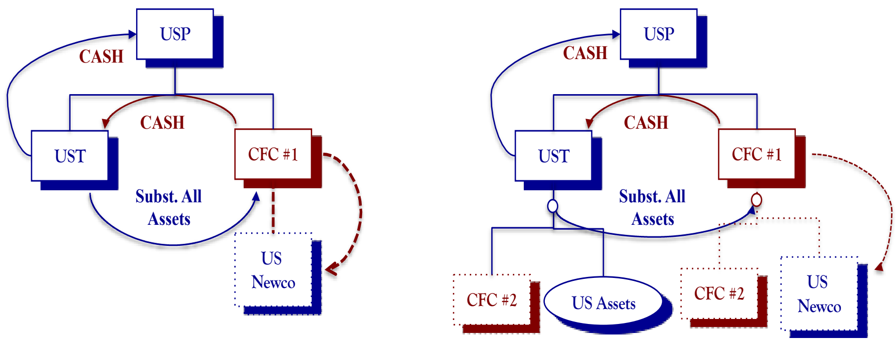
167. Notice 2014–32, 2014–20 I.R.B. 1006, § 5, states that the proposed changes to the regulations described in the notice will apply to a triangular reorganization that is completed on or after April 25, 2014. "The regulations described in this notice will not apply if (i) T was not related to P or S (within the meaning of section 267(b)) immediately before the triangular reorganization; (ii) the triangular reorganization was entered into either pursuant to a written agreement that was (subject to customary conditions) binding before April 25, 2014 and all times afterward, or pursuant to a tender offer announced before April 25, 2014 or that is subject to . . . comparable foreign laws; and (iii) to the extent the P acquisition that occurs pursuant to the plan of reorganization is not completed before April 25, 2014, the P acquisition was included as part of the plan before April 25, 2014." *Id.*

168. *See* Notice 2014–32, 2014–20 I.R.B. 1006, § 5. The IRS did make a statement that it believed that the anti-abuse rules of Reg. § 1.367(b)-10(d) have been too narrowly construed by taxpayers. *See* Notice 2104–32, 2014–20 I.R.B. 1006, § 2.04. So, it will be interesting to see if the IRS proceeds to attack these transactions on that basis.

169. Mindy Herzfeld, *News Analysis: The IRS Shuts Down the Serial 'Killer B,'* 2014 TAX NOTES TODAY 86-3 (May 5, 2014).

"Deadly D reorganizations" that were of concern to the government are set forth in the below diagrams.

"Deadly D" Reorganizations / All Cash D Reorganization"



In these reorganizations, cash boot is paid to the transferor corporation for substantially all of the transferor's assets at a time when both are under common control, and thereafter the transferor corporation is immediately liquidated as part of the reorganization. Under subchapter C of the Code, the cash boot paid by CFC #1 in both of the above diagrams is not taxable to the transferor corporation (i.e., the company designated as "UST" in the above two diagrams) if the transferor corporation (UST) distributes that cash boot to its shareholder,[170] and in this scenario the transferor shareholder (USP) is taxable on the receipt of the cash boot only to the extent that the cash boot exceeds the shareholder's (i.e., USP's) basis in its UST stock.[171] Furthermore, taxpayers had concluded that UST's and USP's receipt of cash should not create an independent tax recognition event under section 367(a) as long as appropriate basis adjustments contemplated by section 367(a)(5) were made in USP's "old and cold" basis in the CFC #1 shares to preserve the historic built-in gain in those CFC #1 shares, or at least so thought taxpayers. As a result of this analysis, "all cash D reorganization" strategies came to be employed as a means to repatriate cash from foreign subsidiaries without triggering an income inclusion of CFC #1's unrepatriated section 1248 earnings and profits.

In Notice 2008–10,[172] the IRS surprised many in the tax community by stating that the necessary basis adjustments required by section 367(a)(5) could only be made with respect to the newly-issued CFC #1 shares and that

170. *See* I.R.C. § 361(b)(1)(A).
171. *See* I.R.C. § 356(a)(1), (2).
172. Notice 2008–10, 2008–1 C.B. 277.

any basis in the old and cold CFC #1 shares must be excluded in this analysis. Thus, in the above diagrams, since no new CFC #1 shares were issued in the all-cash D reorganization, the U.S. parent did not receive new shares in CFC #1 in an amount equal to the inside gain inherent in the assets transferred in the reorganization. Consequently, the Treasury Department said that the built-in gain that exists in the U.S. target's assets could not be appropriately preserved in the new shares received. Because appropriate basis adjustments could not be made in the new shares received to preserve the inside gain inherent in the UST assets, the basis adjustments required by section 367(a)(5) could not be made. Based on this analysis, the government stated that the built-in gain in the assets that were transferred as part of the valid section 368(a)(1)(D) reorganization was taxable by reason of section 367(a)(1) because appropriate basis adjustments as required by section 367(a)(5) could not be made. Proposed regulations consistent with this notice were issued later that same year,[173] and final regulations were issued in 2013.[174] Under the final regulations, as long as newly-issued shares in CFC #1 were issued in the reorganization and those newly-issued shares had a fair market value equal to or in excess of the inside gain in the assets that were being transferred by UST to CFC #1, then and only then would an appropriate basis adjustment be possible within the meaning of section 367(a)(5) such that the outbound transfer would not be taxable to any extent under section 367(a)(1).[175] The effect of this redefinition of section 367(a) was to prevent U.S. corporations from being able to effectively avail themselves of the boot-within-gain rule of section 356(a) with respect to old and cold high basis shares in UST.

Another area evidencing the Treasury Department's and IRS's evolving concern with respect to the ability to repatriate cash in a tax-free manner concerns the interplay of section 304 and section 367. Prior to 2005, the IRS apparently believed that both section 367(a) and section 367(b) applied to any cross-border section 304 transaction.[176] In 2005, the Treasury Department and IRS proposed to exempt the deemed section 351 transfer that occurs as part of a section 304(a)(1) exchange from a section 367

173. *See* Prop. Reg. § 1.367(a)-7 (2008). In general, these proposed regulations retained Notice 2008–10's pronouncement that basis adjustments required by § 367(a)(5) can only be made to the newly-issued CFC #1 stock received as part of the reorganization exchange and could not be made to the basis in the "old and cold" CFC #1 stock.

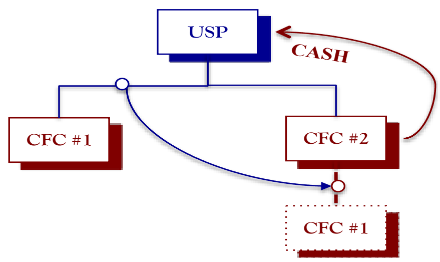
174. *See* T.D. 9614, 78 Fed. Reg. 23,487 (Apr. 18, 2013).

175. *See* Reg. § 1.367(a)-7(c)(3). For an illustration of this nuance, see Regulation section 1.367(a)-7(g) Ex. (1).

176. *See, e.g.*, Rev. Rul. 92–86, 1992–2 C.B. 1999; Rev. Rul. 91–5, 1991–1 C.B. 114.

analysis entirely.[177] This section 351 exchange is graphically depicted in the below diagram by the transfer of the CFC #1 shares from USP to CFC #2.

§304 Transaction
(<u>Gain Greater That E&P</u>)



The government finalized these regulations in 2006, and the final regulations continued the government's belief that the policies of sections 367(a) and (b) would be preserved if section 304 solely applied because the income inclusion required by the transferor in a section 304 transaction would generally exceed the transferor's built-in gain in the assets that were being transferred.[178] Thus, allowing the transaction to be controlled entirely by

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177. *See* Notice of Proposed Rulemaking, 70 Fed. Reg. 30,036 (May 25, 2005). In this notice of proposed rulemaking, the government stated as follows:

> In a section 304(a)(1) transaction in which a U.S. person transfers the stock of an issuing corporation to a foreign acquiring corporation, without the application of section 367(a), the U.S. person will nevertheless recognize an amount of income that is at least equal to the inherent gain in the stock of the issuing corporation that is being transferred to the foreign acquiring corporation. This income recognition results from the construct of the transaction as a distribution in redemption of the acquiring corporation shares. The income recognized may be in the form of dividend income, gain on the disposition of stock, or both. Section 301(c)(1), (3).

Id. at 30,038.

178. *See* T.D. 9250, 71 Fed. Reg. 8,802 (Feb. 21, 2006) which states as follows:

> The IRS and Treasury believe that, in most or all cases, the income recognized in a section 304 transaction will equal or exceed the transferor's inherent gain in the stock of the issuing corporation transferred to the foreign acquiring corporation. Elimination of the application of section 367(a) and (b) in this context will also serve the interests of sound tax administration by creating greater certainty and simplicity in these transactions, and by avoiding the over-inclusion of income that could result when section 367 and section 304 both apply to such transactions. As a result, this

section 304 meant that the distribution would first be treated as a dividend to the extent of earnings and profits of CFC #1 and CFC #2 and then secondarily as a return of capital and then thirdly as gain. Consequently, in situations where CFC #1 and CFC #2 did not have significant earnings and profits, the distribution would be treated as a tax-free return of capital by reason of section 301(c)(2). The downward basis adjustment in the case of a tax-free repatriation would ensure that the built-in gain in the property transferred in the section 304 transaction would be preserved, which again was the historic concern of section 367(a). The IRS repeated this belief that the framework of section 304 appropriately handled section 367(a) concerns in proposed regulations issued in 2009.[179]

However, later in 2009, the Treasury Department reversed course and stated that although section 367(a) and (b) generally would not apply to an outbound transaction subject to section 304, section 367(a) would nevertheless apply where a taxpayer recovered basis in the old and cold shares and not solely from the stock deemed issued and redeemed under

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> Treasury decision finalizes the proposed regulations and makes section 367(a) and (b) inapplicable to deemed section 351 exchanges pursuant to section 304(a)(1) transactions.

Id. at 8,803. However, the preamble to the final regulations did caution that instances where the income inclusion under section 304 was less than what would otherwise be required under section 367(a) and (b) may be problematic in the following statement:

> [C]ommentators posit that P in the above example may not recognize income or gain because the adjusted basis of both the F2 stock that is treated as being issued in the deemed section 351 exchange, and the adjusted basis of the F2 stock already held by P prior to the transaction, is available for reduction under section 301(c)(2). On these particular facts (i.e., no earnings and profits in either the acquiring corporation or the issuing corporation), this basis position would mean that income or gain is not recognized as a result of the transaction. The IRS and the Treasury believe, however, that current law does not provide for the recovery of the basis of any shares other than the basis of the F2 stock deemed to be received by P in the section 351(a) exchange (which would take a basis equal to P's basis in the F1 stock). Thus, in the case described, P would recognize $ 100x of gain under section 301(c)(3) (the built-in gain on the F1 stock), and P would continue to have a $ 100x basis in its F2 stock that it holds after the transaction. This issue will be addressed as part of a larger project regarding the recovery of basis in all redemptions treated as section 301 distributions. This larger project will be the subject of future guidance.

Id. at 8,803.

179. *See* Prop. Reg. § 1.304-2(a)(4), 74 Fed. Reg. 3,509 (2009).

section 304.[180] In Notice 2012–15, the Treasury Department finished its course reversal by stating that all outbound section 304(a)(1) transactions would be subject to both section 367(a) and (b). Thus, again, the effect of this notice is to prevent taxpayers from claiming that they are not taxable on the receipt of cash from their controlled foreign corporations in a transaction that represents a return of basis with respect to the high old and cold share basis.

B. Section 367(d)'s Entrance Into the Policing of Tax-Free Cash Repatriations

With the above background in mind, this Article can now address the cash repatriation concerns raised in the context of an outbound contribution of intangibles subject to section 367(d) that occurs as part of a larger transaction controlled by either section 351(a) or section 368(a) where boot is received by the U.S. transferor. In this context, should the cash payment received by the U.S. transferor be treated as a prepayment of the section 367(d) super royalty obligation or should the cash be considered as boot received in a transaction described under section 351(a) or section 368(a)?

In a 1990 administrative ruling[181] and in a more thorough memorandum issued by the IRS chief counsel in 2005,[182] the IRS concluded that the cash should be treated as a prepayment of the section 367(d) super royalty and should not be treated as boot received as part of the section 351 transaction. The essential facts in Chief Counsel Advice 2006-100-19 were that a U.S. subsidiary acquired intangible property from its U.S. parent corporation and then re-contributed the intangible property to a wholly-owned controlled foreign corporation in exchange for both common stock and nonqualified preferred stock.[183] The taxpayer took the position that section 351(b) applied with respect to the boot received (i.e., the nonqualified preferred stock) and that section 367(d) applied only with respect to the common stock. In the ruling, the IRS concluded that the cash should be treated as having been received as part of the section 367(d) transaction, thus in effect causing section 367(d) to override section 351. Thus, the effect of the ruling was that the entire cash transfer was bifurcated and treated as part of a separate section 367(d) outbound intangible transfer that was independent of the section 351 transfer. By bifurcating the cash

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180. *See* Temp. Reg. § 1.367(a)-9T; Temp. Reg. § 1.367(b)-4T(e); Temp. Reg. § 1.1248-1T(b) (effective Feb. 11, 2009 to Apr. 23, 2012) *in* T.D. 9444, 74 Fed. Reg. 6824 (2009).

181. *See* 1990 IRS NSAR 8126, 1990 WL 10072532.

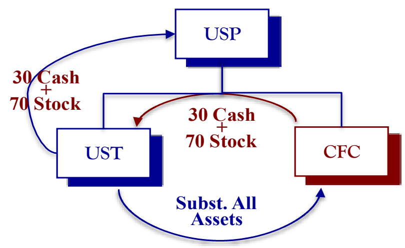
182. C.C.A. 2006–10–019 (Nov. 23, 2005); *see also* P.L.R. 2008–45–044, Ruling 11 (Aug. 4, 2008).

183. C.C.A. 2006–10–019 (Nov. 23, 2005); *see* I.R.C. § 351(g).

payment away from the overall section 351 transaction, the cash was treated as solely a prepayment of the section 367(d) super royalty and was immediately taxable under Regulation section 1.451-5.

In Notice 2012–39,[184] the IRS issued guidance concerning the interaction of section 367(d) with the reorganization provisions of section 368(a). The essential facts of Notice 2012–39 are set forth in the below diagram.

Notice 2012-39



As set forth in the above diagram, UST transfers substantially all of its assets (consisting of $40 of non-IP assets and a patent worth $60) in exchange for CFC #1 stock of $70 and cash of $30. Under subchapter C of the Code, the cash boot paid by the transferee corporation (i.e., CFC #1) to the transferor corporation (UST) is not taxable to the transferor corporation if the transferor corporation distributes that cash to its shareholder (USP),[185] and the transferor shareholder (USP) is taxable upon the receipt of this cash boot only to the extent that the cash exceeds USP's basis in its UST stock.[186] In the notice, the government indicated that taxpayers had taken the position that the receipt of $30 of cash was not taxable to the UST (presumably because the cash was distributed to USP)[187] or to the USP (presumably because USP had a high stock basis in its UST shares such that there was no taxable boot).[188] Furthermore, in Notice 2012-39, the government asserted that taxpayers then claimed that the U.S. parent corporation could then include annual royalty income each year[189] under the commensurate-with-income standards of section 367(d) and then establish a receivable from the controlled foreign corporation in the aggregate amount of the annual royalty

184. Notice 2012–39, 2012–2 C.B. 95.
185. *See* I.R.C. § 361(b)(1)(A).
186. *See* I.R.C. § 356(a)(1) and (2).
187. Notice 2012–39, 2012–2 C.B. 95; *see* I.R.C. § 361(b).
188. Notice 2012–39, 2012–2 C.B. 95; *see* I.R.C. § 356(a).
189. Notice 2012–39, 2012–2 C.B. 95; *see* Temp. Reg. § 1.367(d)-1T(c)(1).

income inclusion.[190] Furthermore, practitioners had urged the Treasury Department to confirm that section 361(b) would control the treatment of boot in this outbound asset reorganization that is described in section 368(a).[191]

In Notice 2012-39, the government asserted that the U.S. parent in effect is paid twice for the same intangible: once upfront in the form of cash boot in the reorganization that was not taxable to USP due to its high "old and cold" basis in its UST stock and then over time in the form of a taxable royalty imputed by reason of section 367(d). Even though cash is paid twice for the same outbound intangible, only one income inclusion occurred.

In response to this planning technique, the government asserted that the U.S. target must include $18 in income[192] immediately as a prepayment of the section 367(d) super royalty obligation and will be able to exclude the first $18 of deemed super royalty in later years and will not be able to establish a receivable to the extent that the deemed super royalty has been prepaid. Thus, in effect, the portion of the cash received that is attributable to the patent is taxable immediately upfront without any benefit of a basis offset in the old and cold basis that USP has in its UST shares. The amount of the future section 367(d) super royalty imputed in future years is reduced to the extent of the prepayment, but so to is the amount of the receivable that can be established. Thus, the taxpayer loses the ability to recover its high "old and cold" basis in UST in this transaction. The ruling is ambiguous (seemingly intentionally ambiguous) on what basis UST has in its non-intellectual property assets that are worth $40. If those assets have $40 of basis, then no separate section 367(a)(5) issues would be present since appropriate basis adjustments are possible in the stock received since the stock received ($70 value) exceeds the amount of the inside gain in the UST assets of $60 (i.e., $100 value less $40 basis). However, if UST's basis in the non-intellectual property assets is less than $30, then the inside gain in the UST assets ($70+) would exceed the fair market value of the stock received ($70), and the ruling leaves unaddressed how to handle this result. Conceptually, if $18 of the boot is taxable as a prepayment of future royalty, then one would think that the maximum that should be taxed under section 367(a)(1) should be no more than the remaining $12 of cash boot, but again this issue is not addressed in the notice and existing regulations would need to be revised to avoid a double-inclusion of gain.[193]

190. Notice 2012–39, 2012–2 C.B. 95; *see* Temp. Reg. § 1.367(d)-1T(g).

191. *See* Letter from PricewaterhouseCoopers LLP to Michael Mundaca, Assistant Secretary (Tax Policy) at 15–18 and 22–23 (Apr. 29, 2011), 2011 WTD 85–21, Doc. 2011–9374.

192. Calculated as 60 percent of assets were intangibles subject to section 367(d) multiplied by $30 of cash boot in the reorganization.

193. Again, as currently envisions, the Treasury regulations that implement the basis adjustments required by section 367(a)(5) require the built-in gain on the

Thus, forthcoming regulations should clarify the outcomes set forth in asset transfers covered by section 351 and outbound asset reorganizations described by section 368(a). In both cases, the Treasury Department has given priority to treating cash payments made in the context of an outbound transfer of an intangible as a separate transaction from the overall transaction that is otherwise subject to either section 351 or section 368(a). This bifurcation of the transaction causes the cash that is paid in exchange for the outbound transfer of the intangible to represent a prepayment of the section 367(d) super royalty and as such is fully taxable upon receipt without any basis offset. However, if boot is paid to the U.S. transferor in excess of the value of the transferred intangible, then that excess cash should be treated as boot in the transaction that is governed by section 351 or section 368(a) and as such should be taxable (or not) in accordance with the boot-within-gain rules of section 356(a)(2) and the basis adjustment rules as set forth in the revised regulations that implement the goals of section 367(a)(5).

IV. CONCLUDING THOUGHTS ON THE WAY FORWARD

As a country, we have been here before. In the 1980s, Congress was agitated about the erosion of the U.S. tax base that occurred due to the outbound migration of intangible property. In response, by enacting section 367(d), Congress expressed a strong desire to systemically address profit-shifting by in effect codifying the assignment of income doctrine so that the residual profits generated from transferred intangible assets would be assigned back to the U.S. developer whose nonroutine U.S. functions created the income-generating intangible asset in the first place. The addition of the commensurate with income standard within section 367(d)(2) finalized the objective as that standard ensures that all actual intangible profits would be considered for purposes of determining section 367(d)'s super royalty rate so that all of the actual ongoing residual income would be assigned back to the U.S. transferor.[194] Concurrently, Congress gave the Treasury Department

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assets to be triggered to the extent that the inside gain of $100 (if UST had no basis in any of its assets) exceeds the fair market value of the stock received of $70. *See* Reg. § 1.367(a)-7(c)(3), (g) Ex. (1). However, if $18 of boot has already been taxable as a prepaid royalty by reason of section 367(d), then somehow only a maximum amount of $12 of gain should be triggered under section 367(a)(1) or else the boot is creating a double income inclusion.

194. *See* Temp. Reg. § 1.367(d)-1T(c)(1) (super royalty amount is determined consistently with section 482); Reg. § 1.482-6(c)(3)(i)(B) (residual profits allocated to those functions that make a nonroutine contribution and only those functions); Reg. §§ 1.482-4(f)(2)(ii)(C)(4), -4(f)(2)(iii), Ex. (2) (specifies and then demonstrates via example that the allocation of residual profits must approximate the actual profit experience to meet the commensurate with income standard).

broad regulatory authority to implement the policy objectives of section 367(d).

Inexplicably, the Treasury Department has not aggressively shut-down the "goodwill loophole" tax planning as it should have done, and the Treasury Department's own cost sharing regulations create an inappropriate "cost sharing loophole" to section 367(d). Instead of fixing these problems through its regulatory authority or through its litigation of cases where taxpayers assert positions that frustrate the goals of section 367(d), the Treasury Department has proposed that Congress again consider further amendments to section 367(d),[195] thus distracting attention away from the real path forward. In a separate arena, the Treasury Department has also been active in amending its regulations under section 367(a) and (b) as a means to prevent tax-free repatriations of cash from foreign subsidiaries, but the Treasury Department has not made corresponding changes to its long-standing temporary section 367(d) regulations to harmonize them with the government's omnibus anti-repatriation goals.

It is now time for the Treasury Department to re-focus its attention on the task at hand. As to the "goodwill loophole" cases, the Treasury Department should forcefully argue along the lines set forth in this Article that section 367(d) does not allow income-generating intangibles to be cloaked under the guise of a "goodwill loophole."[196] As to the "cost sharing loophole" that the Treasury Department itself created, it is past time for the Treasury Department to amend its existing cost sharing regulations in Regulation section 1.482-7 to remove the "cost sharing loophole" so that these regulations do not become the means to migrate high-profit potential intangibles to an offshore risk-taker entrepreneur entity through the use of a CSA.[197] And, with respect to the Treasury Department's goal of preventing tax-free cash repatriations from foreign subsidiaries, the Treasury Department should amend its section 367(d) regulations to provide an explicit coordination rule in situations where a section 367(d) transfer occurs within the context of a transaction that is also described in either section 351(a) or section 368(a) and cash is received by the U.S. transferor.[198] The path forward is clear and unmistakable to those who want to see it. Hopefully, the Treasury Department will get to work on enforcing section 367(d) in a manner that fulfills its already-existing legislative directive. The

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195. The Administration has proposed legislative changes to section 367(d) and for taxing excess intangible returns earned by controlled foreign corporations. *See* GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS, *supra* note 4, at 45–47.

196. *See supra* Reform Recommendation #1 in Part II.D., along with the discussion in Part II.A. & B.

197. See *supra* Reform Recommendation #2 in Part II.D., along with the discussion in Part II.C.

198. *See supra* discussion in Part III.

Treasury Department has been given the authority it needs to address all of these issues, and it is past time for it to do so.

Presentation:

"REVISITING §367(d)"

18TH ANNUAL INTERNATIONAL TAX SYMPOSIUM

STATE BAR OF TEXAS

Professor Bret Wells

November 12-13, 2015

Agenda

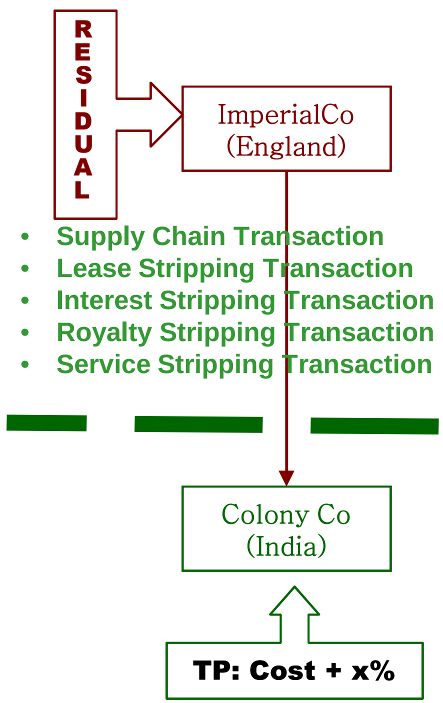
I. Overview of International Consternation Over Base Erosion and Profit Shifting by MNEs (OECD and US [Apple, Microsoft, Caterpillar])
II. Section 367(d) and the Goodwill Loophole (Caterpillar)
III. Section 367(d) and the Cost Sharing Agreement
IV. Conclusions on Status of Section 367(d).

What does this picture tell us that is relevant to the debate about Profit Shifting?

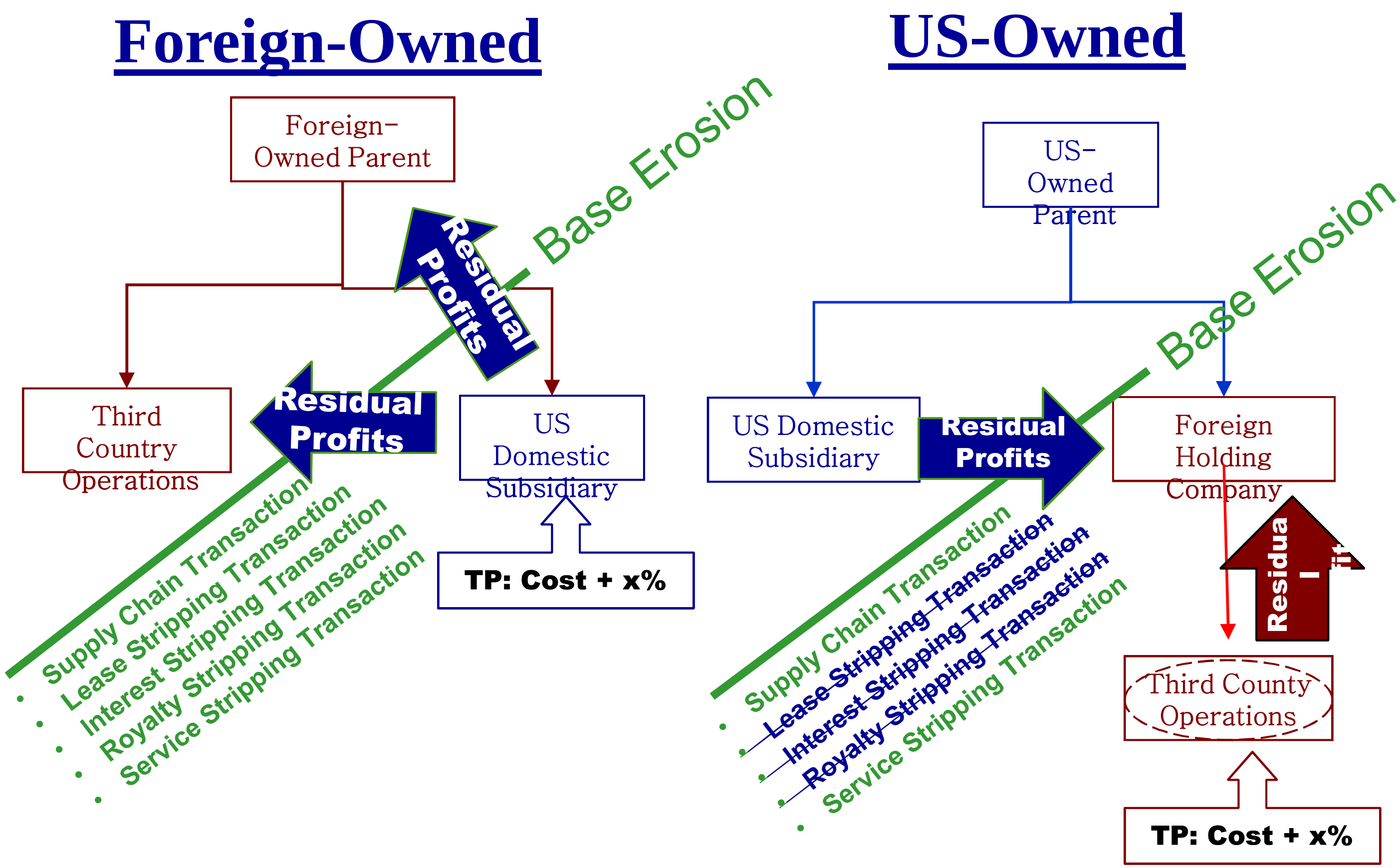
What is the function of this thing?

The Elephant in the Room:
Source vs. Residence Implication of OECD MODEL Treaty

1920s Mercantile Structure



Current Reality: Residence Choice is Often a Territorial Jurisdiction



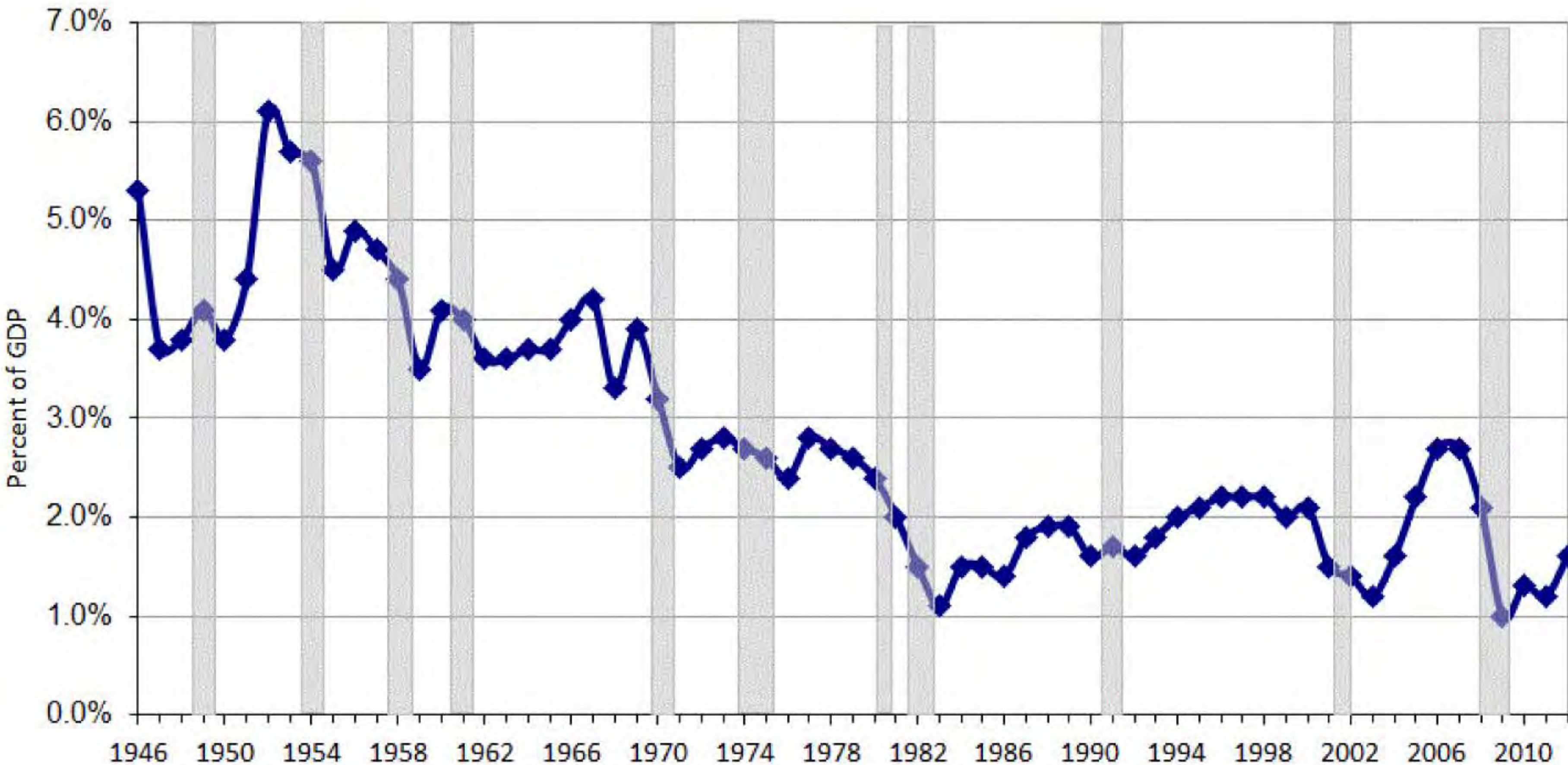
Bret Wells and Cym Lowell, "Tax Base Erosion and Homeless Income: Collection at Source is the Linchpin," 65 TAX L. REV. 535 (2012)

OECD
ACTION ITEMS FINALIZED BY DECEMBER 2015

1) Tax challenges of the digital economy
2) Hybrid mismatch arrangements
3) CFC rules
4) Deductibility of interest and other financial payments
5) Harmful tax practices of countries
6) Treaty abuse
7) Artificial avoidance of permanent establishment status
8) Transfer pricing for intangibles
9) Transfer pricing for risks and capital
10) Transfer pricing for other high-risk transactions
11) Development of data on BEPS and actions addressing it
12) Disclosure of aggressive tax planning arrangements
13) Transfer pricing documentation
14) Effectiveness of treaty dispute resolution mechanisms
15) Development of a multilateral instrument for amending bilateral tax treaties

Bottom Line: Everything is on the table except the OECD's Model Treaty and a fundamental re-examination of Source vs. Residency allocations

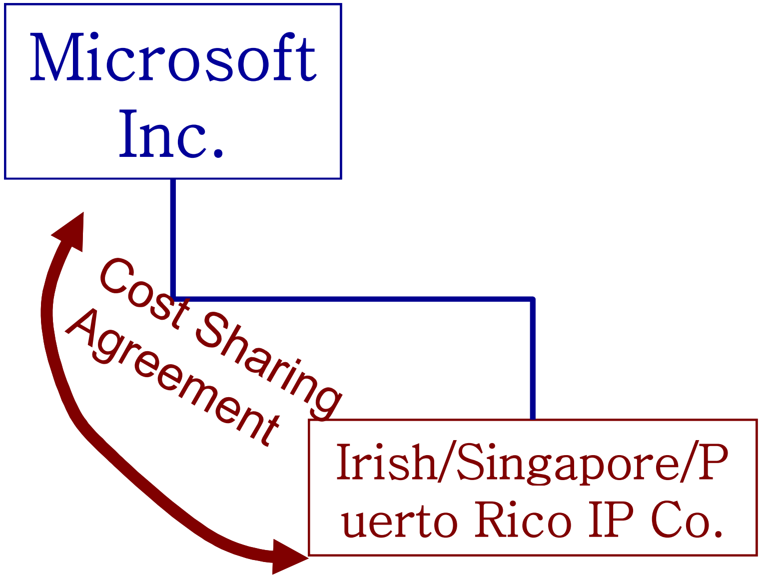
Corporate Tax Revenue as Percentage of GDP (1946-2012)



Notes: Shaded areas represent recessionary periods as recorded by the National Bureau of Economic Research. Miscellaneous taxes such as estate and gift taxes are omitted for the sake of clarity, and comprise a very small fraction of total revenues in any case.

Source: Budget of the United States Government, Historical Tables, Table 2.3
Based on Adam Carasso, "The Corporate Income Tax In the Post-War Era," Tax Facts Column, Tax Notes Magazine, March 03, 2003

Permanent Subcommittee on Investigations
Microsoft Hearing September 20, 2012

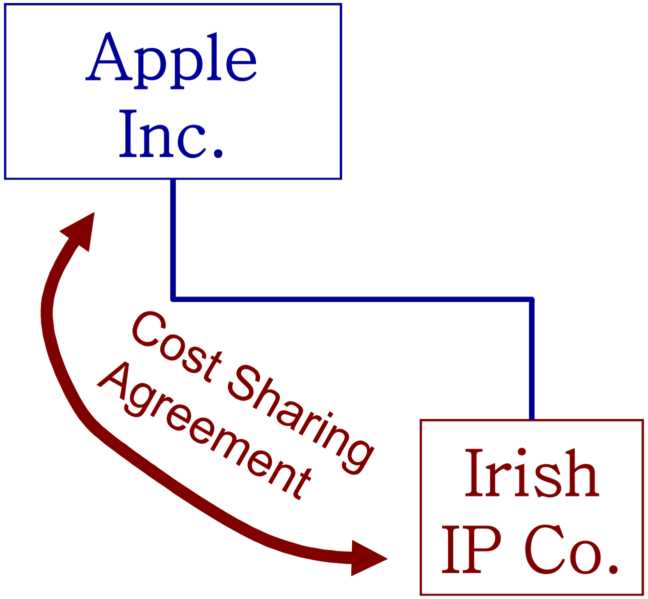


Microsoft's Ireland/Singapore/Puerto Rico Facts

- $15.43 Billion of 2011 Pre-tax Income in Ireland/Singapore resulting in $13 million of Irish tax
- R&D Conducted in US, but Foreign Affiliates paid $4 billion of R&D cost and had the right to $20.43 billion in revenue.

Use of Cost Sharing Agreement Allows Microsoft to transfer ownership of newly development Windows software offshore

Permanent Subcommittee on Investigations
Apple Hearings May 21, 2013



Apple's Ireland Facts

- $22 Billion of 2011 Pre-tax Income in Ireland resulting in $13 million of Irish tax. $74 Billion pre-tax profit in Ireland for 2009-2012.
- 64% of 2011 Consolidted Profits in Ireland
- 1% of Customers in Ireland
- 4% of Apple Employees in Ireland. No employees before 2012.
- R&D Conducted in US, but Ireland paid $5 billion of R&D cost and had the right to $79 billion in revenue.

Use of Cost Sharing Agreement to Allow Apple Ireland to Be the Tax Owner of the iPhone

Permanent Subcommittee on Investigations
Caterpillar Hearings April 1, 2014

CATERPILLAR®

Swiss Co.

Caterpillar Swiss Facts

- Swiss Branch Operated for Many Years at a de minimis profit.
- Swiss branch transferred to a Swiss Corporation and now $8 billion in profits on spare parts reported in Swiss Corp even though the spare parts business is managed and operated from US.
- Caterpillar claimed that no separate intangibles exists at time of transfer (only "goodwill") but then this subsidiary generated $8 billion of net profits.

***See* Staff of the Joint Committee on Taxation, "Present Law and Background Related to Possible Income Shifting and Transfer Pricing," at 73-76, JCX-37-10 (July 20, 2010) (the Charlie Company scenario posits a migration of intangible assets where over $15 billion of intangible value was transferred and almost all of the transferred value was designated as foreign goodwill).**

CAT

Conceptual Challenge:
Is Current Law Deficient to Stop IP Migration Tax Strategies?

Treasury Department Says "Yes." In its General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals (February 2015)

1. Congress needs to amend Section 367(d) to make outbound transfers of goodwill subject to Section 367(d)'s super royalty provision.
2. Congress should amend US anti-deferral rules (subpart F rules) to impose minimum 19% tax.

Question: Is this the right analysis? Is Section 367(d) broken or simply not aggressively enforced? Does blame for the income shifting via intangible migration rest with Congress or with the US Treasury Department? Understanding the source of the IP migration problem is critical in order to understand what policy response is appropriate.

Agenda

I. Overview of International Consternation Over Base Erosion and Profit Shifting by MNEs (OECD and US [Apple, Microsoft, Caterpillar])

II. Section 367(d) and the Goodwill Loophole (Caterpillar)

III. Section 367(d) and the Cost Sharing Agreement

IV. Conclusions on Status of Section 367(d).

Historical Context for Section 367(d): Assignment of Income Principles

1. Scope of Assignment of Income. Heim v. Fitzpatrick. Assignment of patent license royalties to wife and children. Were royalties received by wife & children taxable to inventor/husband/parent?Held: gifts of income producing property causes owner of the income from the property to shift. Distinguish Lucas v. Earl.
2. Planning Opportunity: Develop US intangible property and then transfer the intangible to an offshore entity.
   - Seagate Tech v. Commissioner (favorable outbound Section 367(a) ruling to transfer intangibles to Singapore affiliate).
   - Dittler Bros. v. Commissioner (unfavorable outbound Section 367(a) ruling but the Tax Court ruled for the taxpayer).
3. Pharmaceutical Companies and Puerto Rican credit.

Impact of Historical Context for Section 367(d): Assignment of Income Principles

1. IRS in litigation asserted that the migration of high profit potential assets outside the United States should be prevented through an extension of Assignment of Income Doctrine, but the courts refused to extend the judicially created assignment of income doctrine to reassign profits from property to the property developer.

   Eli Lily & Co., 84 T.C. at 1123 ("Respondent's reallocations conflict with a fundamental principle of Federal income tax law: that income from property is earned by the owner of the property. See Helvering v. Horst, 311 U.S. 112 (1940); Blair v. Commissioner, 300 U.S. 5 (1937)").

2. Congress responded by enacting Section 367(d) for outbound transfers.

Section 367(d)(1)-(2)

(1) In General. Except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property (within the meaning of section . . . the provisions of this subsection shall apply to such transfer.

(2) If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as—

- (i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and
- (ii) receiving amounts which reasonably reflect the amounts which would have been received—
  - (I) annually in the form of such payments over the useful life of such property, or
  - (II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition.

The amounts taken into account under clause (ii) shall be commensurate with the income attributable to the intangible.

Section 936(h)(3)(B)

The term "intangible property" means any—

(i) patent, invention, formula, process, design, pattern, or know-how;

(ii) copyright, literary, musical, or artistic composition;

(iii) trademark, trade name, or brand name;

(iv) franchise, license, or contract;

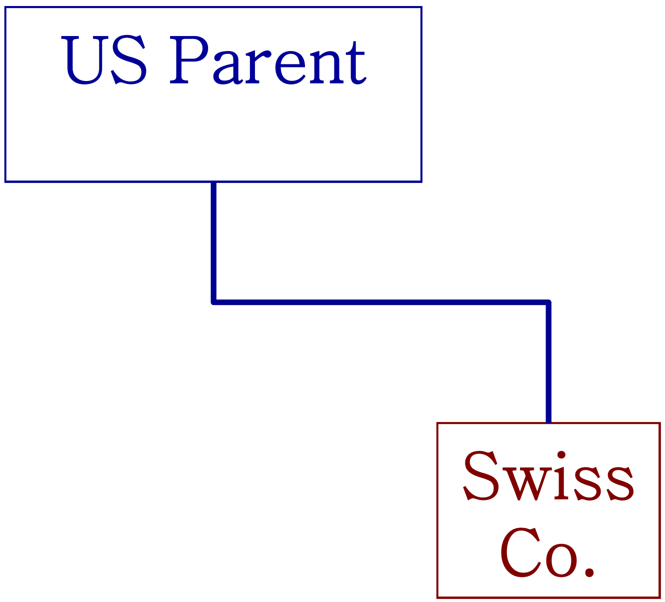
(v) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or

(vi) any similar item,

which has substantial value independent of the services of any individual.

Impact of Section 367(d)(2)

But, regulations and legislative history says that "goodwill" is not a specified intangible under Section 936(h)(3)(B)



Contribution:

Tangibles	$ 100
Manufacturing Intangibles	$ 100
Foreign Goodwill	$ 800
	$1,000

Residual Profits of $900.

* Taxpayer claims only 1/9th of the residual profits relate to the manufacturing intangible and thus is subject to §367(d). But, the taxpayer claims that the $800 relates to "exempted" goodwill.

Issue: Is Section 367(d) fundamentally flawed? Does it have a fatal "goodwill loophole" that prevents its effective application?

Medtronic v. Commissioner, Tax Court Docket 6944-11 2011 WL 1373498 (U.S.Tax Ct.) (Trial Pleading) (March 23, 2011); Amazon v. Commissioner, Tax Court Docket 31197-12 (Petition) (December 28, 2012).

Goodwill
(Dismantling of the Mass Asset Rule)

1. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974) (allowed newspaper subscription list to be separately identified apart from goodwill and amortized). Fifth Circuit said "mass asset rule" was merely a rule based on failure of factual proof.
2. Rev. Rul. 74-456 stated that intangibles that could be separately identified are distinct from goodwill, thus in effect repudiating mass asset rule.
3. Congress enacted Section 1060 that used a ***residual allocation methodology***. Goodwill had no static meaning. Merely value that was left-over after all identified assets were allocated purchase price.
4. Supreme Court in Newark Morning Ledger v. U.S. stated

   "Goodwill" remains nondepreciable under applicable regulations, and we do not purport to change that fact. In interpreting those regulations, however, we have concluded that because the "paid subscribers" is an asset found to have a limited useful life and an ascertainable value which may be determined with reasonable accuracy, it is depreciable. *By definition, therefore, it is not "goodwill."*

   See Newark Morning Ledger v. United States, 507 U.S. at 546 n.13

Goodwill
(Final Thoughts)

Under modern valuation principles, if an item is capable of generating nonroutine returns, then it is capable of being identified. After Newark Morning Ledger, it is difficult to believe that goodwill can cloak any real profit-making potential. If systemic profits exists, then the intangible that creates that profit should be identified.

Goodwill is a residual category. It is supplanted any time there is a real profit-making intangible that is identified.

Bottom Line: Having won the argument with the Supreme Court which resolved a split in the circuits and held that goodwill is supplanted to all other separately identifiable intangible asset, the taxpayer cannot help but wear that same shoe in the international context.

Congress stopped the factual fight in the domestic context by enacting §197 in 1993 that makes all intangibles (including goodwill) amortizable over 15 years. But the holding of Newark Morning Ledger lives on.

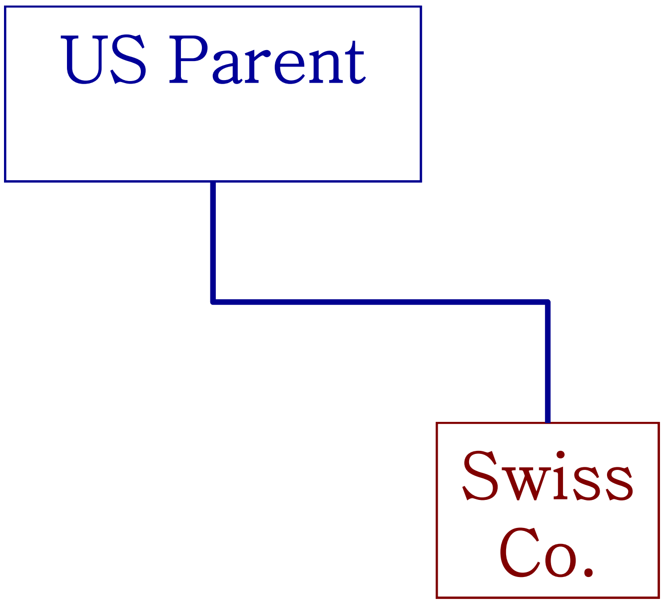
Section 936(h)(3)(B)(vi)
"Similar Item"

1. Section 936(h)(3)(B)(i) – (v) sets forth a list that one would think catches every conceivable item that can create value. If so, and if goodwill represents a "left-over" category that is supplanted once intangibles are identified, then the earlier discussion means that the IRS should be successful.
2. However, assume there is a separately identifiable asset capable of identification but is not described in Section 936(h)(3)(B)(i) – (v), would the taxpayer win? In other words, what is a "similar item" within the meaning of Section 936(h)(3)(B)(vi)?
3. Answer: Treas. Reg. 1.367(d)-1T(c)(1) states that the principles of Section 482 are applied to determine the royalty under Section 367(d).
4. Treas. Reg. §1.482-6(b)(6) defines a similar item as follows:

   > Other similar items. For purposes of section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) of this section if it **derives its value** not from its physical attributes but **from its intellectual content or other intangible properties**.

Section 936(h)(3)(B)(vi)
"Similar Item" and Circular Reasoning

Treas. Reg. §1.482-6(b)(6)'s definition is purposefully circular. If an asset creates value due to its intangible characteristics, then it is a "similar item."



Contribution:

Tangibles	$ 100
Manufacturing Intangibles	$ 100
Foreign Goodwill	$ <u>800</u>
	$1,000

Residual Profits of $900.

*Taxpayer claims only 1/9th of the residual profits relate to the manufacturing intangible and thus is subject to §367(d). But, whatever asset creates intangible returns is a "similar item" and as such is taken out of goodwill and treated as a Section 936(h)(3)(B)(vi) similar item.

Section 936(h)(3)(B)(vi)
September 16, 2015: Proposed Regulations Issued

The proposed regulations:

1. Eliminate the foreign goodwill exception under §1.367(d)–1T and limit the scope of property that is eligible for the active trade or business exception generally to certain tangible property and financial assets.

1. Eliminate the existing rule under § 1.367(d)–1T(c)(3) that limits the useful life of intangible property to 20 years. When the useful life of the intangible property transferred exceeds 20 years, the limitation might result in less than all of the income attributable to the property being taken into account by the U.S. transferor.

2. Provides that property eligible for the active trade or business exception to Section 367(a) can only be certain tangible property, working interest in oil and gas properties, and certain financial instruments.

3. Provides for an immediate effective date (September 16).

Section 936(h)(3)(B)(vi)
Goodwill Loophole Concluding Thoughts

1. Courts should interpret Section 367(d) in a manner consistent with its purpose. The purpose of Section 367(d) was to statutorily extend the assignment of income doctrine to prevent the transfer of intangible assets in the outbound context.
2. After fighting from 1973 to 1993, taxpayers won the argument that "goodwill" has no pre-set meaning. It is only a left-over category after all valuable assets have been identified and valued. Having won the argument that goodwill is always supplanted whenever valuable intangibles are identified, taxpayers must wear that same shoe on the their international "foot" and cannot argue that goodwill has a static meaning that prevents intangible identification.
3. Section 936(h)(3)(B)(vi)'s "similar item" definition purposefully uses circular reasoning. If residual profits exist in the transferee foreign corporation and its business came from a US transferor, then whatever intangible asset creates that value is a "similar item" and thus subject to §367(d)'s super royalty.
4. Treasury did stop asking Congress to amend Section 367(d), amended its own regulations that caused the problem, and is litigating the issue but the arguments have not been as good as they could be. Medtronic v. Commissioner, Tax Court Docket 6944-11 2011 WL 1373498 (U.S.Tax Ct.) (Trial Pleading) (March 23, 2011); Amazon v. Commissioner, Tax Court Docket 31197-12 (Petition) (December 28, 2012).

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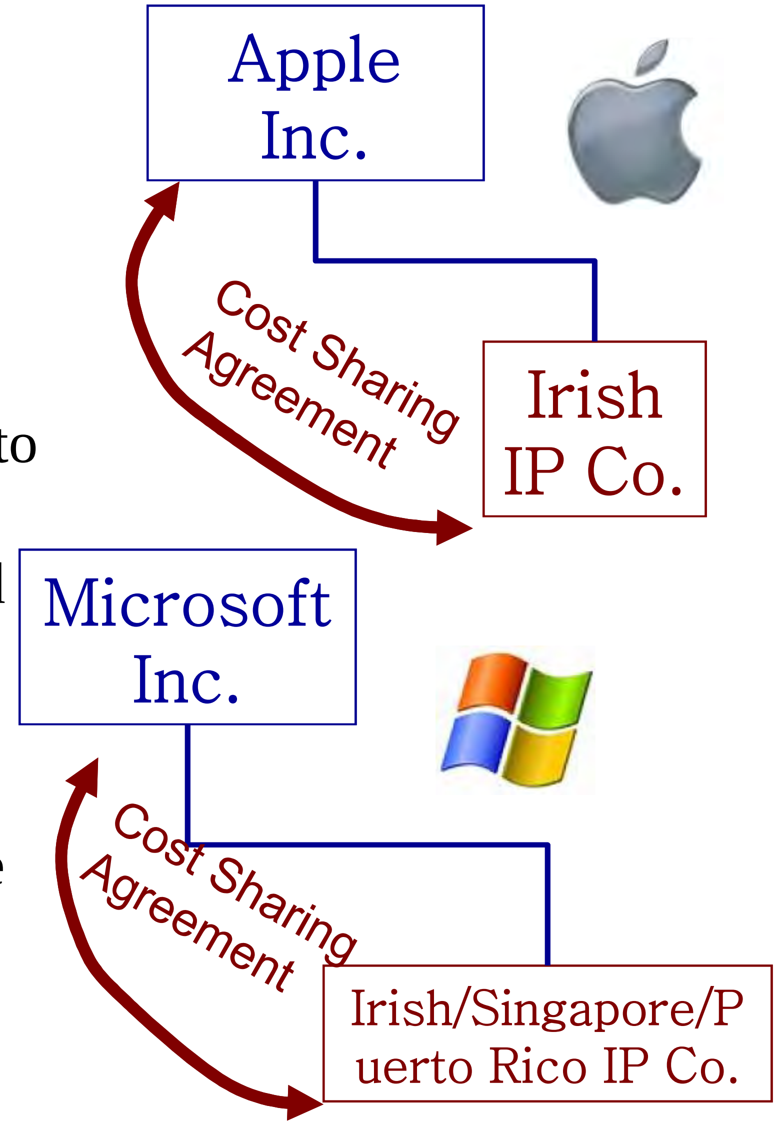
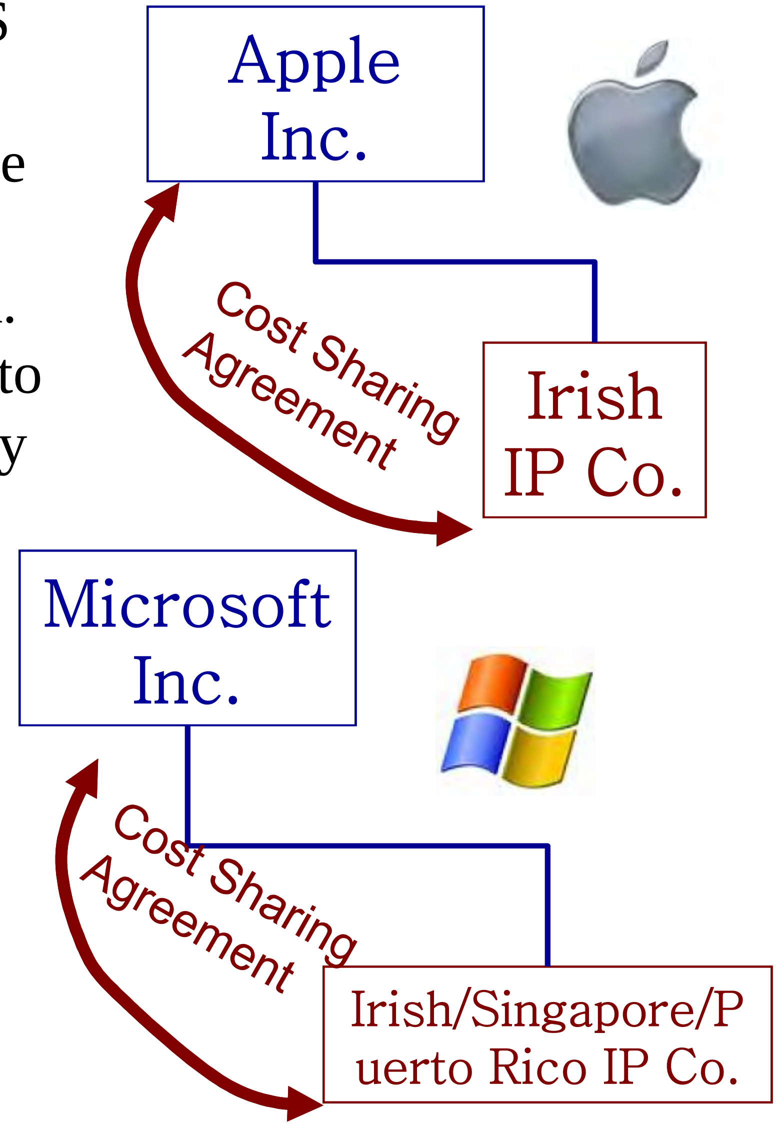
Cost Sharing Regulations
Risk-Taker Mistake (pp. 49-65)

1. The legislative history to Section 367(d) indicates that the commensurate-with-income provisions of sections 367(d) and 482 were not intended to prevent “appropriate use” of cost sharing arrangements. What is an appropriate use?
2. Cost sharing regulations allow a risk-taker to fund development of an intangible and be allocated all of the future benefit associated with that funding whereas the profit-split methodology of the transfer pricing regulations requires profits to be allocated based on functional contribution. Thus, the cost sharing regulations allow a result that could **not** be achieved under the normal transfer pricing regulations. This is not an appropriate use.



Cost Sharing Regulations
Risk-Taker Mistake (pp. 49-65)

3. In Notice 88-123, 1988-2 C.B. 458, the IRS asserted it had authority to require CSAs to comply with the commensurate with income requirements of Section 482, but it backed off doing so when it got withering criticism. This tactical decision is what allows CSAs to continue to shift intangible returns to a party that has no functional contribution to their creation other than funding.
4. “Risker-Taker” is not a Function that deserves residual profits.



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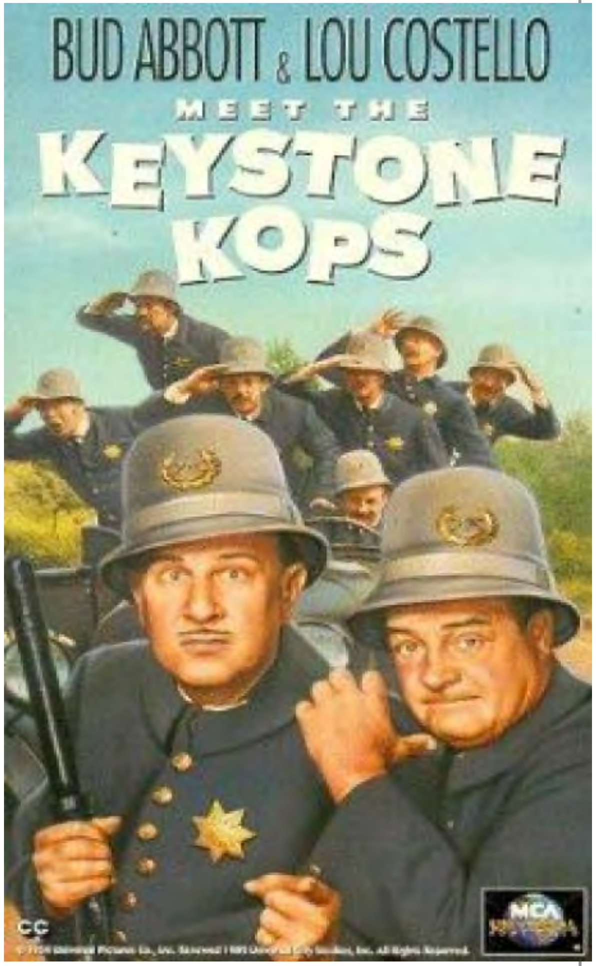
Section 367(d)
Cost Sharing Regulations and Goodwill Loophole

Conclusion #1: Blame for the Goodwill Loophole Blame Rests with the Treasury Department. The Treasury Department's handling of Section 367(d) is abysmal. The Proposed Regulations were long overdue and privately expected for many years.



Conclusion #2 Blame for the Cost Sharing Profit Shifting Rests with the Treasury Department. The US Treasury Department used its regulatory authority to create a cost sharing loophole that would not exist otherwise. Treasury regulations created the loophole, and so one should expect that the Treasury Department will again amend its Treasury regulations to remove this remaining loophole.

Bottom Line: Stop blaming Congress for what is fundamentally a series of administrative (enforcement and regulatory) mistakes!!!

Questions?

This document was not intended or written to be used, and it cannot be used, for the purpose of avoiding U.S. federal, state or local tax penalties.

Expatriation (Including Questions I Can’t Answer)

Philip D. W. Hodgen
HodgenLaw PC | Pasadena, California

18th Annual Texas International Tax Symposium
12-13 November 2015

HODGEN LAW
INTERNATIONAL TAX

Today's topics

- Why do people expatriate?
- A cocktail party guide to expatriation
- Some open issues I worry about and don't always have good answers for

Wait, but . . . why?

Why are *those people* giving up their citizenship?

Reasons people give me for expatriating

- **Paperwork**—Horribly high compliance costs for Americans abroad (e.g., PFICs)

- **Fear of Penalties**—Given recent IRS enforcement activity, reasonable people are afraid of making mistakes

- **Life**—It is difficult or impossible to get financial services as an American abroad, or use retirement plans well

- "**One-citizenship only" laws**—Many countries do not allow dual citizenship

Reasons people give me for expatriating . . . cont’d

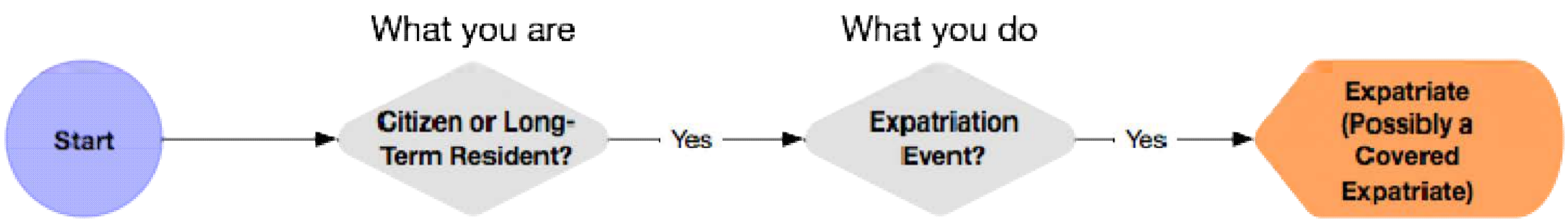
- **Estate tax**—If a U.S. person inherits vast wealth created by the hard work of an ancestor abroad, why should that be subjected to U.S. estate tax when the U.S. person dies?

- **Usually not income tax**—Most of our expatriation clients end up living in high-tax countries after expatriation

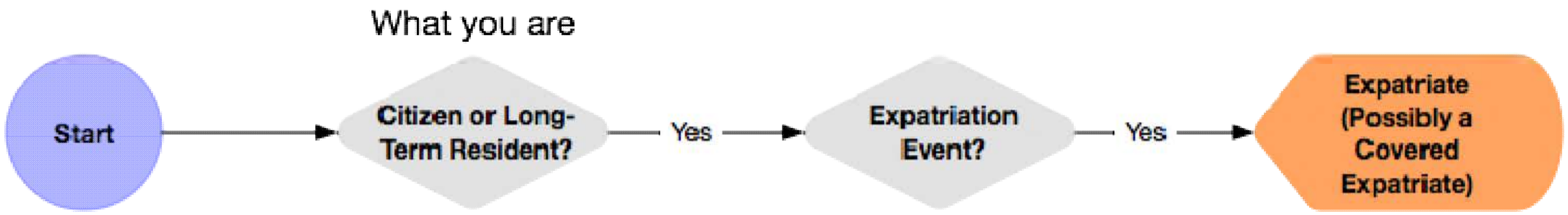
The Cocktail Party Guide to Section 877A

A *very* brief “How it Works”

How to be an expatriate



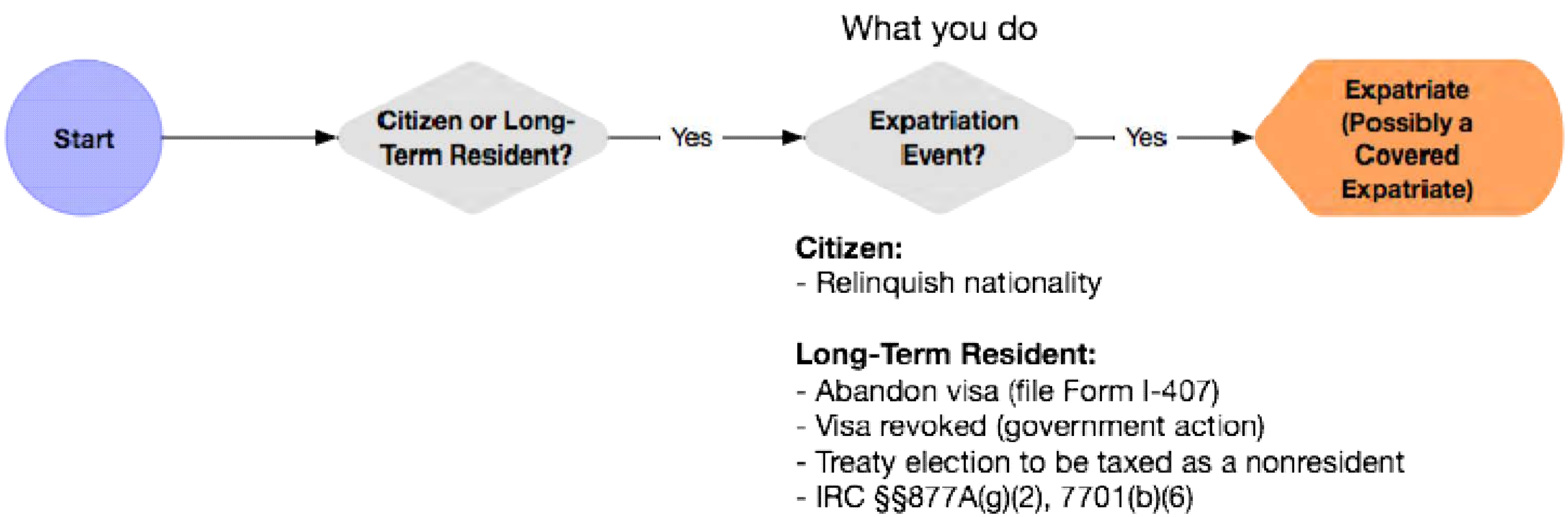
First, be the right type of person



Citizen:
- Normal rules apply

Long-Term Resident
- Green card holder
- "In" at least 8 of previous 15 years
- IRC §§877A(g)(5), 877(e)(2)

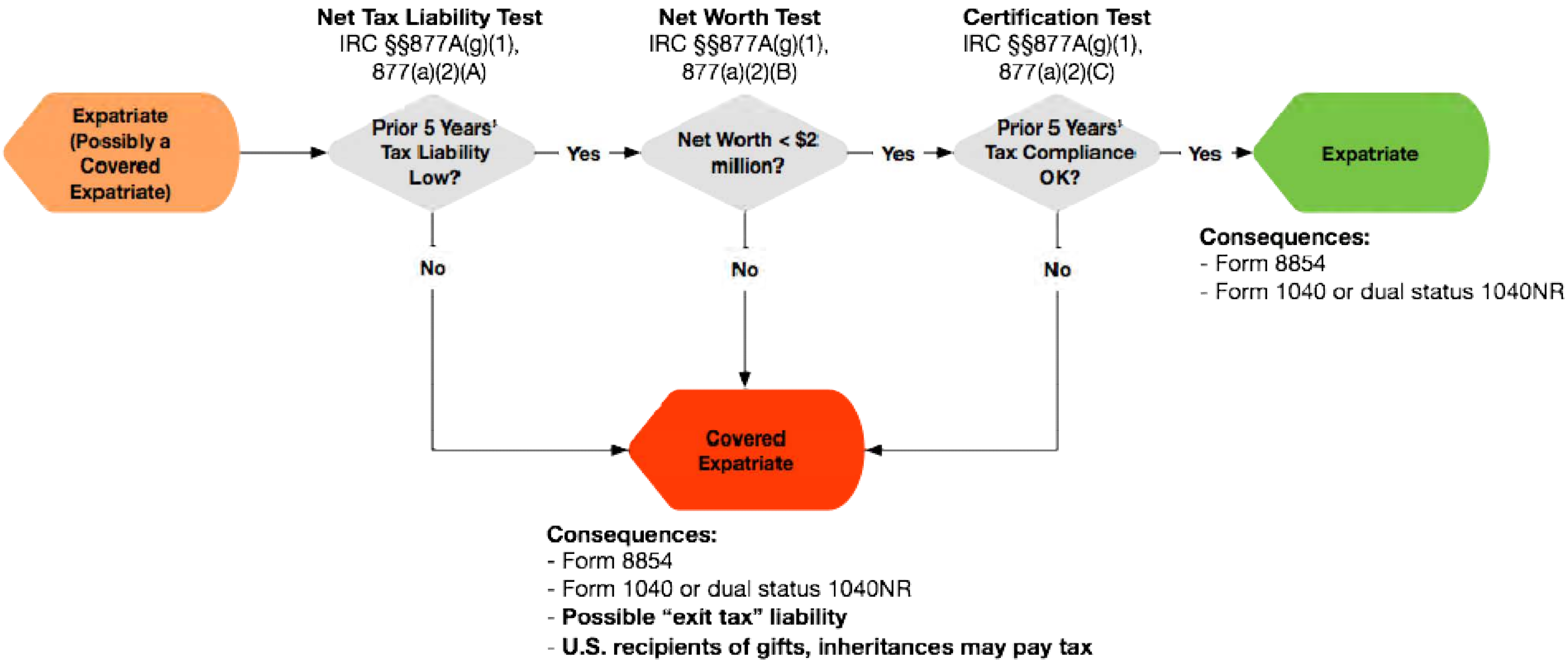
Second, take the right action



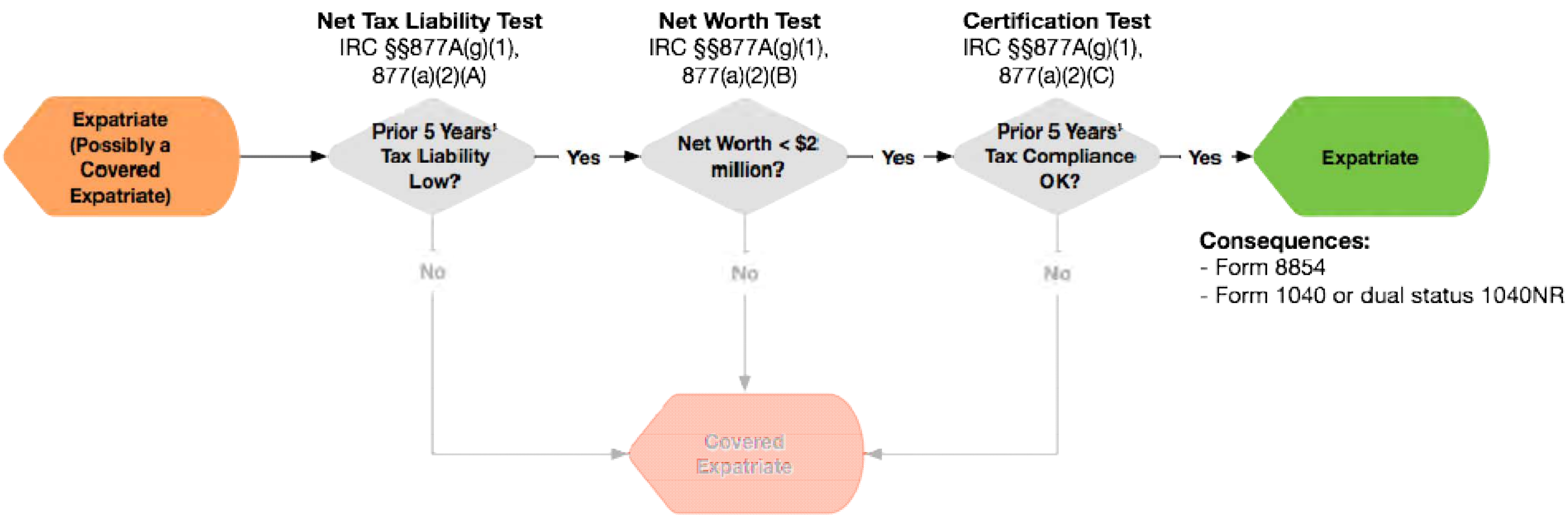
How to renounce your citizenship

- Form DS-4079
- One or two Embassy/Consulate appointments (varies by location)
- While you are there, say some words, sign some forms
- $2,350 fee
- Get a Certificate of Loss of Nationality

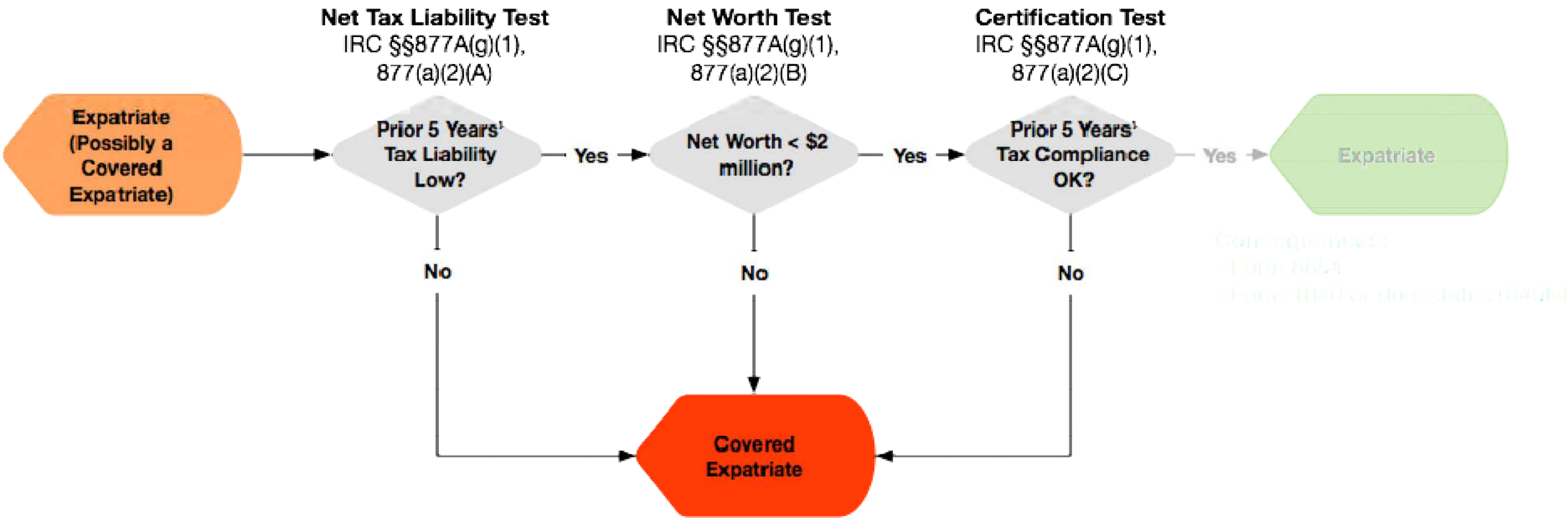
Are you an expatriate or a covered expatriate?



How to not be a covered expatriate



How to be a covered expatriate



Consequences:
- Form 8854
- Form 1040 or dual status 1040NR
- **Possible "exit tax" liability**
- **U.S. recipients of gifts, inheritances may pay tax**

What the covered expatriate pays as an exit tax

- **Specified tax-deferred accounts**—deemed lump sum distribution
- **Ineligible deferred compensation**—deemed lump sum distribution (present value calculation)
- **Everything else**—mark-to-market capital gain minus an exclusion amount
- Everything is taxed at **normal applicable rates**

Covered expatriates after expatriation

- **Eligible deferred compensation**—30% tax paid on payments, as they are received
- **Trust distributions**—30% tax paid on the taxable portion of trust distributions, as the are received
- **U.S. recipients of gifts or inheritance**—the *recipient* pays a tax when receiving a transfer from a covered expatriate (IRC §2801)

Exceptions exist, of course—wheels within wheels

Some things I don't know, or guess at

Not everything is figured out yet.

Problem: Section 877A v. Section 121

Let’s start with an easy one.

Mark-to-market sale of your primary residence

"For purposes of this subtitle . . . all property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value."

- IRC §877A(a)(1)

All gain must be recognized

"In the case of any sale under paragraph (1), **notwithstanding any other provision of this title**, any gain arising from such sale shall be taken into account for the taxable year of the sale. . . ."

- IRC §877A(a)(2)(A)

Wait, but . . . Section 121!

"Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more."

- IRC §121(a)

What trumps what?

- IRC §877A(a) triggers a deemed sale of your primary residence, and you want the IRC §121 exclusion of gain from gross income

- IRC §877A(a)(2)(A), which is can be interpreted as disallowing the exclusion from gross income under IRC §121(a)—**"notwithstanding any other provision of this title"** is pretty clear

- But IRC §877A(a) is all about recognized gain, and IRC §121(a) is an exclusion from gross income, right?

It’s an income exclusion, not a nonrecognition rule

No angels can dance on that pin

- Mark-to-market losses are entirely allowed, *with an enumerated exception* (IRC §877A(a)(2)(B))

- Observation: Congress knows how to allow a statutory exception to the IRC §877A(a) mark-to-market rule

- Congress could have added a statutory exception for IRC §121 in the gain recognition rules at IRC §877A(a)(2)(A), but didn't

- Inference: Congress thought about it and decided "No"

Perplexing: Minor Errors and the Certification Test

Form 8854, Part IV, Line 6

Form 8854, Part IV, Line 6

Part IV **For Persons Who Expatriated During 2014**

Section A **Expatriation Information**

1 Enter your U.S. income tax liability (after foreign tax credits) for the 5 tax years ending before the date of expatriation.

1st Year Before Expatriation	2nd Year Before Expatriation	3rd Year Before Expatriation	4th Year Before Expatriation	5th Year Before Expatriation
$	$	$	$	$

2 Enter your net worth on the date of your expatriation for tax purposes . . . . $

3 Did you become at birth a U.S. citizen and a citizen of another country, and do you continue to be a citizen of, and taxed as a resident of, that other country? . . . . ☐ **Yes** ☐ **No**

4 If you answered "Yes" to question 3, have you been a resident of the United States for not more than 10 of the last 15 tax years? . . . . ☐ **Yes** ☐ **No**

5 Were you under age 18½ on the date you expatriated and have you been a U.S. resident for not more than 10 years? . . . . ☐ **Yes** ☐ **No**

6 Do you certify under penalties of perjury that you have complied with all of your tax obligations for the 5 preceding tax years (see instructions)? . . . . ☐ **Yes** ☐ **No**

Form **8854** (2014)

Signature Line of Form 8854

Sign Here	Under penalties of perjury, I declare that I have examined this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than filer) is based on all information of which preparer has any knowledge.	
	Your signature	Date

The Certification Test

- A taxpayer is a covered expatriate if:

. . . such individual fails to certify under penalty of perjury that he has met the requirements of this title for the 5 preceding taxable years or fails to submit such evidence of such compliance as the Secretary may require.

- IRC §877(a)(2)(C)

Does the certification test demand perfection?

- Consider the implications of a typo—reporting $19 of interest income instead of $91
- Does this mean you fail the certification test and become a covered expatriate?
- The Code demands that you have done everything right
- Notice 2009-85 is silent
- What should a prudent taxpayer to do?

I don’t know the answer

- Everything I have experienced in tax practice tells me foot faults should just be a money problem, not a Red Queen “Off with her head!” problem—congratulations, you are a covered expatriate!

- Until we are told otherwise, the Code means what the Code says—“all means all”

- Dueling perjury clauses leave me confused

What I would like the answer to be

- Foot faults should not flip the taxpayer to covered expatriate status—if an audit would just ask for more money, late payment penalties, and interest, then the certification test should not be violated

- Serious stuff wrong? Fail the certification test

- The Code uses “penalty of perjury” language, and courts seem to be pretty good at understanding how to deal with that

What we do

- Fix the serious stuff—omitted income, special forms, big penalties
- While you're there fixing stuff, clean everything up
- Tell people their Primary Purpose is to make a clean break from the USA; they can decide whether to give their prior five years' returns the OCD treatment—or not
- At some level it is a dilemma for the return preparer, too

Perplexing: Certification Test—Certify as of When?

On your expatriation date? Or when you sign and file Form 8854?

Can you answer “yes” to the certification test?

- You have not filed a tax return for 10 years
- You renounce your U.S. citizenship
- You prepare and file five years of income tax returns, and pay all of the tax
- The IRS bills you for interest, penalties; you pay
- Can you check the “yes” box for the certification test on a timely filed Form 8854?

Form 8854, Part IV, Line 6

Part IV **For Persons Who Expatriated During 2014**

Section A **Expatriation Information**

1 Enter your U.S. income tax liability (after foreign tax credits) for the 5 tax years ending before the date of expatriation.

1st Year Before Expatriation	2nd Year Before Expatriation	3rd Year Before Expatriation	4th Year Before Expatriation	5th Year Before Expatriation
$ ______	$ ______	$ ______	$ ______	$ ______

2 Enter your net worth on the date of your expatriation for tax purposes . . . . $ ______

3 Did you become at birth a U.S. citizen and a citizen of another country, and do you continue to be a citizen of, and taxed as a resident of, that other country? . . . . ☐ **Yes** ☐ **No**

4 If you answered "Yes" to question 3, have you been a resident of the United States for not more than 10 of the last 15 tax years? . . . . ☐ **Yes** ☐ **No**

5 Were you under age $18^{1}/_{2}$ on the date you expatriated and have you been a U.S. resident for not more than 10 years? . . . . ☐ **Yes** ☐ **No**

6 Do you certify under penalties of perjury that you have complied with all of your tax obligations for the 5 preceding tax years (see instructions)? . . . . ☐ **Yes** ☐ **No**

Form **8854** (2014)

2014 Form 8854 Instructions

compensation items in 2014. Enter the part of the distribution that you would include in gross income if you continued to be subject to tax as a U.S. citizen or resident. Also enter the total amount of tax withheld by the payer(s) of any eligible deferred compensation items.

Do not enter the part of any payment that is attributable to services performed outside the United States before or after the expatriation date while you were not a citizen or resident of the United States.

Line 3

Unless the exception at the end of this section applies, check the "Yes" box if you received any direct or indirect distributions of property (including money) from a nongrantor trust in 2014. Enter the part of the distribution that you would include in gross income if you continued to be subject to tax as a U.S.

Line 6

Check the "Yes" box if you have complied with your tax obligations for the 5 tax years ending before the date on which you expatriated, including but not limited to, your obligations to file income tax, employment tax, gift tax, and information returns, if applicable, and your obligation to pay all relevant tax liabilities, interest, and penalties. You will be subject to tax under section 877A if you have not complied with these obligations, regardless of whether your average annual income tax liability or net worth exceeds the applicable threshold amounts.

Section B—Property Owned on Date of Expatriation

Complete Section B only if you are a covered expatriate (see *Covered expatriate,* earlier). If you need

c. The compensation is payable on or after the expatriation date.

Examples of items of deferred compensation include: a cash-settled stock appreciation right, a phantom stock arrangement, a cash-settled restricted stock unit, an unfunded and unsecured promise to pay money or other compensation in the future (other than such a promise to transfer property in the future), and an interest in a trust described in section 402(b)(1) or (4) (commonly referred to as a secular trust).

4. Any property, or right to property, that you are entitled to receive in connection with the performance of services to the extent not previously taken into account under section 83 or in accordance with section 83. Examples of these items include, but are not limited to, restricted stock,

Instructions for Form 8854 (2014) -5-

Three tests—as of when, exactly?

- **Net tax liability test**—the time frame is defined (average of previous five taxable years)

- **Net worth test**—the time is defined (as of the expatriation date)

- **Certification test**—only the method for certification is given (“on Form 8854”), but no time given for “this is true as of <DATE>”

You are certifying as of which date?

- On the day you relinquish your U.S. citizenship?
- When you file Form 8854?

You cannot certify truth about the future

- You renounce your citizenship on January 2, 2015
  - Certification for 2010-2014 is impossible—you have not filed your 2014 income tax returns yet
- You renounce your citizenship on October 1, 2015, while your 2014 income tax returns are on extension
  - Same result—you cannot certify that you have satisfied your Title 26 duties for 2014

What I think

- You certify your compliance for the prior five years when you sign and file Form 8854 for the expatriation year
  - Congress knows how to specify an effective date—as shown by the net worth test

Perplexing: Late Form 8854 = Covered Expatriate?

You “must” file Form 8854 by the due date. What if you don’t?

Notice 2009-85, Section 8—file Form 8854 or else

- *Certification of compliance with tax obligations for preceding five years*. All U.S. citizens who relinquish their U.S. citizenship and all long-term residents who cease to be lawful permanent residents of the United States (within the meaning of section 7701(b)(6)) must file Form 8854 in order to certify, under penalties of perjury, that they have been in compliance with all federal tax laws during the five years preceding the year of expatriation. **Individuals who fail to make such certification will be treated as covered expatriates** within the meaning of section 877A(g) whether or not they also meet the tax liability test or the net worth test. (Emphasis added).

When do you make the certification?

"This certification must be made on Form 8854 and **must be filed by the due date** of the taxpayer's Federal income tax return for the taxable year that includes the day before the expatriation date. See section 8 of this notice for information concerning Form 8854." (Emphasis added)

- Notice 2009-85, Section 2.A

What if you file Form 8854 late?

- Does "make such certification" mean
  - Certified on Form 8854?
  - Certified on Form 8854 AND filed Form 8854 on time?

Statutory authority for Form 8854

- IRC §6039G requires the IRS to collect data from expatriates
- As usual, the IRS has the power to specify the methodology, timing, etc. for compliance with these requirements—penalties, too
- The sole penalty is a $10,000 fine (IRC §6039G(c))

What I think

- Missing the Form 8854 filing deadline will not make you a covered expatriate
    - Expatriation-year compliance is not a trigger event for covered expatriate status in IRC §877(a)(2)
    - The IRC §6039G information-gathering requirement is not referenced in IRC §877A, so the penalty for disobeying the rules under IRC §6039G is the penalty built in there—the usual $10,000 penalty

Easy: Green card holders who don’t file Form 8854

If not “long-term resident”, then IRC §877A doesn’t apply; if IRC §877A doesn’t apply, IRC §6039G doesn’t apply; if IRC §6039G doesn’t apply, then the paperwork driven by that Code section doesn’t need to be filed.

Someone who gives up a green card in 5 years

- Long-term resident + cease being a lawful permanent resident = expatriate
- If you never become a long-term resident, you never have an exit tax problem under IRC §877A

Form 8854 and IRC §6039G

"Notwithstanding any other provision of law, any individual to whom section 877 (b) or 877A applies for any taxable year shall provide a statement for such taxable year which includes the information described in subsection (b)."

- IRC §6039G(a)

- Form 8854 is how the Internal Revenue Service implemented the reporting requirements in IRC §6039G

“Long-Term Resident”

- “[An] individual (other than a citizen of the United States) who is a lawful permanent resident of the United States in at least 8 taxable years during the period of 15 taxable years ending with the taxable year during which the [individual expatriates].” IRC §§877(e)(2), 877A(g)(5)

- Two ingredients
  - Status (lawful permanent resident)
  - Time (8 out of 15 years)

Do not hit the "8 of 15 years"

- Start date is the day you received the green card visa
- (Compare with the first day of resident alien status for income tax purposes—setting foot in the USA with a green card visa) IRC §7701(b)(2)(A)(ii)
- "In" means one day is enough to be a full year towards the 8 out of 15
- Treaty election years do not count toward the 8 years

If you never meet the 8 out of 15 years requirement

- You can never be an expatriate, because you are not a "long-term resident"
- Therefore, the exit tax rules of IRC §877A will never apply to you
- If the rules of IRC §877A never apply to you, the disclosure requirements of IRC §6039G never apply to you, so no Form 8854 is required when you leave
- File an appropriate final year income tax return only

Perplexing: The Dual Citizen Exception

What if you live in a country that has no income tax?

How dual citizens avoid covered expatriate status

- Dual citizens are exempted from the net worth test and the net tax liability test in determining whether they are covered expatriates (IRC §877A(g)(1)(B)(i))

- Dual citizens must still satisfy the certification test

What is a dual citizen?

- "[B]ecame at birth a citizen of the United States and a citizen of another country and, as of the expatriation date, continues to be a citizen of, **and is taxed as a resident of**, such other country" (IRC §877A(g)(1)(B)(i)(I))

- PLUS "[H]as been a resident of the United States (as defined in section 7701(b)(1)(A)(ii)) for not more than 10 taxable years during the 15-taxable year period ending with the taxable year during which the expatriation date occurs" (IRC §877A(g)(1)(B)(i)(II))

Taxed as a resident

- What if the country has an income tax but the individual has no tax liability under that system (e.g., territorial tax systems like Hong Kong)?
  - Probably OK
- What if the country does not have an income tax (e.g., Saudi Arabia)?
- Indeed: *what type of tax is the Code speaking about?*

What I think

- The dual citizen exception is probably meant to be the equivalent of an anti-treaty shopping rule for IRC §877A
- The Code probably means "if they had an income tax, you would be taxed as a resident under that country's income tax system"
- We claim the dual-citizen exception in cases like this

Perplexing? Form W8-CE and the 30 day deadline

Almost everyone blows this deadline.

What Form W-8CE does

- Establishes the value of certain assets owned by a covered expatriate
- Informs the withholding agent that this is a covered expatriate and withholding should occur

The meat of Form W-8CE

Under penalties of perjury, I certify that I am a covered expatriate (as defined in the instructions below). Furthermore, I authorize this form to be provided to any withholding agent that has control, receipt, or custody of the income of which I am the beneficial owner or any withholding agent that can disburse or make payments of the income of which I am the beneficial owner.

Name of payer ______	Account Number (or other identifying information)
For the payer above, check the box below if you had any of the following items on the day before your expatriation date (see instructions).	
☐ 1. Eligible Deferred Compensation Item. Checking this box notifies the payer that you are irrevocably waiving any right to claim any reduction in withholding for such eligible deferred compensation item under any treaty with the United States (see instructions)	
☐ 2. Ineligible Deferred Compensation Item	
☐ 3. Specified Tax Deferred Account	
☐ 4. Nongrantor Trust. Checking this box notifies the payer that you will be treated as having waived any right to claim any reduction in withholding on any distribution from this trust under any treaty with the United States (see instructions)	

☐ Checking this box notifies the payer that you are electing to be treated as having received the value of your interest in the trust on the day before your expatriation date and that you will be subject to withholding under section 877A until the payer receives (a) a copy of the letter ruling issued by the IRS stating the value of your interest in the trust and (b) your certification that you have paid any tax due on the receipt of the value of your interest in the trust (see instructions).

▶ Signature ______ Date ______

The filing deadline

1040NR. An election is not valid unless your income tax return is filed by the due date plus extensions.

When To File

File Form W-8CE on the earlier of (a) the day before the first distribution on or after the expatriation date or (b) thirty (30) days after the expatriation date for each specified tax deferred account, item of deferred compensation, or interest in a nongrantor trust.

Where To File

Give Form W-8CE to each payer of the

Eligible deferred compensation item defined

"Eligible deferred compensation item means any deferred compensation item with respect to which: (i) the payor is either a U.S. person or a non-U.S. person who elects to be treated as a U.S. person for purposes of section 877A(d)(1) and (ii) the covered expatriate notifies the payor of his or her status as a covered expatriate and irrevocably waives any right to claim any withholding reduction under any treaty with the United States. See section 8 of this notice for the applicable filing and reporting requirements."

- Notice 2009-85, Section 5.B(2)

So what happens if you miss the 30 day window?

- Does the "eligible deferred compensation item" convert to an "ineligible deferred compensation item"?

- Or are you just late with the withholding paperwork?

What I think

- The “30 days after expatriation” rule was entirely arbitrary
- A failure to file Form W-8CE based on a filing deadline set by the IRS under its standard discretion for procedure should not cause a change in the character of an asset from “eligible” to “ineligible”
- Continue to treat these as eligible deferred compensation distributions

The Double Taxation Risk

Covered expatriates have a serious double-taxation risk that has yet to be solved by the IRS

Covered expatriates have a double tax risk

- A covered expatriate owns real estate in the U.K.
- Mark-to-market gain is taxed under IRC §877A(a)
- The covered expatriate has a step-up in basis for U.S. tax purposes, but not for U.K. tax purposes
- Can the covered expatriate claim a tax credit in the U.K.?
- Can the covered expatriate get basis step-up in the U.K.?

Here is another one

- A covered expatriate's IRA is deemed distributed on the day before expatriation (IRC §877A(e)(1))
  - Is that deemed distribution also a taxable distribution in the taxpayer's home country? Probably not
  - If not, how will the taxpayer be taxed in his home country when there is a later actual distribution? It is probably taxable
  - Will the taxpayer get a foreign tax credit his home country for the IRC §877A tax paid? Probably not

Canada's departure tax—template for a solution

- Canada has a departure tax similar to our exit tax
- **Revenue Procedure 2010-19** is how the U.S. finally synchronized the Canadian departure tax to the U.S. system to prevent double taxation
- You can elect a deemed sale in the U.S. The Canadian departure tax is eligible for U.S. foreign tax credit
- This reconciliation of competing systems has not occurred between the U.S. and other countries for the U.S. exit tax (yet)

What we do

- Engineer actual sales if at all possible—this creates a taxable event in both countries
  - Real income tax is paid, not funky IRC §877A tax
  - The timing is right, so foreign tax credits will work
- Problem—you probably don't want to sell your house
- Problem—this doesn't necessarily work for pensions

Official Resources

What the government has given us so far

Official Resources

- IRC §877A — income tax on covered expatriates
- Notice 2009-85, 2009-45 IRB 598 — about IRC §877A
- IRC §877 — some definitions are used for IRC §877A
- IRC §2801 — transfer tax on recipients of gifts or inheritances from covered expatriates
- REG-112997-10, 80 Fed. Reg. 54,447 (Sept. 10, 2015) — proposed Regulations under IRC §2801

Disclaimer/Waiver/Warning Shot/Pre-Emptive Strike

A speech by some dude and a few slides? *You* wouldn’t make serious decisions based on such meager authority. :-)

Do your own research and come up with your own answers.

Thanks!

Philip D. W. Hodgen

HodgenLaw PC
301 East Colorado Boulevard, Suite 323
Pasadena, California 91101
hodgen.com
w: +1 626 689 0060

e: phil@hodgen.com

Sign up for our email newsletters at hodgen.com/lists

Estate Planning in the Twilight Zone: U.S. Taxation of Nonresident Aliens

18th Annual International Tax Symposium
Presented by the State Bar of Texas Tax Section
Dallas, Texas – November 12, 2015
Houston, Texas – November 13, 2015

BECKETT TACKETT JETEL
ATTORNEYS AT LAW PLLC

Beckett Tackett & Jetel, PLLC Attorneys at Law • Heritage Plaza, Suite 210 • 7800 N. MoPac • Austin, Texas 78759
Tel: 512.436.9102 • Fax: 512.436.9741 • **www.btjlaw.com**

Amy P. Jetel
ajetel@btjlaw.com
512.370.2747

Threshold Matters

Home Country Taxation

- No planning should be undertaken before considering whether home country taxation is relevant
  - Typical planning vehicles for U.S. persons can be disastrous to a nonresident alien individual (for example, a transfer to a revocable trust by a U.K. resident will trigger immediate IHT)
  - Tax counsel in the other jurisdiction is essential
- If no treaty applies, tax credits or other adjustments may be available when two countries tax the same income

Treaty Analysis

- U.S. taxation of foreign investors may be modified by treaty
  - No exception from U.S. taxation of gain from real estate, but treaties can reduce or eliminate tax on interest and dividends
  - Almost all treaties contain “limitation on benefits” provision to counteract abuse

- Treaty analysis first requires an understanding of whether each country considers the client to be resident in that country under its internal rules
  - Again, tax counsel in the other jurisdiction is essential to understand home country taxation

Income Tax Treaties & Estate and Gift Tax Treaties

- The U.S. is party to more than 60 income tax treaties, but only 15 estate and gift tax treaties (because many countries do not have an estate, inheritance, or gift tax)
- Below are the countries with which the U.S. is party to estate and/or gift tax treaties:
  - Australia
  - Austria
  - Canada
  - Denmark
  - Finland
  - France
  - Germany
  - Greece
  - Ireland
  - Italy
  - Japan
  - Netherlands
  - South Africa
  - Switzerland
  - United Kingdom

U.S. Tax Residency

U.S. Income Tax Residency

- **Objective Test** for Non-Citizens
  - Green card
  - Substantial presence test
  - First-year election
- Exceptions
  - Closer connection (subjective)
  - Treaty-based position
  - Certain exempt individuals (e.g., foreign students, scholars, government employees)

U.S. Estate & Gift Tax Residency

- **Subjective Test** for Non-Citizens
- A U.S. resident for transfer-tax purposes is a person who is "domiciled" in the U.S. at the time of death or at the time of the gift
  - A person acquires domicile in a place by **living there**, for even a brief period of time, with no definite present **intention** to leave

U.S. Tax Residency Mismatch

- An individual can be a U.S. resident for **income-tax** purposes and not for **transfer-tax** purposes, and vice versa
  - There is no "perfect" holding structure for U.S. assets, but it's even more challenging for a client who is income-tax resident and transfer-tax nonresident

U.S. Income Taxation of NRAs

Different Types of Income Taxed Differently

- Business (“Effectively Connected”) Income (**ECI**)
  - Taxed on net basis, as a U.S. person would be
  - Gains on real estate treated as ECI under FIRPTA
  - Foreign corporations subject to branch-profits tax on ECI
- Passive (“**FDAP**”) Income
  - Taxed by way of withholding on gross income
  - No U.S. tax on certain types of U.S.-sourced interest
- **Gains** – Non-Real Estate
  - Not subject to U.S. tax
- **Gains** – Real Estate
  - FIRPTA taxes as ECI

Effectively Connected Income (ECI)

- Foreign taxpayers' income that is "**effectively connected with a U.S. trade or business**" is taxed at regular U.S. rates (individual or corporate)
- Foreign taxpayers may **elect** to treat certain passive types of real estate income as ECI (e.g., rents and royalties from mineral interests) – §§ 871(d), 882(d)
  - Cannot switch back and forth each year; must wait 5 years after revoking the election
- Foreign Investment in Real Property Tax Act of 1980 (**FIRPTA**) treats gain/loss on sale of "United States real property interests" as ECI – § 897
  - Exception to the general rule of non-taxation of U.S. gains

Branch Profits Tax on Foreign Corporations' ECI

- Foreign corporation that is engaged in a U.S. trade or business (including through the ownership or sale of U.S. real property) is taxed at regular U.S. corporate rates (35%)
- In addition, the foreign corporation is subject to branch-profits tax (§ 884)
- Branch taxes are intended to treat U.S. trade or business as if it were a separate U.S. corporation (i.e., mimics U.S. corporate double-taxation):
  - Dividend tax rate *x* "dividend equivalent amount"
  - Interest tax rate *x* interest allocated to U.S. branch
  - Treaties often reduce or even eliminate branch taxes
- Dividend equivalent does not apply to liquidation proceeds, if formalities met

“Passive” Income (FDAP)

- Foreign taxpayers are subject to a 30% tax (withheld by the U.S. payor) on all fixed, determinable, annual, or periodic income (“FDAP income”) from U.S. sources
- FDAP income includes rents, interest, and dividends
- Certain exceptions apply to interest that is not ECI
  - Short-term OID
  - Bank interest
  - Portfolio interest exemption
- Treaties typically reduce withholding tax on interest and dividends

U.S. Tax Withholding

- Source withholding ensures that the U.S. will collect taxes from individuals and entities that are outside the IRS's reach
- U.S. withholding agent (the U.S. person in possession of income that will be paid to a foreign person) is liable for the tax if not properly withheld and withholding agent did not receive adequate documentation (Forms W-8, W-9)
- Withholding regimes:
  - FIRPTA: § 1445
  - FDAP: § 1441; 1442
  - Partnerships: § 1446
  - FATCA: § 1471–1474

Withholding: FIRPTA (§ 1445)

- FIRPTA requires that purchasers withhold 10% of gross amount realized from sale or exchange of USRPI by a nonresident
  - Some states also require withholding on sale by nonresident
  - Excess withholding can be avoided based on maximum tax (see IRS Form 8288-B and Rev. Proc. 2000-35)
- Exemptions:
  - Non-foreign affidavit
  - Non-USRPHC affidavit
  - Sales price <$300,000 on property that will be transferee's residence (amount not indexed for inflation in >30 years)
  - Publicly traded stock
  - Situations where withholding is required under partnership withholding rules (§ 1446)

Withholding: Rents, Interest, Dividends (§§ 1441 & 1442)

- Payor must withhold 30% of gross amount of U.S.-source FDAP income paid to foreign individual or corporation
- Treaties can reduce or exempt payments from withholding, if foreign person certifies its entitlement to treaty benefits (typically on Form W-8BEN)

Withholding: Partnerships (§ 1446)

- A partnership must withhold on its foreign partners' allocable share of the partnership's ECI
  - Over-withholding is often a problem
- Applicable rate is the highest rate under § 1 or § 11
  - Long-term capital gains rates can apply to individual partner
- Publicly traded partnerships (Treas. Reg. §1.1446-4)
  - Withholding based on distributions, not income allocations
  - Preferential rates may not be used

Withholding: FATCA (§§ 1471-1474)

- Foreign Accounts Tax Compliance Act (FATCA) implemented an entirely new withholding regime targeted at catching unreported income of U.S. taxpayers

- If proper documentation is not provided to U.S. withholding agent, FATCA requires withholding on certain U.S.-sourced payments to foreign accounts, entities, or financial institutions that would not otherwise be subject to withholding
  - The most egregious being a gross-proceeds withholding on U.S. gains

U.S. Transfer Taxation of NRAs

Gift Tax

- Nonresident aliens are taxed on gifts of **only** :
  - U.S.-sitused real estate
  - U.S.-sitused tangible property
- Gifts of U.S. stock are **not** subject to tax
- Gifts of partnership interests **may not** be subject to tax, but this result is less certain
  - Uncertainty should lead to conservative planning

Gift Tax

- Annual exclusion is available to nonresident aliens. In 2015, annual exclusion amounts are:
  - $14,000 for gifts to non-spouses
  - $147,000 for gifts to non-citizen spouses
    - QDOT not available for *inter vivos* gifts (only testamentary)
- No unified credit; all gifts above annual exclusion to non-spouses or to non-citizen spouses are taxable
- Unlimited marital deduction for gifts to citizen spouses

Estate Tax

- Nonresident aliens are subject to estate tax on **property located in the United States.** Includes:
  - U.S. real property
  - Tangible personal property located in the U.S.
  - Debt obligations of U.S. persons, unless portfolio exemption applies
  - Stock in U.S. corporations (whether or not publicly traded)
  - Foreign partnership interests uncertain
    - No bright line rule: Some authorities use "aggregate" approach, and some use the "entity" approach
    - If partnership is engaged in U.S. trade or business, clearly a U.S. asset
    - Uncertainty on this issue should lead to conservative planning

Estate Tax

- Trusts
  - Revocable trusts, or other trusts in which the decedent retained an interest under which a transferred asset could be "clawed back" under Code Sections 2033 through 2038
    - Look to situs of assets
    - Ensure that only foreign assets are transferred to the trust
      - If the nonresident alien transfers a U.S. asset to the trust, and then the trust later sells the U.S. asset and buys a foreign asset, there will be estate inclusion (§ 2104)
  - Irrevocable trusts
    - Structure like a typical completed-gift trust to ensure no estate inclusion

Estate Tax

- Limited to \$60,000 estate-tax exemption (\$13,000 tax credit)
- Unlimited marital deduction if assets left to a spouse who is a U.S. citizen
  - QDOT must be used to defer estate tax if surviving spouse is a non-citizen
- Charitable deduction and deduction for estate administration expenses
  - Ratio of U.S. assets to worldwide assets
- Nonrecourse debt on U.S. property results in only net value included in U.S. estate

Covered Gifts & Bequests: Inheritance-Type Tax

- **Gifts** or **bequests** from “covered expatriates” to a U.S. citizen or resident (including a domestic trust) are subject to an inheritance-type tax instead of a transfer tax
  - Meaning that the tax is **payable by the U.S. recipient**
  - Covered **gifts** taxed only to the extent exceed annual exclusion
- Covered gift/bequest to foreign trust taxed only when distribution attributable to the gift/bequest made to U.S. beneficiary
  - How to administer?
- Exception for transfers that are otherwise subject to U.S. transfer tax and reported on a gift- or estate-tax return
- Tax is reduced by foreign gift tax or estate tax

Basis Adjustment for Foreign Property Acquired from an NRA Decedent

- **Direct Inheritance**
  - NRA owned asset outright and leaves it to U.S. beneficiary, whether via will or intestacy

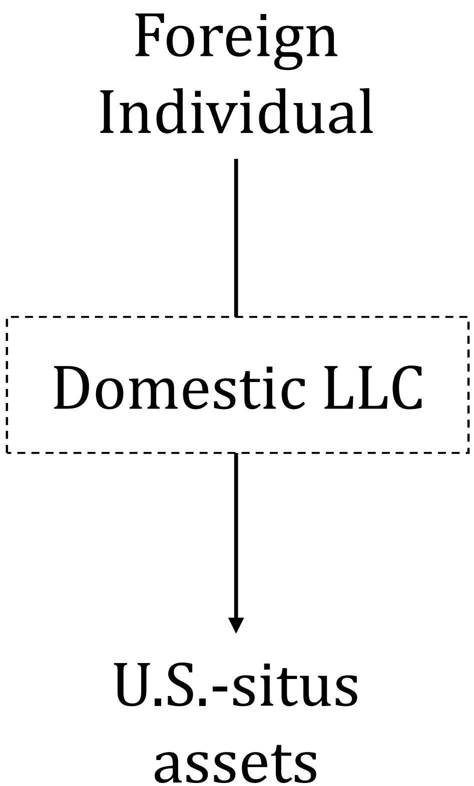
- **Inter Vivos Trusts – only two types**
  - Income payable to, or on direction of, NRA, and NRA may revoke
  - Income payable to, or on direction of, NRA, and NRA may make any change in enjoyment of trust income through power to alter, amend, or terminate

- Property Passing by **Exercise of General Power of Appointment**

- **Surviving Spouse's ½ of Community Property**, if NRA spouse's ½ was "includible" in estate

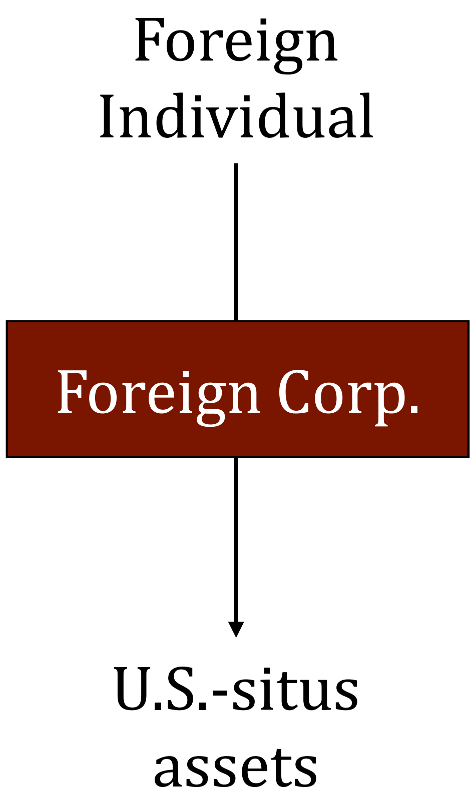
Analysis of Ownership Structures

Individual / U.S. LLC Ownership



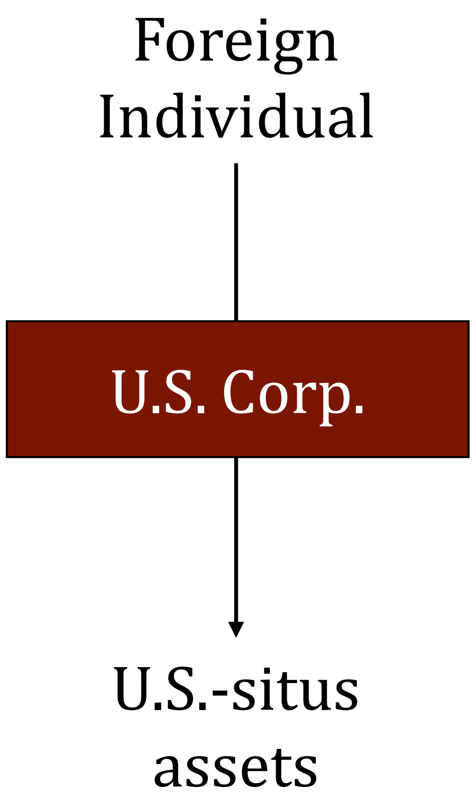
- Individual ownership is the same as ownership through a domestic LLC for tax purposes
- Estate tax
- Gift tax (real estate/tpp)
- One level of income tax & favorable capital-gains rates
- Basis adjustment

Ownership through Foreign Corporation



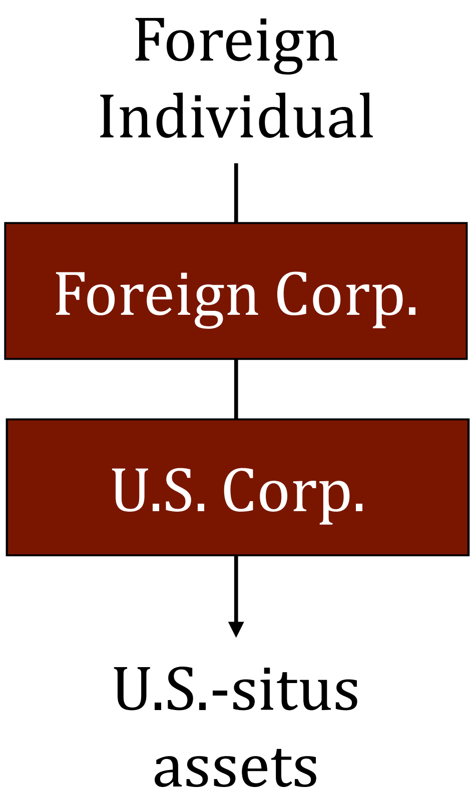
- No estate tax
- No gift tax
- Branch profits tax
- Sale of stock is non-taxable (unless real estate and corporation elects to be treated as a USRPHC)
- Gain on distribution of U.S. real estate to foreign individual
- Outside basis adjustment
- Built-in gain/CFC problems for heirs

Ownership through U.S. Corporation



- Estate tax
- No gift tax
- No branch profits tax
- Dividend withholding tax
- Sale of stock non-taxable unless USRPHC
- Gain on distribution of U.S. real estate to foreign individual
- Outside basis adjustment
- Built-in gain problem for heirs

Ownership through Foreign and U.S. Corporation

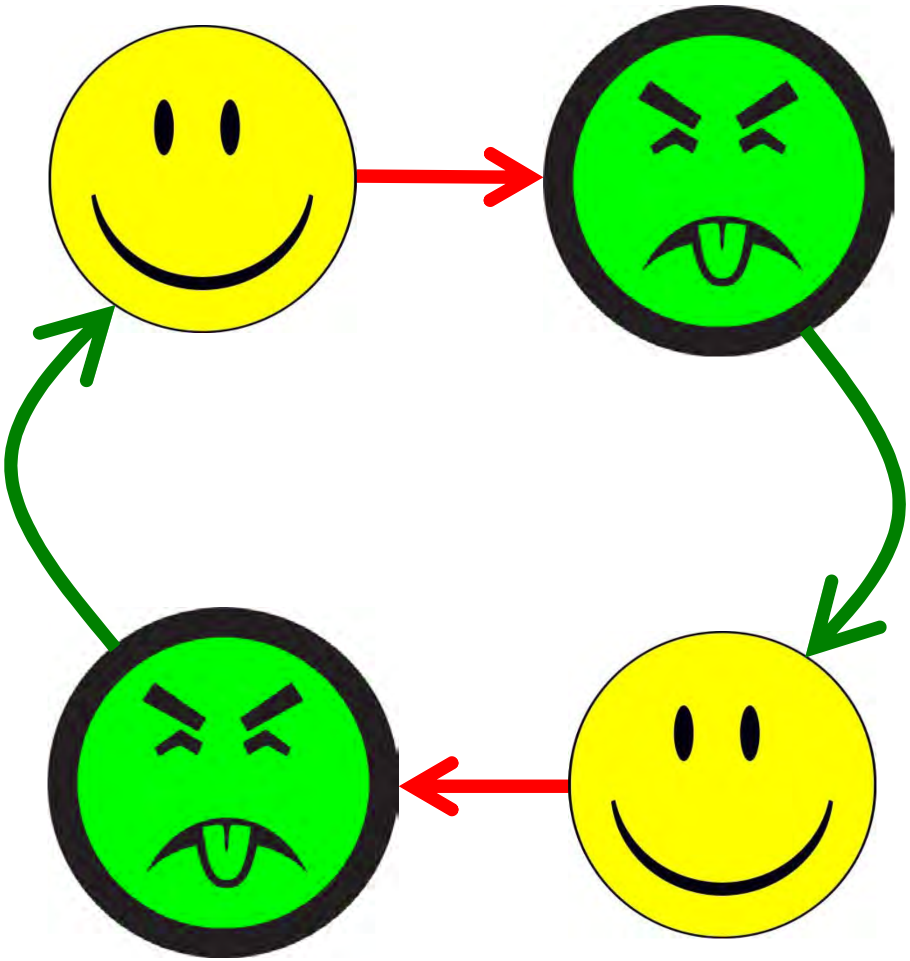


- No estate tax
- No gift tax
- No branch profits tax
- Sale of stock is non-taxable
- Gain on distribution of U.S. real estate to foreign corporation, unless it's a liquidating distribution
- Outside basis adjustment
- Built-in gain/CFC problems for heirs

There is No Perfect Corporate Structure

Direct ownership or pass-through entity:
- capital gains rates
- no double taxation
- simple

Direct ownership or pass-through entity:
- personal tax filings
- estate tax
- gift tax (real estate/tpp)



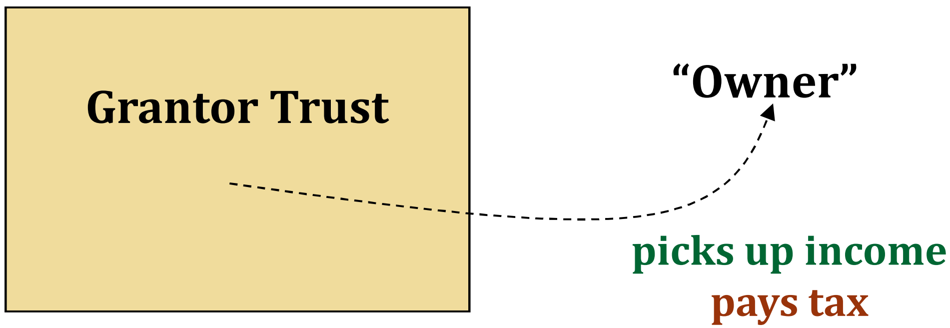
Corporate ownership:
- corporate rates
- double taxation
- branch profits
- built-in gain

Corporate ownership:
- no personal tax filings
- no estate tax (with foreign entity)
- no gift tax

Ownership through Trusts

- If U.S. estate tax avoidance is the goal, a trust is usually only for "true gifting" if trust will own U.S. assets
  - Use foreign blocker corporation if it's a retained-interest trust
  - Remember limited basis-adjustment rules with trusts that hold foreign assets
- Foreign trust is usually not desirable if there are only U.S. beneficiaries
- To make a determination of the type of trust recommended, need to understand intricacies of grantor trust status versus non-grantor trust status

U.S. Tax Consequences – Grantor Trust



- The trust’s “owner” is deemed to own the trust’s income for U.S. tax purposes
- Income is currently taxable to the owner (whether or not it is distributed); and therefore, beneficiaries are not taxable on distributions
- If the owner is a **U.S. person**, the owner pays U.S. tax on the trust’s worldwide income
- If the owner is a **foreign person**, U.S. tax is paid only on certain U.S.-sourced income (via source withholding)

U.S. Tax Consequences – Grantor Trust with Foreign Owner

- A trust properly characterized as having a **foreign owner**, and which does not invest in U.S. assets, can provide complete avoidance of U.S. tax on trust income during the grantor's life, even when it is distributed to U.S. beneficiaries
- **NOTE:** Foreign owner of grantor trust will most likely be subject to U.S. estate tax on U.S.-situs assets in the trust

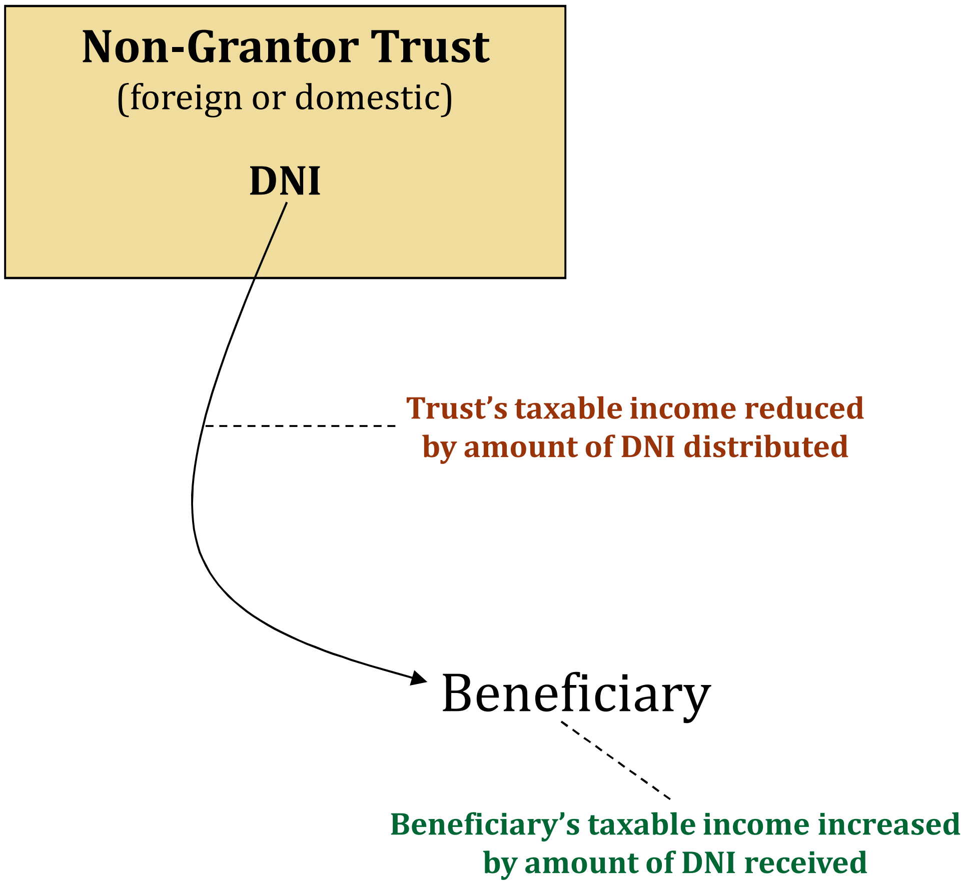
U.S. Tax Consequences – Non-Grantor Trust; Undistributed Income

Non-Grantor Trust

income not distributed
pays tax

- Undistributed income is considered to be "owned" by the trust itself
- If it's a **U.S. trust**, it pays U.S. tax on worldwide income
  - Undistributed income in Year 1 becomes <u>principal</u> in Year 2
- If it's a **foreign trust**, U.S. tax is paid only on certain U.S.-sourced income (via source withholding)
  - Undistributed income in Year 1 becomes <u>undistributed net income</u> (UNI) in Year 2

U.S. Tax Consequences – Non-Grantor Trust; Distributed Income



- In computing taxable income, the trust receives a <u>deduction</u> equal to **distributable net income (DNI)** actually distributed to beneficiaries
- The beneficiaries must <u>include</u> in income their pro-rata share of the portion of trust distributions that carry out DNI
- The DNI of a foreign non-grantor trust includes realized capital gains (unlike a U.S. non-grantor trust)

U.S. Tax Consequences – Foreign Non-Grantor Trust

- Because the foreign trust itself is subject to U.S. tax only on limited types of U.S.-source income, there's an opportunity for avoidance of U.S. tax on accumulated income that is distributed to U.S. beneficiaries
- Enter the "throwback" rules

Foreign Non-Grantor Trusts – UNI & Accumulation Distributions

- DNI becomes **undistributed net income (UNI)** if not distributed within 65 days of year end
  - Foreign trusts only
  - If a foreign trust has U.S. beneficiaries, it must account for all of its historical income as if it were a U.S. trust
- Only "**accumulation distributions**" are subject to the throwback tax (distributions that exceed current-year DNI)

Foreign Non-Grantor Trusts – How the Throwback Tax Works

- The throwback regime captures the incremental amount of tax that would have been paid if DNI had been distributed (and taxed) to the beneficiary in the years in which it was earned
  - Regular income tax is imposed on the distribution in the U.S. beneficiary's hands, plus an interest charge on the tax
  - The interest charge is compounded over the length of time that the UNI accumulated in the trust
    - For years prior to 1996, 6% simple interest
    - For 1996 and after, the interest is compounded daily using federal underpayment rate in effect from time to time over the accumulation period (currently 3%)
  - Realized capital gains lose their character if not distributed currently

Foreign Non-Grantor Trusts with UNI – Throwback Tax is Nearly Impossible to Avoid

- Once a foreign non-grantor trust has UNI, it remains in the trust until it is distributed
  - UNI can be distributed to a foreign beneficiary without triggering the throwback tax (but beware of closed loophole below)
- All loopholes for improperly avoiding throwback have been closed
  - Distributing funds to a foreign beneficiary who then "gifts" it to a U.S. beneficiary is an accumulation distribution to the U.S. beneficiary
  - Transferring funds from one trust to another trust can be considered an accumulation distribution directly to the beneficiaries in some cases
  - Rent-free use of trust property will carry out DNI and UNI

Accumulation Distributions from Foreign Non-Grantor Trusts – Tiering Rule

- **DNI** is distributed first until depleted; then
- **UNI** is deemed distributed until depleted; then
- Non-taxable **principal** is distributed.

Foreign Non-Grantor Trust

Current Year's DNI: $100

Prior Years' UNI: $200

$400 distribution

U.S. Beneficiary's income includes:

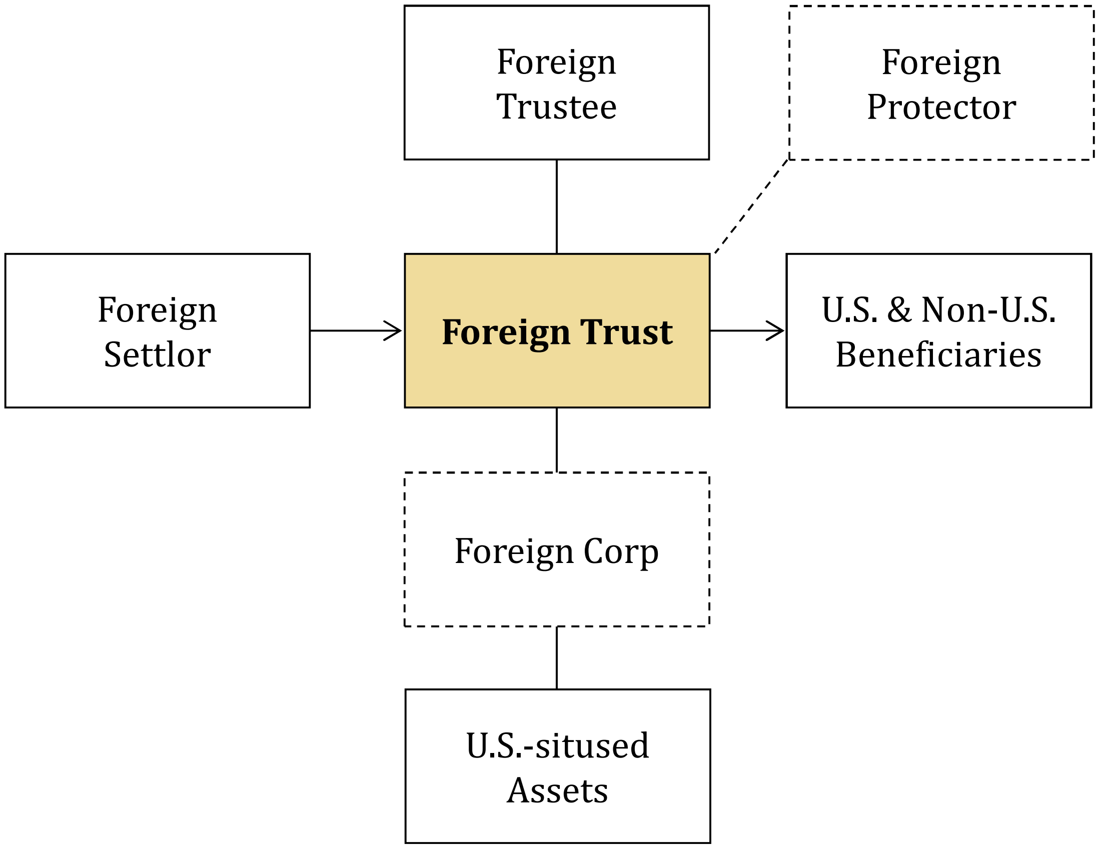
$100 DNI
$200 UNI (subject to throwback tax)
$0 (principal of $100)

Non-Grantor Trust with U.S. Beneficiaries: Choosing Foreign or Domestic

- Foreign non-grantor trusts can provide some good planning opportunities, but throwback-tax complications for U.S. beneficiaries can lean in favor of using a U.S. trust instead
- When choosing U.S. trust vs. foreign trust, it's also important to remember that realized capital gains in a foreign non-grantor trust must be distributed to avoid UNI, whereas gains (net of U.S. tax) can remain in a U.S. non-grantor trust

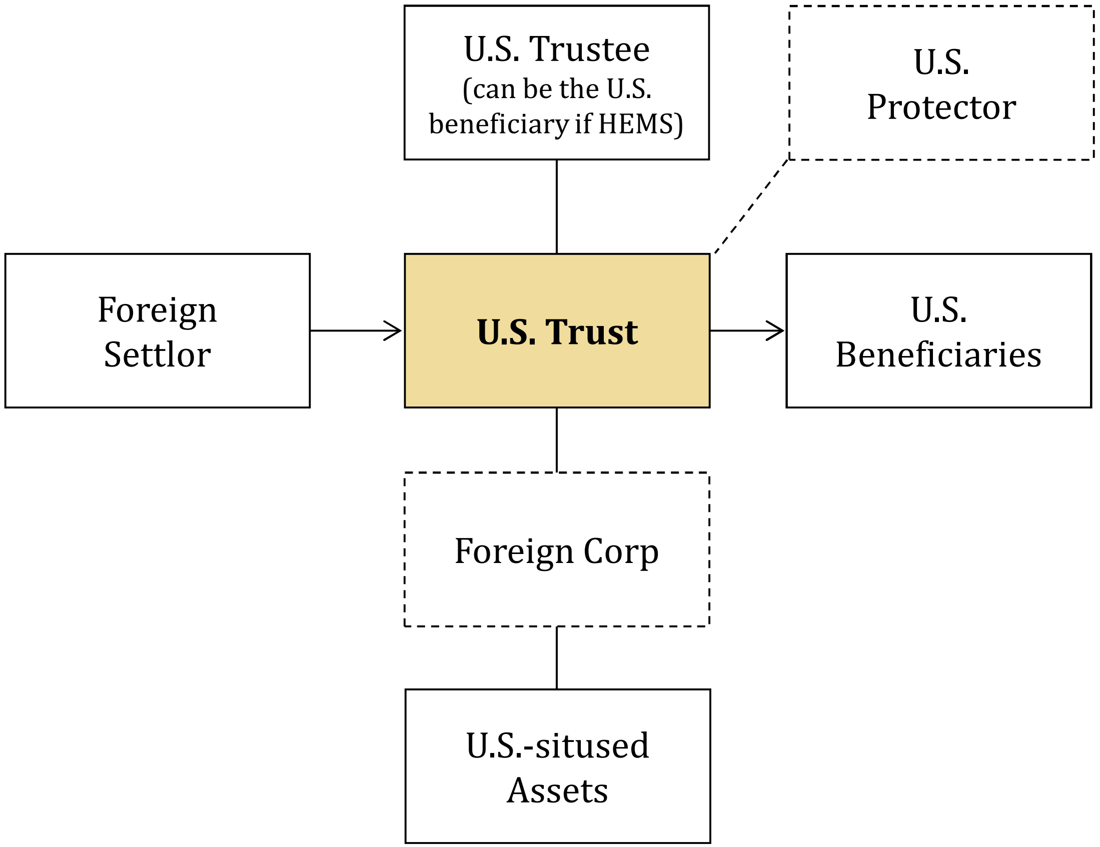
Foreign Trust Structure

- Non-U.S. assets can be gifted with abandon
- If real estate, foreign person must sell (subject to FIRPTA), or gift in increments
- If grantor trust, use foreign corp to hold U.S. assets
- No U.S. estate tax if structured right
- No GST tax if structured right
- U.S. beneficiaries report distributions on Form 3520
- Include redomiciliation provision



U.S. Trust Structure

- Non-U.S. assets can be gifted with abandon (Form 3520)
- If real estate, foreign person must sell (subject to FIRPTA), or gift in increments
- If grantor trust, use foreign corp to hold U.S. assets
- No U.S. estate tax if structured right
- No GST tax if structured right
- No Form 3520 reporting for U.S. beneficiaries
- Include redomiciliation provision



Estate Planning in the Twilight Zone: U.S. Taxation of Nonresident Aliens

18th Annual International Tax Symposium
Presented by the State Bar of Texas Tax Section
Dallas, Texas – November 12, 2015
Houston, Texas – November 13, 2015

Beckett Tackett & Jetel, PLLC Attorneys at Law • Heritage Plaza, Suite 210 • 7800 N. MoPac • Austin, Texas 78759
Tel: 512.436.9102 • Fax: 512.436.9741 • **www.btjlaw.com**

Amy P. Jetel
ajetel@btjlaw.com
512.370.2747

THE IRS'S OFFSHORE VOLUNTARY DISCLOSURE PROGRAM AND RELATED PROCEDURES

MEADOWS COLLIER
ATTORNEYS AT LAW
MEADOWS, COLLIER, REED, COUSINS, CROUCH & UNGERMAN, L.L.P.

Jason B. Freeman

901 Main Street, Suite 3700
Dallas, TX 75202
214.744.3700 800.451.0093
fax 214.747.3732
jfreeman@meadowscollier.com
www.meadowscollier.com

GRAY REED
GRAY REED & MCGRAW, P.C.

Austin C. Carlson

1300 Post Oak Boulevard, Suite 2000
Houston, Texas, 77056
713-986-7213 (Direct)
acarlson@grayreed.com
www.grayreed.com

Today's Program

- History and Context of the Offshore Voluntary Disclosure Program (OVDP) and the IRS's voluntary disclosure practice
- Various Offshore Programs and Procedures
- The OVDP Process
- Practical Pointers

The Offshore Voluntary Disclosure Program ("OVDP")

- The OVDP is an IRS program that provides a uniform penalty structure and process for taxpayers who come forward voluntarily and report their previously undisclosed foreign accounts and assets.
- The program allows taxpayers to report and correct past noncompliance with respect to reporting of foreign income and/or foreign assets.
- The OVDP requires that the taxpayer pay the additional tax liability, plus certain tax penalties and interest, as well as an OVDP penalty.
- In exchange, the IRS agrees not to seek additional penalties or to recommend the taxpayer for criminal prosecution.

Illustrating the Problem

Assume that a taxpayer had the following amounts and activity in a foreign financial account:

Year	Amount on Deposit	Interest Income	Account Balance
2007	$1,000,000	$50,000	$1,050,000
2008		$50,000	$1,100,000
2009		$50,000	$1,150,000
2010		$50,000	$1,200,000
2011		$50,000	$1,250,000
2012		$50,000	$1,300,000
2013		$50,000	$1,350,000
2014		$50,000	$1,400,000

Further assume that the taxpayer willfully failed to report any income on this foreign financial account or to file FBARs or any foreign informational returns during any years. Taxpayer's marginal tax rate is 35%.

Illustrating the Problem *(cont.)*

- If the taxpayer in the above example comes forward and his/her voluntary disclosure is accepted by the IRS, he/she faces the following potential scenario under the OVDP:
  - He would pay $<u>553,000</u> plus interest. This includes:
    - Tax of $140,000 (8 years at $17,500) plus interest,
    - An accuracy-related penalty of $28,000 (i.e., $140,000 x 20%), and
    - A miscellaneous offshore penalty of $385,000 (i.e., $1,400,000 x 27.5%).
  - Most importantly, the IRS effectively grants criminal amnesty, agreeing not to refer the taxpayer for criminal prosecution.

Illustrating the Problem *(cont.)*

- If the taxpayer does not come forward, he/she faces significant civil tax and criminal exposure.
- Statutes authorize potential fines of over $<u>4,000,000</u> plus applicable interest, as well as any fines related to required information return penalties.
- The civil liabilities potentially include:
  - The tax, accuracy-related penalties, and, if applicable, the failure-to-file and failure-to-pay penalties, plus interest;
  - FBAR penalties totaling up to $3,825,000 for willful failures to file complete and correct FBARs (2009 - $575,000, 2010 - $600,000, 2011 - $625,000, 2012 - $650,000, and 2013 - $675,000, and 2014 - $700,000) (***but see*** recent IRS guidance on FBAR penalty assessment);
  - A potential fraud penalty (75%); and
  - Potential substantial additional information return penalties if the foreign financial account is held through a foreign entity such as a trust or corporation and required information returns were not filed.
- In addition, if the taxpayer is not in the OVDP and the foreign noncompliance started before 2007, the Service may examine tax years prior to 2007.
- Most importantly, the taxpayer faces severe <u>criminal</u> exposure.

Various Offshore Programs and Procedures

- History of programs
- Major changes to the 2014 program (current)
- Requirements to be accepted
- When is the OVDP the right choice?

History of the Voluntary Disclosure Programs

- Background – program specifically designed for taxpayers with exposure to criminal/civil penalties due to willful failure to report foreign financial asset and pay all taxes due in respect to those assets
- 2009 OVDP
- 2011 OVDI
- 2012 OVDP
- 2014 OVDP

Major Changes in the 2014 Program

- Disclosure of additional (potentially self-incriminating) information in preclearance process
- Disclosure of entity information
- 50-percent penalty
- Upfront payment
- Changes related to new streamlined program

Requirements to Be Accepted into the OVDP

- Taxpayers who have legal source funds invested in undisclosed OVDP assets and meet the requirements of IRM 9.5.11.9 are eligible to apply for the OVDP.
  - Note: The Voluntary Disclosure Practice does **not** apply to illegal source income.
  - Individuals who facilitated the tax noncompliance of others are **not** eligible to participate in OVDP.
  - If the IRS has initiated a civil examination for any year, regardless of whether it relates to undisclosed OVDP assets, the taxpayer will not be eligible to participate in the OVDP. A taxpayer under criminal investigation by CI is also ineligible.
- Entities are eligible to participate in the OVDP.

OVDP Process

- Preclearance
- The voluntary disclosure letter
- The voluntary disclosure package
- Opt-out (if applicable)
- Finishing the process

Step 1: Preclearance

- Purpose
  - Is the taxpayer "cleared" to make a voluntary disclosure?
  - In other words, does the IRS already have the taxpayer's name/information?
    - How might the IRS already have the taxpayer's name/information?
- Process
  - A one-page fax request to IRS CI
  - Under the new 2014 program, requires providing certain incriminating information
  - How long does it take?

Step 2: Voluntary Disclosure Letter

- Voluntary disclosure letter
  - IRS Form 14457, *Offshore Voluntary Disclosure Letter*
  - IRS Form 14454, *Attachment to Voluntary Disclosure Letter*
  - Each account requires a separate attachment
  - Signed under penalty of perjury
- "Preliminary acceptance"
  - Following successful CI background check and processing of voluntary disclosure letter and attachments

Step 3: Voluntary Disclosure Package

- Taxpayer must submit the "OVDP Package" for the required period
- OVDP package includes:
  - Original tax returns
  - Amended returns
    - Must include any previously omitted income, foreign or domestic
  - Copy of Offshore Voluntary Disclosure Letter
  - FBARs
  - SOL waiver
    - Form 872 and
    - FBAR
  - Foreign Account or Asset Statement
  - Penalty Calculation Worksheet
  - Payment of tax, interest, 20% accuracy penalty, and, if applicable, failure-to-file and failure-to-pay penalties
  - OVDP penalty ("in lieu of" penalty)
    - 27.5% (50%, if applicable)
  - Account Statements
  - Any required disclosure statements

Calculating the Penalty

- The penalty base
- Common issues
  - Currency conversion
  - Transfers between accounts
  - Valuation discounts for assets held through entities?
  - Co-ownership of OVDP assets issues

The 50-Percent Penalty

- Under the 2014 Program, taxpayers with an undisclosed foreign financial account are now subject to a 50-percent miscellaneous offshore penalty if, at the time of submitting the preclearance letter to IRS Criminal Investigation, an event has already occurred that constitutes a public disclosure that either:
  - The FFI where the account is held, or a facilitator who assisted in establishing or maintaining the taxpayer's offshore arrangement, is or has been under investigation by the IRS or the DOJ in connection with accounts beneficially owned by a U.S. person;
  - the FFI or other facilitator is cooperating with the IRS or the DOJ; or
  - the FFI or other facilitator has been identified in a court-approved issuance of a summons seeking information about U.S. taxpayers who may hold financial accounts (a "John Doe summons").

The 50-Percent Penalty
(cont.)

- Once the 50-percent miscellaneous offshore penalty applies to any of the taxpayer's accounts or assets, it will apply to all of the taxpayer's assets subject to the penalty, including accounts held at another institution or established through another facilitator for which there have been no events constituting public disclosures. FAQ 7.2

List of “Bad” Banks

- The List is growing!
- Check it for each disclosure.

Opting Out

- An “Opt-out” is the election by a taxpayer to have his/her case handled under the standard audit procedure, rather than submit to the OVDP’s one-size-fits-all penalty structure.
- An “opt out” is distinct from a “removal” from the program.
- So long as the taxpayer continues to cooperate, he/she continues to receive protection against criminal referral.
- The decision to “opt out” is irrevocable.
- “Opt Outs” come with significant risks.
  - Those risks may be mitigated somewhat in light of recent IRS guidance.

Finishing the Process

- Revenue Agent assigned
- Possible IDRs
- Closing Agreement, Form 906

Common Questions

- How long does the process take?
- When does the client have to pay?
- Are penalties negotiable?
- Is a taxpayer still eligible for streamlined relief if the account was held at a 50% bank?
- Can the taxpayer just disclose some, but not all unreported accounts?
- When will the OVDP end?

Alternatives to the OVDP

- "Head in the sand" approach
- Quiet disclosures
- Streamlined relief
- Delinquent filing procedures

Head-in-the-Sand Approach

- Do nothing
- Presents serious risks
- Is there a legal obligation to file amended returns?

Quiet Disclosures

- A quiet disclosure involves filing amended returns and forms reporting the additional unreported income and assets without making a voluntary disclosure or otherwise notifying the IRS.

Streamlined Relief

- The streamlined filing procedures have been expanded and modified to accommodate a much broader group of U.S. taxpayers.
- Major changes to the streamlined procedures include:
  - Extension of eligibility to U.S. taxpayers residing in the U.S.;
  - Elimination of the $1,500 tax threshold; and
  - Elimination of the risk assessment process associated with the streamlined filing compliance procedure announced in 2012

Streamlined Relief

(cont.)

- Two New Streamlined Procedures
  - Streamlined Foreign Offshore Procedure (“SFOP”)
  - Streamlined Domestic Offshore Procedure (“SDOP”)
- Certification
  - Due to non-willful conduct
  - Taxpayer must certify that the failure to report foreign financial assets and report all tax due in respect of those assets did not result from willful conduct on their part.
- Not eligible if IRS started civil examination

How is the Streamlined Procedure Different from the OVDP?

- Except for certain “transitional” relief, the two programs are mutually exclusive.
- No protection against criminal referral
- Reduced penalties:
  - SFOP: Penalties are waived
  - SDOP: 5% penalty
  - Compare to OVDP Penalty of 27.5% (or 50%, if applicable)
- Requires certification of non-willfulness
- Tax returns are processed like any other return
- May be subject to audit, but not automatically
- No closing agreement

The SDOP Penalty

- The Title 26 miscellaneous offshore penalty for SDOP is equal to 5% of the highest aggregate balance/value of the taxpayer's foreign financial assets that are subject to the miscellaneous offshore penalty during the years in the covered tax return period and the covered FBAR period.
- The Penalty Base

Risks Associated with Streamlined Program

- Once a streamlined submission is made, the taxpayer may *not* participate in the OVDP
- Non-willful certification
- No preclearance protection
- No protection against criminal referral or application of civil fraud penalties if IRS determines was “willful” violation

Willful vs. Non-Willful

- What is “willful” and “non-willful” conduct?
- Willfulness: “a voluntary, intentional violation of a known legal duty.” IRM 4.26.16.4.5.3
- Non-willful conduct is conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law.
- What evidence is relevant?

Streamlined Foreign Offshore Procedure Steps

- For each of the most recent 3 years for which the U.S. tax return due date (or properly applied for extended due date) has passed:
  - Submit a complete and accurate delinquent tax return using Form 1040 or amended tax return using Form 1040X, as the case may be, together with the required information returns.
- Complete and sign a Certified Statement certifying:
  - (1) Eligibility for the Streamlined Foreign Offshore Procedures;
  - (2) that all required FBARs have now been filed; and
  - (3) that the failure to file tax returns, report all income, pay all tax, and submit all required information returns, including FBARs, resulted from **non-willful conduct**.
- Submit payment of all tax due and all applicable statutory interest with respect to each of the late payment amounts.
- For each of the most recent 6 years for which the FBAR due date has passed, file delinquent FBARs and include a statement explaining that the FBARs are being filed as part of the Streamlined Filing Compliance Procedures.

Streamlined Domestic Offshore Procedure Steps

- For each of the most recent 3 years for which the U.S. tax return due date (or properly applied for extended due date) has passed:
  - Submit a complete and accurate amended tax return using Form 1040X, together with any required information returns.
- Complete and sign a Certified Statement certifying :
  - (1) that you are eligible for the Streamlined Domestic Offshore Procedures;
  - (2) that all required FBARs have now been filed;
  - (3) that the failure to report all income, pay all tax, and submit all required information returns, including FBARs, resulted from **non-willful conduct**; and
  - (4) that the miscellaneous offshore penalty amount is accurate.
- Submit payment of all tax due and all applicable statutory interest with respect to each of the late payment amounts. Submit payment of the Title 26 miscellaneous offshore penalty.
- For each of the most recent 6 years for which the FBAR due date has passed, file delinquent FBARs according to the FBAR instructions and include a statement explaining that the FBARs are being filed as part of the Streamlined Filing Compliance Procedures.

Delinquent International Information Return Submission Procedures

- Available for taxpayers who do not need to use the OVDP or the Streamlined Filing Compliance Procedures to file delinquent or amended tax returns to report and pay additional tax, but who:
  - have not filed one or more required international information returns,
  - have reasonable cause for not timely filing the information returns,
  - are not under a civil examination or a criminal investigation by the IRS, and
  - have not already been contacted by the IRS about the delinquent information returns
- Supersedes old FAQ 18

Delinquent FBAR Submission Procedure

- Available for taxpayers who do not need to use either the OVDP or the Streamlined Filing Compliance Procedures to file delinquent or amended tax returns to report and pay additional tax, but who:
  - have not filed a required Report of Foreign Bank and Financial Accounts (FBAR) (FinCEN Form 114),
  - are not under a civil examination or a criminal investigation by the IRS, and
  - have not already been contacted by the IRS about the delinquent FBARs
- Supersedes old FAQ 17

Hypothetical 1 (Time Permitting)

- Taxpayer established a numbered Swiss bank account in 2005, funding it with $5,000,000. Since that time, the account has earned interest and dividends, but Taxpayer has never reported the existence of the account or any associated earnings to the IRS. Taxpayer has filed tax returns for every year, but checked "no" on box 7a of Schedule B of his Form 1040s.

- What exposure does Taxpayer face?

- What options does Taxpayer have?

Hypothetical 2 (Time Permitting)

- Taxpayer inherited a foreign financial account containing over $500,000 in 2010. The account has had significant earnings each year since. Taxpayer did not become aware that she had inherited the account until this year. Taxpayer's failure to report the account was <u>not</u> willful.

Hypothetical 3 (time permitting)

- Taxpayer is the Power of Attorney for his aging mother. His mother, who is a foreign person, has an account in a foreign country that Taxpayer has signature authority over, but no financial interest in. Taxpayer has never exercised any rights over the account and has never reported the account.

Hypothetical 4 (time permitting)

- Taxpayer established a trust domiciled in the Isle of Man. The trust has a foreign bank account with over $10,000. Through a letter of wishes and informal agreements, Taxpayer had the effective ability to cause disbursements of funds, which could have been made to U.S. persons. Taxpayer has never reported the account or any earnings from the account.

DISCLAIMER

The information included in these slides is for discussion purposes only and should not be relied on without seeking individual legal advice.

Estate & Gift Tax Treaties

November 12-13, 2015

Prepared and Presented by

John R. Strohmeyer

Crady, Jewett & McCulley, LLP
2727 Allen Parkway, 17th Floor
Houston, Texas 77019
(713) 739-7007 telephone
(713) 739-8403 facsimile
jstrohmeyer@cjmlaw.com

U.S. Income Tax Treaties

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- Partnerships
- International Businesses
- Small Businesses & Self-Employed

International Businesses Topics

- Individual Taxpayer
- Income Tax Treaties
- KYC Rules
- **International Businesses Home**

United States Income Tax Treaties - A to Z

The United States has tax treaties with a number of foreign countries. Under these treaties, residents (not necessarily citizens) of foreign countries are taxed at a reduced rate, or are exempt from U.S. taxes on certain items of income they receive from sources within the United States. These reduced rates and exemptions vary among countries and specific items of income. Under these same treaties, residents or citizens of the United States are taxed at a reduced rate, or are exempt from foreign taxes, on certain items of income they receive from sources within foreign countries. Most income tax treaties contain what is known as a "saving clause" which prevents a citizen or resident of the United States from using the provisions of a tax treaty in order to avoid taxation of U.S. source income.

If the treaty does not cover a particular kind of income, or if there is no treaty between your country and the United States, you must pay tax on the income in the same way and at the same rates shown in the instructions for the applicable U.S. tax return.

Many of the individual states of the United States tax income which is sourced in their states. Therefore, you should consult the tax authorities of the state from which you derive income to find out whether any state tax applies to any of your income. Some states of the United States do not honor the provisions of tax treaties.

This page provides links to tax treaties between the United States and particular countries. For further information on tax treaties refer also to the Treasury Department's Tax Treaty Documents page.

-

A

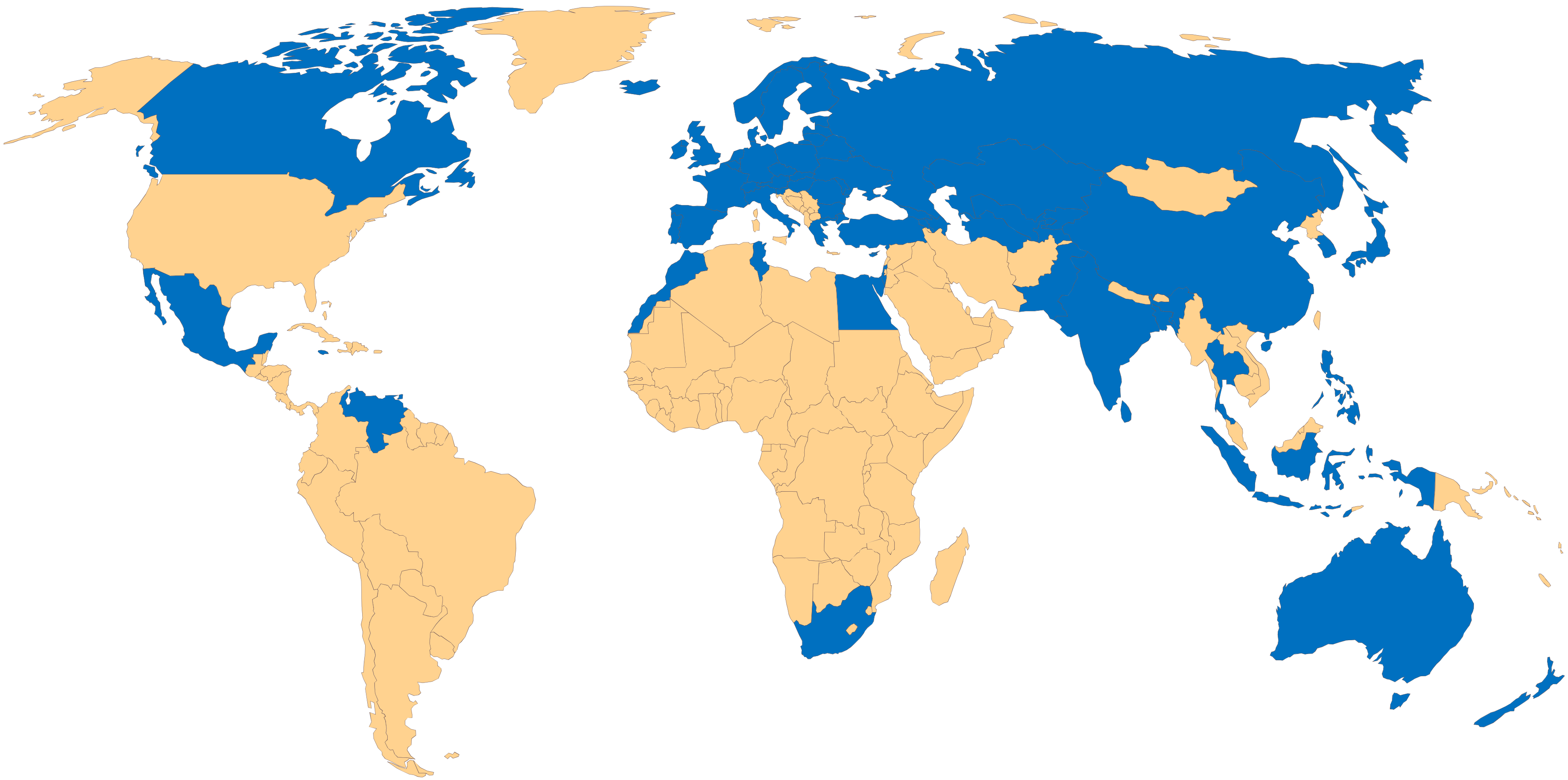
Armenia
Australia
Austria
Azerbaijan

B

Bangladesh
Barbados
Belarus
Belgium
Bulgaria

Available at http://ow.ly/TGSdp

U.S. Income Tax Treaty Partners



U.S. Estate & Gift Tax Treaties

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- International Businesses
- Small Businesses & Self-Employed

Small Business/Self-Employed

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- A-Z Index for Business
- Forms & Pubs
- Starting a Business
- Deducting Expenses
- Businesses with Employees
- Filing/Paying Taxes
- Post-Filing Issues
- Closing Your Business

Estate & Gift Tax Treaties (International)

Country	Separate Estate	Separate Gift	Combined E & G	Other	Signed	Transfers made on or after:	Comments	
Australia	No	Yes	No	No	5305	12/14/53		PR-UC
Australia	Yes	No	No	No	5305	01/07/54	old *	PR-UC
Austria	No	No	Yes	No	8206	07/01/83	new *	
Belgium	Yes	No	No	No	5405	not yet	old	no effect
Canada	No	No	No	1995 Protocol	9503	11/09/95 **	estate tax only	PR-UC
Denmark	No	No	Yes	No	8304	11/07/84	new	
Finland	Yes	No	No	No	5203	12/18/52	old	PR-UC
France	No	No	Yes	No	7811	10/01/80	new	PR-UC (Protocol)
Germany	No	No	Yes	No	8012	01/01/79	new	PR-UC (Protocol)
Greece	Yes	No	No	No	5002	12/30/53	old	PR-UC
Ireland	Yes	No	No	No	4909	12/20/51	old	
Italy	Yes	No	No	No	5503	10/26/56	old	PR-UC
Japan	No	No	Yes	No	5404	04/01/55	old	PR-UC
Netherlands	Yes	No	No	No	6907	02/03/71	new	
Norway	Yes	No	No	No	4906	12/11/51	old	PR-UC
South Africa	Yes	No	No	No	4704	07/15/52	old	
Sweden	No	No	Yes	No	8306	09/05/84 (through 12/31/07)	new (terminated 01/01/08)	
Switzerland	Yes	No	No	No	5107	09/17/52	old	PR-UC
U.K.	No	No	Yes	No	7810	11/11/79	new	

* old or new refers to whether the treaty has the "old" situs rules, or the "new" provisions that generally restrict the U.S. to taxing nonresident aliens' U.S. real estate and business property.

** the 1995 Protocol had retroactive effect to TAMRA. Claims for refund based upon the treaty had to be filed by 11/09/96.

"**PR-UC**" in comments section above refers to a pro-rata unified credit provision. (The pro-rata unified credit provisions in the German and French treaties apply only to estate tax, not to gift tax.)

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Page Last Reviewed or Updated: 02-Jun-2015

Related Topics

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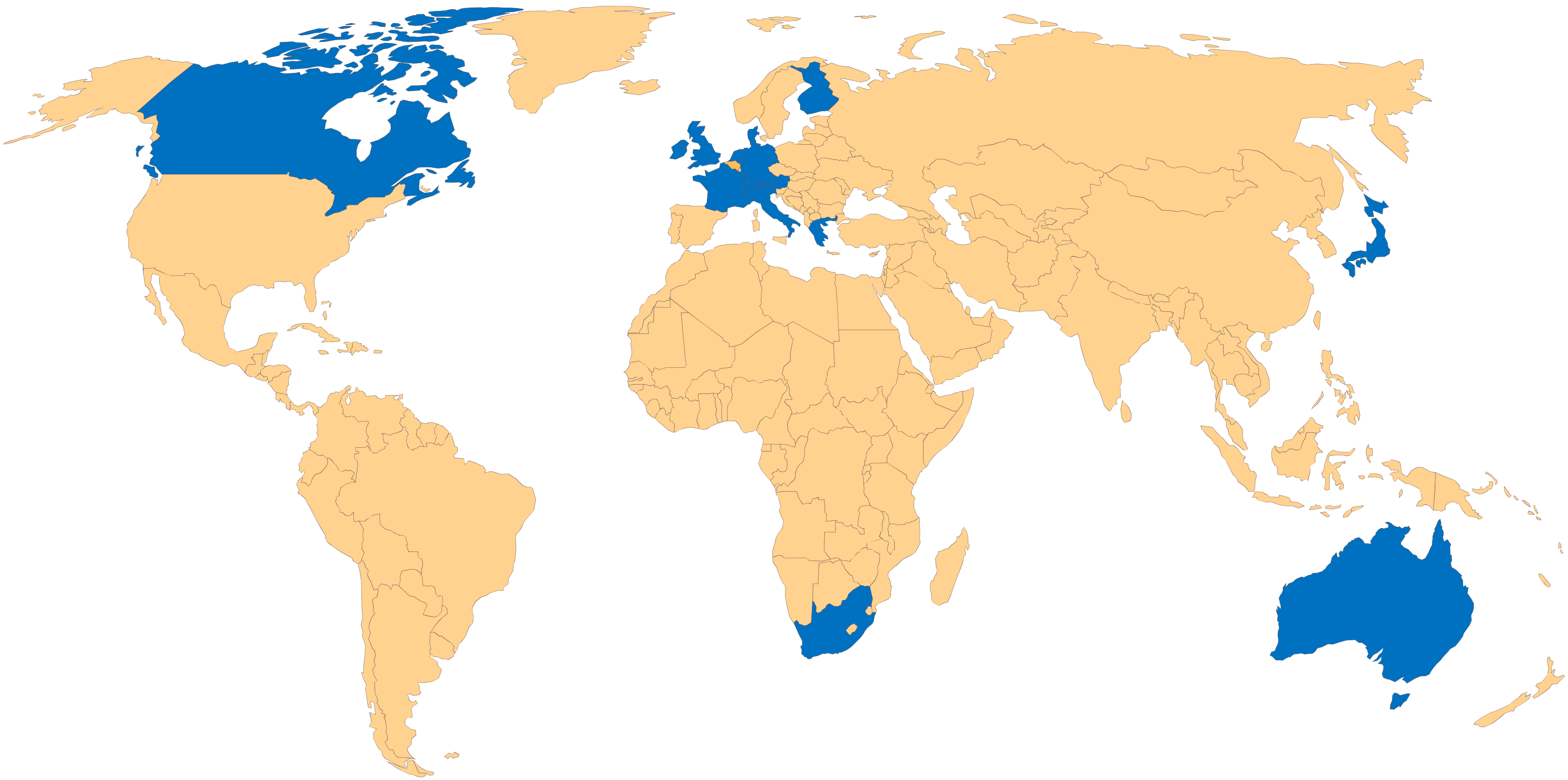
U.S. Estate & Gift Tax Treaty Partners



Transfer Tax Residents

- Transfer Taxes are imposed on U.S. citizens and residents
  - Residents are those who are domiciled and primarily residing in the U.S.A. with no definite present intention of leaving, regardless of the time actually present. Treas. Reg. §§ 20.0-1(b), 25.2501-1(b).
  - Not a bright-line rule like Substantial Presence, but a facts and circumstances test
- All others are considered a "nonresident not a citizen of the United States"

U.S. Transfer Taxation of Nonresidents

- Estate Tax applied to property located in the U.S.A.
  - Stock in U.S. corporations (whether or not publicly traded)
  - Real property
  - Tangible property in the U.S.A. (e.g., cash in a safe deposit box)
  - Uncertain treatment of foreign partnership interests
  - Revocable trusts or trusts
- $60,000 estate-tax exemption
- Nonrecourse debt on U.S. property results in only net value included in U.S. estate

U.S. Transfer Taxation of Nonresidents

- Unlimited marital deduction is available for assets left to U.S.-citizen spouses.
  - A “QDOT” can be established for non-citizen spouses
- Charitable deduction and deduction for estate administration expenses
  - Ratio of U.S. assets to worldwide assets
- Donees take stepped-up basis in transferred property

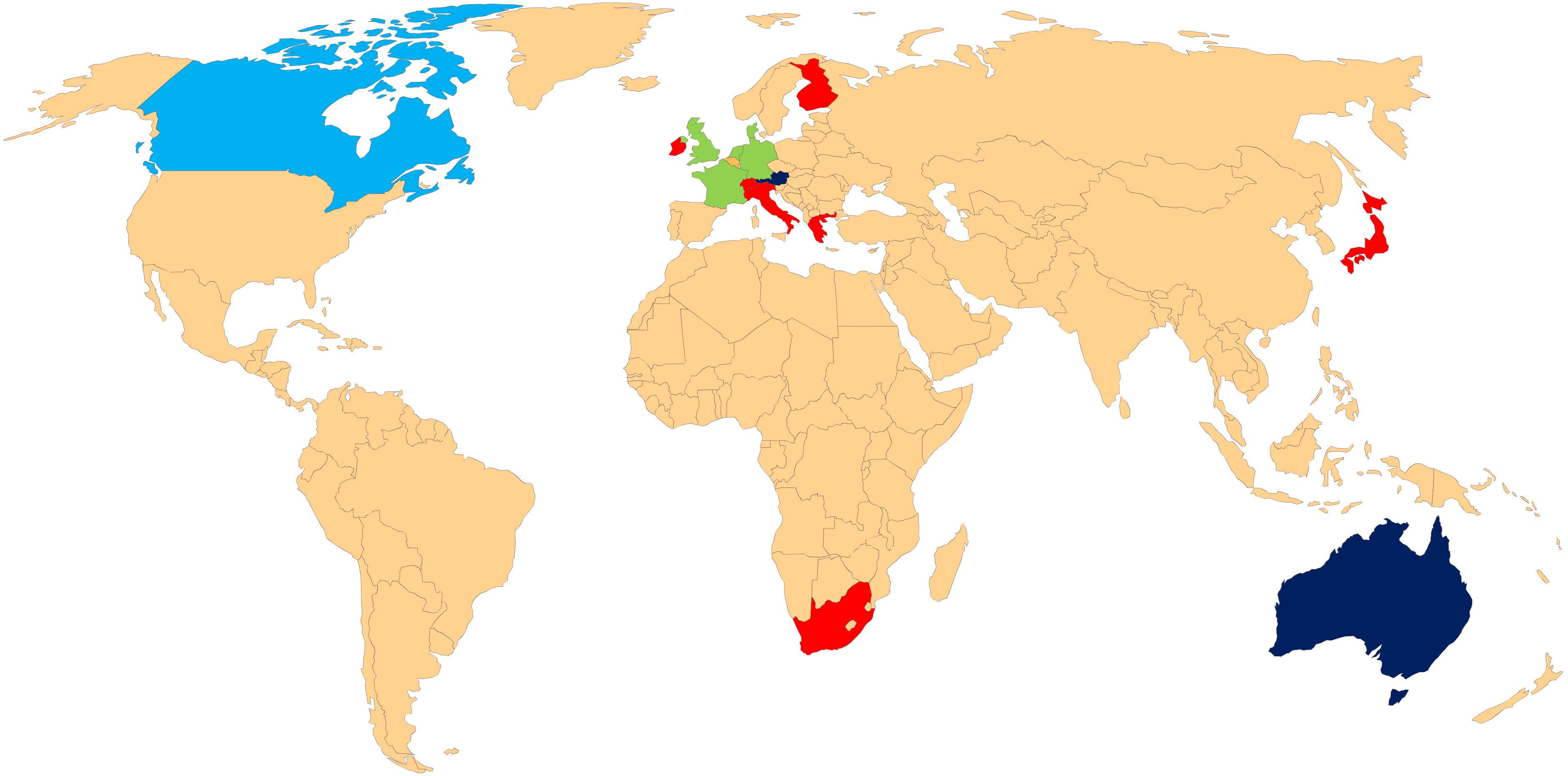
U.S. Transfer Taxation of Nonresidents

- Gift Tax
  - No lifetime exemption
  - $14,000 Annual Exclusion for gifts to non-spouses
  - $147,000 Annual Exclusion for gifts to non-citizen spouses
  - Unlimited marital deduction for gifts to citizen spouses
  - Unlimited exclusions for educational and medical payments
  - Donees take a carryover basis in transferred property
- The GST Tax applies if the Estate & Gift Taxes apply
  - $1,000,000 GST exemption(?)—Treas. Reg. § 26.2632-1(a).

Estate & Gift Tax Treaties

- 8 Situs-Type Treaties
  - Allocation taxation of assets to jurisdictions based on the situs of the assets
  - Estate tax treaties with Australia, Finland, Greece, Ireland, Italy, Japan, South Africa, & Switzerland
- 7 Domicile-Type Treaties
  - Allocate taxation of assets to jurisdictions based on the domicile of the taxpayer
  - Estate tax treaties with Austria, Denmark, France, Germany, Netherlands, & the United Kingdom
  - 1995 Protocol Amending United States-Canada Income Tax Treaty

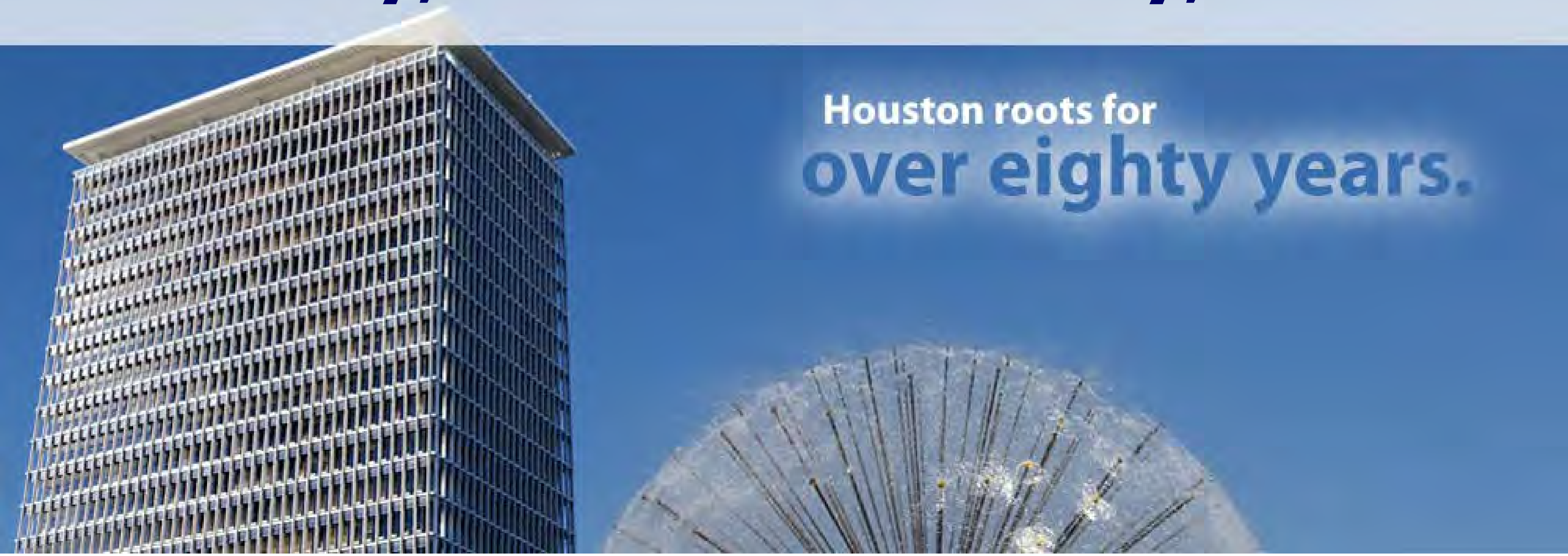
U.S. Estate & Gift Tax Treaty Partners



Comparison

- Mexico—Default rules, no treaty, no tax
- Belgium—No treaty, 30% inheritance tax
- Japan—Situs-Type Treaty, 55% inheritance tax
- Blackacre—Model Treaty
- Canada—Domicile-Type Treaty, 50% capital gains tax on unrealized gains
- France—Domicile-Type Treaty, 45% inheritance tax
- United Kingdom—Domicile-Type Treaty, 40% inheritance tax

Crady, Jewett & McCulley, LLP



Crady, Jewett & McCulley, LLP
2727 Allen Parkway, Suite 1700
Houston, Texas 77019-2125
(713) 739-7007 telephone
(713) 739-8403 facsimile

Tax Disclosure: Please note that this outline was written for the 33rd Annual Advanced Tax Law Course held October 29-30, 2015 and any statement in this outline (including attachments) is not written or intended to be used, and cannot be used, for the purpose of (i) avoiding tax penalties, or (ii) promoting, marketing, or recommending to another person the tax treatment of any transaction or matter. Any recipient should seek advice based on the recipient's particular circumstances from an independent tax advisor.

Mailed 10/30/15

TAX SECTION
State Bar of Texas

October 30, 2015

By First Class Mail

Honorable Michael B. Thornton
Chief Judge
United States Tax Court
400 Second Street, N.W.
Washington, D.C. 20217

RE: Comments on United States Tax Court's Rules of Practice and Procedure

Dear Chief Judge Thornton:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the Court's invitation for comments, concerns and proposals regarding its Rules of Practice and Procedure.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE 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 TAX SECTION, 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 TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL

MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We thank the Court for inviting comments regarding its rules and procedures, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Alyson Outenreath

Alyson Outenreath, Chair
State Bar of Texas, Tax Section

cc: The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

COMMENTS ON UNITED STATES TAX COURT'S
RULES OF PRACTICE AND PROCEDURE

These comments on the United States Tax Court's ("Court's") Rules of Practice and Procedure ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Richard L. Hunn, who is Chair of the Tax Controversy Committee of the Tax Section of the State Bar of Texas. Juan F. Vasquez, Jr., who is Chair of the Pro Bono Committee of the Tax Section of the State Bar of Texas, also drafted substantive portions of these Comments. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Henry Talavera, Jeff Blair, and Jason Freeman reviewed these Comments and made substantive suggestions on behalf of COGS. Michael A. Villa, Jr. also substantively reviewed these Comments.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:

Richard L. Hunn
richard.hunn@nortonrosefulbright.com
(713) 651-5293
Norton Rose Fulbright US LLP
1301 McKinney, Suite 5100
Houston, TX 77010-3095

Date: October 30, 2015

These comments are provided in response to the Court's invitation for comments, concerns and proposals regarding the Court's Rules of Practice and Procedure. The Tax Section thanks the Court for its efforts to improve and modernize its rules and procedures and for the opportunity to provide input in that process.

Most of the Tax Section's comments relate, and are in response, to proposals made by the Internal Revenue Service Office of Chief Counsel in its letter addressed to the Court on September 11, 2015 (individually, "Chief Counsel's Proposal" and collectively "Chief Counsel's Proposals"). We largely agree with Chief Counsel's Proposals and believe that they represent constructive recommendations to improve the Court's rules and procedures. However, there are certain areas where our views respectfully differ from those of Chief Counsel, and we have provided our perspective and comments on those areas below. In addition, we have provided the following suggestions regarding the Court's rules and procedures:

1. We recommend that the Court amend Rule 110(b) to explicitly provide that the Court may schedule a pretrial conference to require the return of subpoenas *duces tecum* directed to third-party record custodians.
2. Where a petitioner files a petition with this Court that inadvertently fails to include a notice of deficiency or notice of determination, rather than issuing an order, as Chief Counsel proposes, that directs the petitioner to correct the deficiency or face dismissal, we recommend that the Court adopt a procedure whereby the Commissioner determines whether such a notice has been issued and attaches it to the Commissioner's answer or response or otherwise asserts that no such notice has been issued.
3. We respectfully disagree with Chief Counsel's recommendation that Rule 74 be amended to allow nonconsensual depositions of party witnesses upon notice to the party without requiring leave of the Court by motion.
4. We recommend that the Court's Standing Pretrial Order be revised to clarify that a certificate of service is not required when the document in question is filed electronically with the Court and the opposing party has consented to receive electronic service from the Court.
5. Finally, we support a requirement that the Commissioner's answer (or a form cover letter accompanying it) provide the contact information of the Chief Counsel attorney responsible for the case, and the time frame within which the petitioner will be contacted by an Appeals or Settlement Officer. However, we respectfully disagree with Chief Counsel's recommendation to permit a general denial.

<u>Chief Counsel's Proposal Regarding Subpoenas</u>

Chief Counsel expressed concern that litigants encounter difficulty obtaining documents from third-party custodians of records in a timely fashion, because trial subpoenas are made returnable at the call of the calendar for the trial session on which a case has been calendared. Chief Counsel states that third-party custodians of records such as financial institutions often will not produce documents subject to a subpoena *duces tecum* until the return date. According to

Chief Counsel, this hinders the parties' ability to adequately examine the documents and prepare for trial, as well as to stipulate to or authenticate documents. In our experience, however, third-party custodians of records routinely comply with subpoenas *duces tecum* in advance of trial so that they can avoid appearing at trial.

Chief Counsel advances several alternative proposals to address this issue. One such proposal is far preferable to the others. Specifically, we agree with Chief Counsel's proposal to amend Rule 110(b) to expressly authorize the Court to require a third-party custodian of records to return a subpoena *duces tecum* at a pretrial conference. We agree with Chief Counsel that the Court has, on rare occasions, scheduled a pretrial conference to allow for the return of a subpoena *duces tecum* directed to a third party. We respectfully suggest that it would be helpful to amend Rule 110(b) to explicitly provide that the Court may schedule a pretrial conference to require the return of a subpoena *duces tecum* directed to a third-party custodian.

We suggest that Chief Counsel's alternative proposals, however, would likely be problematic for practitioners and could potentially lead to abuses by parties before the Court. Chief Counsel proposes amending Rule 147 to generally allow for the return of subpoenas *duces tecum* addressed to third-party custodians of records in advance of trial.[1] In effect, this proposal would allow parties to proceed with such subpoenas without the Court's prior knowledge and supervision. This could result in litigants abusing the process, necessitating the Court's intervention perhaps through a motion to quash.

While Fed. R. Civ. P. 45 allows a party in federal district court to serve document subpoenas on third parties that are returnable before trial without prior involvement of the court, that approach would not be effective or efficient for litigation in Tax Court. While the Tax Court has nationwide subpoena power, the Court does not sit continually in every part of the country. The Court would thus face difficulty administering Chief Counsel's proposal. As a result, we recommend that the Court amend Rule 110(b), as discussed above, to provide for the return of such subpoenas at a pretrial conference at a time and place determined by the Court to be practicable and appropriate.

Chief Counsel also proposes amending Rules 74 and 147(d) to provide a procedure for streamlined, nonconsensual depositions of third-party custodians of records. Under this proposed procedure, the party seeking the deposition would be presumed to have satisfied the requirement that the documents cannot be obtained through other methods of discovery, and the burden to quash the subpoena would be placed on the objecting party. However, the fact that a party is pursuing a nonconsensual deposition implies that the opposing party will not consent to a deposition. In our experience, parties routinely stipulate to consensual depositions of third-party

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[1] Chief Counsel also suggests that the Court could consider scheduling hearings, including via the Electronic Courtroom, to allow for the return of subpoenas at least 30 days prior to trial. As noted above, we recommend that this issue be addressed by an amendment to Rule 110(b) expressly allowing the Court to schedule pretrial conferences for purposes of return of subpoenas *duces tecum* directed to third-party custodians, rather than pursuant to a more general amendment to Rule 147.

custodians of records. In those instances where a party seeks a nonconsensual deposition, it is typically because the other party has reasons to object. A procedure that presumptively overrides those objections would contravene the Tax Court's established practice of requiring the parties to cooperate through informal means of discovery before resorting to more formal methods of discovery.[2]

Chief Counsel's Proposal Regarding Imperfect Petitions: Filing Fee, Signature, and Attached Notice

Chief Counsel recommends that when petitions are filed that (i) are not signed, (ii) lack an attached notice of deficiency or notice of determination, or (iii) otherwise do not comply with the Court's rules concerning the content of a petition, the Court should issue an order directing the petitioner to correct the defect or face dismissal. Chief Counsel further recommends that the Commissioner should not be required to file an answer or otherwise respond to the petition until the order has been satisfied or discharged.

We respectfully disagree with these recommendations to the extent that they would result in the dismissal of a case for failure to attach a notice of deficiency or notice of determination to the petition. Such circumstances invariably involve *pro se* petitioners who are often unsophisticated and may not understand the difference between one type of notice or another, or who may fail to retain a copy of the pertinent notice. We suggest that it would be unfair to dismiss a petition for failure to attach a notice of deficiency or notice of determination—particularly petitions filed by *pro se* petitioners—when the Commissioner can readily search his records under the taxpayer's name and taxpayer identification number to determine if there is a notice of deficiency or notice of determination. We instead suggest that the Commissioner, after determining whether such a notice exists, attach it to the Commissioner's answer or response or otherwise assert that there is no such notice.

Deposition of Party Witnesses

We respectfully disagree with Chief Counsel's recommendation that Rule 74 be amended to allow nonconsensual depositions of party witnesses upon notice to the party without requiring leave of the Court by motion. As Chief Counsel correctly acknowledges, under the current version of Rule 74, the Court considers the deposition of a party witness to be an extraordinary method of discovery that is only available when other means of gathering information fail, and that requires either consent of the parties or leave of the Court. Chief Counsel correctly acknowledges that this may be the result of the Court's policy to encourage the informal exchange of information.[3] Chief Counsel further correctly notes that this may also be in recognition of the extensive fact gathering available during the examination stage.

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[2] *See e.g.,* T.C. Rule 70(a)(1); *Branerton Corp. v. Comm'r*, 61 T.C. 691 (1974); *Odend'hal v. Comm'r*, 75 T.C. 400 (1980).

[3] *See* T.C. Rule 70(a)(1); *Branerton Corp. v. Comm'r*, 61 T.C. 691 (1974).

Chief Counsel justifies the proposed expansion of nonconsensual party depositions on grounds that the current rules may hinder trial preparation in some large, complex and extremely factual cases, such as transfer pricing cases, where the petitioner may attempt to restrict even informal access to significant fact witnesses. However, this justification overlooks the Commissioner's substantial powers during the examination stage, including the Commissioner's ability to issue administrative summonses and to enforce them in court. Indeed, the Commissioner is even permitted to utilize information obtained by administrative summonses issued after the examination has concluded, so long as they are issued before a petition is filed with this Court.[4] The Commissioner's justification also gives little weight to the formal discovery procedures—interrogatories, requests for production, and requests for admission—that are available after the case is docketed with the Court.

Our primary concern, however, with the proposed expansion of nonconsensual depositions of party witnesses is that it would, in effect, be an entirely one-sided grant of authority. Because the Court generally will not look behind a notice of deficiency,[5] the petitioner will rarely be able to depose the Commissioner's witnesses. Hence, this proposed rule change would almost always give the Commissioner the power to obtain nonconsensual depositions of party witnesses of the petitioner, but the petitioner would almost never have the power to obtain nonconsensual depositions of the Commissioner's witnesses.

Standing Pretrial Order

When a case is calendared on a trial session, the current version of the Court's Standing Pretrial Order provides as follows:

> It is ORDERED that every pleading, motion, letter, or other document (with the exception of the petition and the posttrial briefs, see Rule 151(c)) submitted to the Court shall contain a certificate of service as specified in Rule 21(b), which shows that the party has given a copy of that pleading, motion, letter or other document to all other parties.

This provision seems to contradict Rule 21(b)(5), which allows a party to effectuate service pursuant to the electronic service procedures prescribed by the Court. Those procedures expressly provide that if the other party has consented to receive electronic service from the Court, the party filing electronically is not required to include a certificate of service. This provision of the Court's Standing Pretrial Order, read literally, would nevertheless appear to require a party filing electronically to include a certificate of service when the other party has consented to receive service electronically from the Court. We recommend that the Standing Pretrial Order be revised to clarify that a certificate of service is not required when the document

[4] *See Ash v. Commissioner*, 96 T.C. 459 (1991).

[5] *See Greenberg's Express, Inc. v. Commissioner*, 62 T.C. 324, 327-328 (1974).

in question is being filed electronically with the Court and the opposing party has consented to receive electronic service from the Court.

<u>Answers in Small Tax Cases</u>

Chief Counsel proposes several changes to Rule 173 regarding answers in small tax cases. These include allowing the Service to file an answer that consists of: (1) a general denial of the allegations in the petition; (2) contact information of the Chief Counsel attorney responsible for the case; and (3) the time frame within which the petitioner will be contacted by an Appeals or Settlement Officer. The stated purpose of these changes is to reduce confusion that the current answer practice creates for a significant percentage of *pro se* taxpayers.

We share Chief Counsel's goal of minimizing confusion for *pro se* taxpayers. We are a proud participant in the Tax Court's calendar call program, and our volunteer attorneys and Chief Counsel have worked closely to make the calendar call program a success in Texas and to maximize the extent to which *pro se* taxpayers understand the judicial review process. Our experience in the program has also given us insight into which procedural improvements may help (and which may not) with the continuing effort to demystify the judicial process for unrepresented taxpayers. Based on this experience, we fully support a requirement that the answer (or a form cover letter accompanying it) provide the contact information of the Chief Counsel attorney responsible for the case and the time frame within which the petitioner will be contacted by an Appeals or Settlement Officer.

However, we respectfully disagree with Chief Counsel's recommendation to permit a general denial. Rather, we recommend that the administrative file be consulted to the greatest extent time permits and that as much information as possible be provided in the answer, including perceived documentation or substantiation deficiencies in a *pro se* taxpayer's case. In addition, we recommend that the Service accompany the filing of its answer with a statement that clarifies that the answer filed by the Service is not a ruling by the Court on the taxpayer's petition and represents only the view of the Service, who is not the decision-maker in the proceedings. Many *pro se* taxpayers may already be confused about the relationship between the Service and the Tax Court, and receiving an answer may lead certain *pro se* taxpayers to believe that their case has been decided against them. We believe a clear statement such as the one suggested here should minimize such confusion.

TAX SECTION
State Bar of Texas

November 6, 2015

Via email to Notice.Comments@irscounsel.treas.gov

Internal Revenue Service
Attn: CC:PA:LPD:PR
(Notice 2015-72)
Room 5203
P.O. Box 7602
Ben Franklin Station
Washington, D.C. 20044

RE: Comments on IRS Notice 2015-72 Regarding Proposed Revenue Procedure to Update Rev. Proc. 87-24

Dear Sirs:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Internal Revenue Service in Notice 2015-72 for comments on the proposed revenue procedure which would update Rev. Proc. 87-24, 1987-1 C.B. 720, regarding practices for the administrative appeals process in cases docketed in the United States Tax Court.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE 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 TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

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THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Internal Revenue Service for the time and thought that has been put into preparing the proposed revenue procedure included in IRS Notice 2015-72, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Alyson Outenreath

Alyson Outenreath, Chair
State Bar of Texas, Tax Section

COMMENTS ON IRS NOTICE 2015-72 REGARDING PROPOSED REVENUE PROCEDURE UPDATING REV. PROC. 87-24

These comments on the proposed revenue procedure ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Richard L. Hunn, Chair of the Tax Controversy Committee. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Mary McNulty reviewed the Comments and made substantive suggestions on behalf of COGS. Robert D. Probasco, Co-Chair of COGS, also reviewed these Comments.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:

Richard L. Hunn
richard.hunn@nortonrosefulbright.com
(713) 651-5293
Norton Rose Fulbright US LLP
1301 McKinney, Suite 5100
Houston, TX 77010-3095

Date: November 6, 2015

These Comments are provided in response to the Internal Revenue Service's (the "IRS") request in Notice 2015-72 for comments on a proposed revenue procedure (the "Proposed Revenue Procedure") that would update Rev. Proc. 87-24, 1987-1 C.B. 720, regarding practices for the administrative appeals process in cases docketed in the United States Tax Court (the "Tax Court"). The Tax Section thanks the Internal Revenue Service for the opportunity to provide input in this process. We largely agree with the proposals contained in the Proposed Revenue Procedure and believe that they represent constructive recommendations to improve the Internal Revenue Service's procedures for handling administrative appeals of cases docketed in the Tax Court. However, there are certain areas where we recommend some changes to the proposed procedures, and we have provided our perspective and comments on those areas below.

Cases in Which the Notice of Deficiency Was Issued by Appeals

In those cases in which the notice of deficiency was issued by the IRS Office of Appeals ("Appeals"), we recommend that the language in section 2.01 of Rev. Proc. 87-24 which gives the IRS Office of Chief Counsel ("Counsel") the discretion to refer the case to Appeals also be included in the Proposed Revenue Procedure. This could be accomplished by adding that language, with some minor modifications, to the end of section 3.02 of the Proposed Revenue Procedure, as follows:

> In other cases in which Appeals issued the statutory notice of deficiency or made the determination, Counsel in its discretion may refer the case to Appeals unless Counsel determines that there is little likelihood that a settlement of all or a part of the case can be achieved in a reasonable period of time.

This sentence would allow for other circumstances in which Counsel believes that a referral to Appeals would be beneficial. This could benefit the overall process by allowing for circumstances where a referral could conserve the parties' resources and result in a settlement.

Time Limits for Appeals' Jurisdiction Over Cases

For small tax cases (under I.R.C. § 7463), section 3.07 the Proposed Revenue Procedure would require Appeals to return the case to Counsel six months after the case is received by Appeals, or earlier, if necessary so that it is received by Counsel no later than three weeks prior to the date of the calendar call. This is similar to the procedure in section 2.03 of Rev. Proc. 87-24, which applies to "S" cases (i.e., small tax cases) or cases involving deficiencies of $10,000 or less, and requires Appeals to return cases to Counsel after six months, or, if earlier, one month before calendar call for a regular case or 15 days before calendar call for an "S" case.

In our experience, the six-month time limit has not been followed in practice, and the vast majority of small tax cases are settled by Appeals well after they have appeared on a trial calendar. We recommend that the six-month time limit be deleted and that Appeals simply be required to return small tax cases to Counsel no later than three weeks prior to the date of the calendar call or earlier, as provided in Section 3.14 of the Proposed Revenue Procedure, if

Counsel requests that Appeals return the case (including settlement authority) to Counsel because needed for trial preparation.

For cases other than small tax cases, section 3.07 of the Proposed Revenue Procedure would require Appeals to return the case to Counsel when Appeals concludes that the case is not susceptible to settlement or within 10 days after the case appears on a trial calendar, whichever is sooner. This is analogous to section 2.02 of Rev. Proc. 87-24, which requires Appeals to return cases involving deficiencies of $10,000 or more when no progress toward settlement is made or when the case appears on a trial calendar.

In our experience, most such cases in practice remain under Appeals consideration (i.e., per an extension of time for Appeals consideration as agreed with Counsel) and are settled well after the case appears on a trial calendar. In comments submitted on September 11, 2015, by Counsel to the Tax Court regarding its Rules of Practice and Procedure, Counsel recommended that notification of the placement of cases on a trial calendar be provided to the parties one month earlier, so that the notification is provided a full six months prior to the calendar call. (In our comments to the Tax Court, we agreed with that proposal.) We believe the Tax Court's adoption of such a proposal would allow for a one-month period of time after a case has been placed on a trial calendar for Appeals to settle the case before trial deadlines become imminent, and without Appeals having to arrange for an extension of time from Counsel. In the event the Tax Court adopts that proposal, we recommend that section 3.07 of the Proposed Revenue Procedure be modified to provide that in cases other than small tax cases Appeals be required to return the case when Appeals concludes that the case is not susceptible to settlement or within one month after the case appears on a trial calendar, whichever is sooner.

Section 3.07 provides that in all cases Counsel and Appeals may agree to extend the time for Appeals to consider a case if settlement appears reasonably likely. We agree with that provision.

Conclusion

We appreciate the opportunity to comment on the Proposed Revenue Procedure and to be a part of the IRS's efforts to update its procedures regarding administrative appeals of cases docketed in the Tax Court.

TAX SECTION
State Bar of Texas

December 3, 2015

CC:PA:LPD:PR (REG-103033-11)
Room 5205
Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

RE: Comments on Proposed Regulations Regarding Amount of Penalty Under Section 6707A
IRS REG-103033-11

Dear Sirs:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Treasury Department and the Internal Revenue Service in the Notice of Proposed Rulemaking (REG-103033-11) issued on August 28, 2015. The proposed regulations provide guidance regarding the amount of the penalty under Internal Revenue Code section 6707A for a taxpayer's failure to disclose required information with respect to a reportable transaction.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE 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 TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS

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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 TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Treasury Department and the Internal Revenue Service for the time and thought that has been put into preparing the proposed regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Alyson Outenreath

Alyson Outenreath, Chair
State Bar of Texas, Tax Section

cc: The Honorable Mark J. Mazur
Assistant Secretary for Tax Policy
United States Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, D.C. 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW, Ste 3026
Washington, DC 20224

The Honorable Emily S. McMahon
Deputy Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

COMMENTS ON PROPOSED REGULATIONS
UNDER SECTION 6707A

These comments on the proposed regulations under Internal Revenue Code section 6707A ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Richard L. Hunn, Chair of the Tax Controversy Committee. Professor Bruce McGovern, Vice Chair of the General Tax Issues Committee, reviewed these Comments and provided substantive suggestions. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Joel Crouch reviewed the Comments and made substantive suggestions on behalf of COGS. Robert Probasco, Co-Chair of COGS, also reviewed these Comments and provided substantive suggestions. Jason Freeman, Vice Chair of COGS, also reviewed these Comments.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:

Richard L. Hunn
richard.hunn@nortonrosefulbright.com
(713) 651-5293
Norton Rose Fulbright US LLP
1301 McKinney, Suite 5100
Houston, TX 77010-3095

Date: December 3, 2015

These comments are provided in response to the request of the Treasury Department ("Treasury") and the Internal Revenue Service (the "Service") in their Notice of Proposed Rulemaking in REG-103033-11, 2015-37 I.R.B. 325, for comments on proposed regulations (the "Proposed Regulations"). The Proposed Regulations provide guidance regarding the penalty under Internal Revenue Code ("Code") section 6707A for failure to include on any return or statement any information required to be disclosed under Code section 6011 with respect to a reportable transaction. The Tax Section thanks Treasury and the Service for the opportunity to provide input on the Proposed Regulations. While we largely agree with the Proposed Regulations and believe that they clarify the penalty under Code section 6707A, as amended by the Small Business Jobs Act of 2010, we suggest that the Service consider changes as follows:

- We respectfully suggest that the Service reconsider the definition in subsection (d)(1)(i)(B) of the Proposed Regulations in terms of whether it lies within the scope of the underlying statute. If the Service decides to retain that definition, we suggest that the Service explicitly explain, in its promulgation of final regulations, why it believes this definition is consistent with the underlying statute.
- We respectfully suggest that the Service consider amending section 301.6707A-1(d)(3) of the Regulations to add an additional factor that the Service will consider in deciding whether to rescind a Code section 6707A penalty: the fact that a taxpayer timely filed an amended return that removed the tax benefits of the reportable transaction, even if the required disclosures were not filed.

The 75-Percent Penalty With Respect to Tax Resulting from Participation in the Transaction

We believe that it is not clear whether subsection (d)(1)(i)(B) of the Proposed Regulations, which describes the amount of tax upon which the penalty is imposed, falls within the definition in the underlying statute. Subsection (d)(1)(i) provides, in pertinent part, as follows:

> *(d) Calculation of the penalty. (1) Decrease in tax—(i) In general.* As used in this section, the phrase "decrease in tax shown on the return as a result of the transaction or the decrease that would have resulted from the transaction if it were respected for Federal tax purposes" means the sum of (A) the excess of the amount of the tax that would be shown on the return if the return did not reflect the taxpayer's participation in the reportable transaction over the tax actually reported on the return reflecting participation in the reportable transaction and (B) any other tax that results from participation in the reportable transaction but was not reported on the taxpayer's return.

Code section 6707A(b)(1), the statutory basis for this provision of the Proposed Regulations, provides that "the amount of the penalty . . . with respect to any reportable transaction shall be 75 percent of the decrease in tax shown on the return as a result of such transaction (or which would have resulted from such transaction if such transaction were respected for Federal tax purposes)." This statutory language provides for a penalty equal to 75 percent of the *decrease in tax* shown on the return as a result of the transaction; it does not refer to a penalty upon failure to include an *increase* in tax that arguably would result from the transaction.

The parenthetical language in Code section 6707A(b)(1) appears to encompass situations where the Service contends that the transaction should not simply be disregarded, as happens, for example, in some instances where the economic substance doctrine is applied. In some situations, the Service contends that the transaction should be respected for Federal tax purposes but disagrees with the taxpayer's interpretation of the legal effect of that transaction.

The definition in subsection (d)(1)(i)(B) of the Proposed Regulations was apparently intended to treat a tax that should have been shown on the return, but that was not, as a "decrease in tax." While there is some surface appeal to this approach, there is a significant distinction between this definition and the definition in subsection (d)(1)(i)(A). The statute makes no reference to, and does not rely on, whether the Service's position regarding how the transaction should be reported is ultimately upheld. The Section 6707A penalty has been commonly understood as intended by Congress to apply *even if the taxpayer's reporting position is eventually determined to e correct*. This allows the Service to impose the penalty without first requiring an adjudication of the merits of the taxpayer's reporting position.

This is consistent with the definition in subsection (d)(1)(i)(A) of the Proposed Regulations, which involves a mechanical comparison of the tax liability as reported on the taxpayer's return (reflecting participation in the transaction) to the tax liability that would be shown on the return if the transaction were not respected for Federal tax purposes. This definition does not address the validity of the taxpayer's reporting position and does not rely on that reporting position being rejected in an adjudication. The definition in subsection (d)(1)(i)(B), however, is a "decrease in tax" *only* if the taxpayer's reporting position is invalid. If the taxpayer's reporting position was determined to be correct, there would have been no basis to treat the tax not reported on the return as a "decrease." Therefore, this definition is implicitly based on an assumption that the taxpayer's reporting position is invalid. It is questionable whether Congress intended to impose a harsh penalty such as that provided by Section 6707A before an adjudication of the merits, if the application of the penalty implicitly depends on the results of such adjudication.

We respectfully suggest that the Service reconsider the definition in subsection (d)(1)(i)(B) of the Proposed Regulations. If the Service determines that it should be retained as proposed, we respectfully suggest that the Service consider explicitly explaining how that definition fits within the statutory authority. We do not suggest that the Service should always proactively address potential *Chevron* challenges to its regulations. But where there are serious questions concerning the validity of a regulation, explaining in the promulgation of the final regulation why it is a plausible interpretation of the statute may be appropriate under the "reasoned decisionmaking" standard. We suggest that may be the case here.

The Factors that Weigh in Favor of Granting Rescission

We respectfully recommend that Regulation section 301.6707A-1(d)(3) be revised to add an additional factor to the list of factors that the Service considers when determining whether to rescind a Code section 6707A penalty: the filing of a timely amended return that removes the tax benefits claimed with respect to the transaction.

In its current form, section 301.6707A-1(d)(3) of the Regulations provides that the Service will take several factors into consideration in exercising its discretion to rescind a penalty. One such factor is present when the taxpayer, upon becoming aware that it failed to disclose a reportable transaction, files a complete and proper disclosure and, if applicable, attaches it to an amended return. The Regulations, however, provide that such an amended return cannot reflect any other changes to the return that it amends. The Regulations further provide that the amended return and disclosure will weigh heavily in favor of rescission if they are filed before the Service contacts the taxpayer concerning a tax examination and the circumstances suggest that the taxpayer did not delay filing an untimely disclosure until after the IRS had taken steps to identify the taxpayer. *See* Treas. Reg. § 301.6707A-1(d)(3)(i)(A), (B).

We respectfully suggest that the Service consider amending section 301.6707A-1(d)(3) to provide that the Service will consider the fact that a taxpayer, upon becoming aware that it failed to disclose the reportable transaction, filed an amended return that removes the tax benefits of the reportable transaction—even if it does not attach a complete and proper disclosure—so long as it does so within the same time period described in section 301.6707A-1(d)(3)(i)(A) and (B) of the Regulations.

While section 301.6707A-1(d)(3) of the Regulations provides that the list of factors is not an exclusive list, we nonetheless believe that it would be helpful to explicitly add the filing of an amended return that removes the tax benefits of the transaction to the list. For instance, some taxpayers may believe that they can remedy a failure to disclose a reportable transaction by simply filing an amended return that removes the tax benefits of the transaction. They might reasonably believe that, as long as they did not claim the benefits of the transaction on their (amended) return, the required disclosure of the reportable transaction becomes moot. More importantly, the filing of a timely amended return furthers the underlying goal of promoting compliance with the applicable reporting requirements and effective tax administration. The regulations should encourage such attempts to come into compliance.

TAX SECTION
State Bar of Texas

February 5, 2016

Via email to Notice.Comments@irscounsel.treas.gov

Internal Revenue Service
CC:PA:LPD:PR
(Announcement 2015-19)
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Internal Revenue Service Announcement 2015-19

Dear Sirs and Madams:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Internal Revenue Service (the "Service") in Announcement 2015-19 for comments regarding changes to the determination letter program for individually designed plans.

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE 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 TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

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THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Service for inviting comments regarding its rules and procedures relating to the "Employee Plans determination letter program for qualified retirement plans" as described in Announcement 2015-19, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Alyson Outenreath

Alyson Outenreath, Chair
State Bar of Texas, Tax Section

COMMENTS ON CHANGES TO THE
DETERMINATION LETTER PROGRAM FOR
INDIVIDUALLY DESIGNED PLANS,
AS DESCRIBED IN ANNOUNCEMENT 2015-19

These comments regarding the Service's proposed changes to the determination letter program for individually designed plans are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafters of these comments were Sarah Fry, Vice Chair of the Committee on Employee Benefits ("CEB") of the Tax Section of the State Bar of Texas, and Henry Talavera, Co-Chair of CEB. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Robert Probasco, Co-Chair of COGS, reviewed these Comments. Russell Gully also reviewed these comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these comments have clients who would be affected by the principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

Contact Persons:

Sarah Fry
sarah.fry@lockelord.com
(214) 740-8424
Locke Lord LLP
2200 Ross Avenue, Suite 2800
Dallas, TX 75201

Henry Talavera
htalavera@polsinelli.com
(214) 661-5538
Polsinelli PC
2950 N. Harwood, Suite 2100
Dallas, TX 75201

Date: February 5, 2016

These comments are provided in response to the Service's invitation for comments regarding proposed changes to the determination letter program for individually designed plans intended to be tax-qualified ("Qualified Plans") under section 401(a) of the Internal Revenue Code of 1986, as amended (the "Code"),[1] as announced in Announcement 2015-19. The Tax Section's comments are primarily in response to the Service's request for comments concerning changes that should be made to other Service programs to facilitate the changes described in Announcement 2015-19. We appreciate the opportunity to comment on the Service's proposed changes to the determination letter program for Qualified Plans.

We are providing comments on five (5) topics that we respectfully suggest the Service consider:

1. Keeping the determination letter program in its current form to the extent possible. The determination letter program has offered the opportunity for many points of contact. Generally, we believe that broad, cordial and cooperative communication has existed between employers who sponsor Qualified Plans, along with their advisors, (collectively the "Plan Sponsors"[2]) and the Service. We respectfully suggest that this cooperative relationship may deteriorate if the determination letter program is eliminated, leading to, among other things, fewer Plan Sponsors offering Qualified Plans and Plan Sponsors terminating and liquidating the assets of existing Qualified Plans. As a result, we are concerned that the decision by the Service to eliminate the determination letter program will lead to lower assets available to many retirees upon reaching retirement age and, worst case, an overall weakening of our retirement system.

2. Assuming the Service proceeds as intended, allowing a Plan Sponsor alternatives to the determination letter process that would preserve its rights to correct a potential form and/or operational defect under a Qualified Plan through a Voluntary Correction Program ("VCP) application under the Employee Plans Compliance Resolution System ("EPCRS"), as documented in Rev. Proc. 2013-12, as modified by Rev. Proc. 2015-27 and Rev. Proc. 2015-28. Such alternatives might include permitting Plan Sponsors to: (i) make a streamlined submission to the Service, (ii) raise any potential issues on the Form 5500 submitted each year, or (iii) notify the Service of any potential disqualification issues within a reasonable period after the Service commences an audit of the Qualified Plan. If such alternatives are permitted, Plan Sponsors could raise potential defects related

[1] Except as otherwise specified, all references to "section" are references to the applicable sections of the Code.

[2] For purposes of this comment, we treat employer (and/or collectively bargained organization) sponsors of Qualified Plans, along with their corresponding accountants, brokers, administrators, attorneys, agents, third-party record-keepers, consultants and other practitioners as a single "Plan Sponsor" community. In our experience, it takes a village, along with the Service, the U.S. Department of Labor and the Pension Benefit Guaranty Corporation, to keep a Qualified Plan in compliance with the Code and other applicable law. We believe that a critical component of such compliance has been the determination letter program.

to a Qualified Plan for the Service's consideration, particularly in situations when it is not certain that a qualification error or defect has occurred, as is currently permitted as part of the determination letter process.

3. Allowing a Plan Sponsor the discretion to exclude or omit from a Qualified Plan provisions related to changes in the law that have no practical impact on the status of such Qualified Plan. For example, we would suggest that the Service not require provisions in a Qualified Plan relating to the employer-stock diversification requirement of section 401(a)(35) if such plan does not permit investment in the stock of such Plan Sponsor. Alternatively, we suggest that the Service not impose sanctions, or reduce the amount of such sanctions, in those cases.

4. Allowing a Plan Sponsor to obtain rulings on (a) affiliated service group and leased employee issues under section 414, (b) whether a partial termination has occurred, and (c) perhaps a few other selected discrimination and qualified separate line of business issues.

5. Amending the Audit Closing Agreement Program ("Audit CAP") under EPCRS to limit the extent of the review and amount of sanctions for Qualified Plans operating in reasonable, good faith compliance with the Code and applicable law. Since there will likely be fewer direct contacts between Plan Sponsors and the Service once the determination letter program is essentially eliminated as proposed, we respectfully suggest that the Service consider providing more leeway for Plan Sponsors to correct defects or errors that are not egregious or do not benefit "highly compensated employees" as determined under section 414(q) ("HCEs"). We also suggest that the reduced VCP fee for streamlined non-amender corrections should apply if a Plan Sponsor has made an amendment that is intended to comply with applicable legal requirements but is deficient for any reason.

I. WE RESPECTFULLY SUGGEST THAT THE SERVICE CONSIDER KEEPING THE DETERMINATION LETTER PROGRAM IN ITS CURRENT FORM TO THE EXTENT POSSIBLE

A. *Background*

As discussed in more detail below, we respectfully suggest that the Service consider keeping the determination letter program intact to the extent possible. We believe that the elimination of the determination letter program[3] may lead to:

[3] The determination letter program is essentially eliminated because a Qualified Plan may only request a determination letter upon initial adoption of the Qualified Plan and termination of the Qualified Plan.

(i) An increased burden for the Service and Plan Sponsors in their efforts to achieve or evidence compliance with respect to Qualified Plans;

(ii) More of an adversarial relationship between Plan Sponsors and the Service; and

(iii) More terminations and complete liquidations of Qualified Plans.

In the absence of such program, most Plan Sponsors will first learn about potential Qualified Plan defects either during a Qualified Plan audit by the Service or as part of a business/corporate transaction. Restoring the qualification of a Qualified Plan during an audit by the Service or as part a business transaction is, in our experience, typically a very expensive, confrontational and time consuming process.

A Plan Sponsor is not required to obtain a determination letter from the Service. However, many Plan Sponsors have regularly and historically (since at least 1954) filed for a determination letter, among other reasons, to make it easier to represent to their outside auditors that their Qualified Plans are compliant in form with the Code.[4] *See* Rev. Rul. 54-172, 1954-1 C.B. 394. The existence of a determination letter also facilitates transfers of Qualified Plan assets to other Qualified Plans in the ordinary course and provides comfort to purchasers/acquirors in business transactions that a Qualified Plan has been properly maintained in form.

A Plan Sponsor's regular submission for a determination letter has become a best practice for maintaining the qualified status of a Qualified Plan, even for pre-approved plans. "Generally, if the employer operates the plan according to the terms of a plan document with a favorable determination, opinion or advisory letter, the plan will satisfy the law in operation." https://www.irs.gov/Retirement-Plans/Determination-Opinion-and-Advisory-Letter-for-Retirement-Plans-Scope-and-Benefit-of-a-Favorable-Determination-Opinion-or-Advisory-Letter.

The knowledge gained from, and cooperation with, the Service during the determination letter application process has, in our experience, generally translated to better understanding of pre-approved plans by Plan Sponsors. In our experience, historically there has been cooperation and a free flow of information between the Service and Plan Sponsors as a result of the determination letter process. We believe that the elimination of the determination letter program for Qualified Plans may adversely affect Plan Sponsors and Qualified Plan participants.

[4]Typically, the annual required audit by accountants does not address qualification of the underlying form of the Qualified Plan document, as the accountants require Plan Sponsors to certify as to compliance of the Qualified Plan document. This certification will likely become more burdensome, or at least more tenuous or expensive, for Plan Sponsors to provide to their outside auditors, among other parties. In the absence of the determination letter program, we suggest that Plan Sponsors may not have a readily available manner to certify such compliance, at least with respect to the form (or written documentation) of such Qualified Plans.

B. *Cooperation Among All Parties May Be Adversely Affected By Elimination of the Determination Letter Program*

We believe these increased touch points have led to increased compliance of Qualified Plans with the Code and other laws. Without the Service's determination letter program, we are concerned that Plan Sponsors will be unable to comply with the Code and other law with respect to their Qualified Plans, because, among other reasons, such persons may have no practical way of understanding that a particular provision in a Qualified Plan is of concern to the Service prior to contact by the Service. Further, we are concerned that a Plan Sponsor will, as a practical matter, be unable to add provisions to a Qualified Plan to address governance and fiduciary issues under the Employee Retirement Income Security Act of 1974, as amended ("ERISA").

A Plan Sponsor may adopt a "pre-approved" document (e.g., a master and prototype plan or a volume submitter plan) to evidence compliance in form for such Qualified Plan to the extent an approved document provider has received an advisory or opinion letter from the Service with respect to the form of such Qualified Plan. However, a Plan Sponsor must properly tailor the provisions of such pre-approved Qualified Plan to the needs of its business and employees. Regardless, the underlying advisory or opinion letter received cannot be relied upon by the Plan Sponsor to conclusively evidence compliance of the form of the Plan with the Code in most cases, particularly if, among other reasons, an adopting Plan Sponsor tailors the provisions of the pre-approved plan in any respect or has not properly completed such pre-approved plan. *See* section 19 of Rev. Proc. 2016-8.

In such cases, we believe that a pre-approved Qualified Plan document may not be a practical option for certain Plan Sponsors and may not address all laws that may apply to such Qualified Plan. For instance, it may not be feasible to effectively and practically support certain types of Qualified Plans on a pre-approved document. For example, in our experience, there are Plan Sponsors that have maintained their Qualified Plans for decades. Such Qualified Plans, especially defined benefit plans, contain numerous historical provisions, which must be grandfathered and maintained. It may be difficult to effectively replicate these historical provisions in a pre-approved document.[5] Several acquired plans may have been merged into such Qualified Plans. Without the ability to seek an individualized determination letter, we are concerned that many such Qualified Plans (some of the largest) may also be terminated and all assets liquidated, to avoid difficult administrative and related concerns as a result of the elimination of the determination letter program.

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[5]Many Plan Sponsors do not make a Form 5310 application to the Service for a determination letter regarding the status on termination of the Qualified Plan. In our experience, many purchasers will simply refuse to accept rollovers (or a trust-to-trust transfer, i.e., merger) of any assets from such terminating Qualified Plans to avoid any liability and any seller simply wants to avoid the cost and expense of such a filing on termination. As a general rule, rollovers (as opposed to a trust-to-trust transfer) can arguably be accepted without risk only if an administrator knows of no potential qualification defect in the Qualified Plan to be transferred. *See generally,* Rev. Rul. 2014-9 (such administrator must "reasonably conclude" that a rollover contribution from another Qualified Plan is valid).

More importantly, many third-party document sponsors (i.e., preparers) of pre-approved plans ("Document Sponsors") do not adequately address all issues that might need to be addressed in a Qualified Plan, particularly as it relates to ERISA or governance issues. As one example, many pre-approved plans arguably do not adequately address "ERISA accounts or ERISA budget accounts, which are designed to help plans control costs by recapturing some revenue sharing dollars and allowing plans to use them to pay plan expenses." *See* http://www.dol.gov/ebsa/faqs/faq-sch-c-supplement.html; *see also generally* Department of Labor ("DOL") Advisory Opinion 2013-03A (July 2, 2013) (such accounts are subject to ERISA's fiduciary rules).

Many Plan Sponsors would like for the pre-approved plan documents to expressly address allocation issues with respect to these excess assets attributable to such Qualified Plan, and there is some debate as to any language which might be required in a Qualified Plan to adequately address any related ERISA issues with respect to ERISA budget accounts. However, the Document Sponsor may not expressly address the allocation issues with respect to ERISA budget accounts in any respect in the pre-approved Qualified Plan. Since this issue does not affect the qualified status of the Qualified Plan, the Plan Sponsor may not be in a position to require the Document Sponsor or the Service to address this concern in such document. On the other hand, under the determination letter program this issue could be directly addressed by the Plan Sponsor with the Service. Once the determination letter program is removed, this issue can be addressed directly, if at all, by a Plan Sponsor only if a Qualified Plan is terminated.

In addition, it is not uncommon for the Service to question language that may be inserted to comply with ERISA matters. As an example, the U.S. Supreme Court in *US Airways, Inc. v. McCutchen*, 133 S. Ct. 1537 (2013), concluded that ERISA plan provisions could not be trumped in certain cases in the event that benefits were wrongly paid from such plan. *See generally* http://www.americanbar.org/content/newsletter/publications/aba_health_esource_home/aba_health_law_esource_1307_garbe.html.

While the *McCutchen* case addressed welfare plan provisions (e.g., medical, disability, dental), certain Plan Sponsors would like to add similar language in Qualified Plans to provide that such Qualified Plan may have an "equitable lien" on any amounts wrongly paid from such Qualified Plan. This equitable lien provision is unrelated to a provision of the Code, but arguably provides the Plan Sponsor and its Qualified Plan some comfort under ERISA in the event of any dispute with the DOL or a participant regarding amounts incorrectly paid from such Qualified Plan. Outside of the determination letter program, it would be practically impossible to add any such protective language in a Qualified Plan on a timely basis, if at all, as the Document Sponsor can simply choose not to address this issue. Moreover, if "equitable lien" provisions were submitted by a Plan Sponsor during the determination letter process for the review of the Service, the Service might reject such language, but it is this give and take between Plan Sponsors and the Service that has been the cornerstone of Qualified Plan compliance with all law, not just the Code.

It is typical, in our experience, for an examining agent to raise a potential Qualified Plan document failure during a determination letter filing or contest the adequacy or legality of

Qualified Plan provisions submitted by the Plan Sponsor. It is fairly rare for a Plan Sponsor to receive a determination letter back from the Service without some contact from the Service. In cases where the agent raises questions during the determination letter process, he or she prepares questions that Plan Sponsors can respond to with: (i) the best arguments possible to prove that no issue exists, (ii) additional information to satisfy the Service; or (iii) additional modified provisions which satisfy the Service and keep such Qualified Plan in compliance. In the event of a potential qualification failure, VCP has been an alternative to the extent any such potential issues have been adequately raised by the Plan Sponsor. We believe that this give and take and review of the Qualified Plan during the determination letter process improves all parties' understanding of the law, including applicable provisions of the Code and corresponding guidance, in arguably the same way as "iron sharpens iron." Without the buffer of the determination letter program, we are concerned that it will be more burdensome for the Service and practitioners to resolve any potential qualification disputes.

Even if such Document Sponsor could timely and properly address all governance and ERISA issues, there still remains a concern as the Document Sponsor is not typically a law firm that warrants proper completion of the pre-approved plan. In our experience, such pre-approved Qualified Plan documents are routinely improperly completed in some material respect. Periodic approval by the Service of individually designed Qualified Plans (along with pre-approved plans which could also be independently submitted to the Service until recently) through the determination letter process has served as a useful form of compliance check with applicable provisions of the Code and has fostered cooperation between all parties involved in the determination letter process. In addition, the experience gained during the determination letter process for individually designed Qualified Plans has carried over and provided guidance for practitioners and Plan Sponsors to properly complete pre-approved Qualified Plans.

C. *Business Transactions and Qualified Plans*

Finally, a determination letter also makes it easier to merge, or make direct trust-to-trust transfers between, Qualified Plans, as the letter provides assurance that the Qualified Plan or trust is qualified in form under sections 401(a) and section 501(a), respectively. *See* https://www.irs.gov/Retirement-Plans/Determination-Opinion-and-Advisory-Letter-for-Retirement-Plans-Scope-and-Benefit-of-a-Favorable-Determination-Opinion-or-Advisory-Letter.

Determination letters from the Service have historically played a significant role in business transactions, such as mergers, acquisitions and other business transactions. It has been standard practice during an acquisition for the acquiring entity to require a representation and warranty that an acquired entity's Qualified Plans are qualified in form under section 401(a). This representation and warranty is generally accomplished through the acquiring entity's document review of the acquired entity's Qualified Plan, along with the inclusion of a determination letter that covers the acquired entity's Qualified Plan.

The existence of a determination letter during a business transaction provides specific comfort to all involved that the acquired entity regularly maintained the form of its Qualified Plan in conformance with the Code. A Qualified Plan is, in our experience, more likely to be assumed and continued by a buyer if a current determination letter has been issued for such Qualified Plan. If the acquired entity does not have a determination letter, the Qualified Plan is more likely to have form defects, particularly with pre-approved Qualified Plans.

Qualified Plan sponsors do not typically properly complete pre-approved documents as necessary to provide comfort that the Qualified Plan is in compliance upon transfer to the new Plan Sponsor, particularly as to any Qualified Plans which have previously merged into the Qualified Plan to be transferred to any such purchaser. This has resulted in the termination of many Qualified Plans prior to an acquisition, along with expensive and time consuming VCP filings and related filings, rather than assumption and merger of such plan. Consequently, Qualified Plan assets have been lost for later years as not all assets are rolled over to an individual retirement account or another Qualified Plan.

We believe that the elimination of the determination letter program will likely accelerate this leakage of Qualified Plan assets and may lead to the overall weakening of the U.S. retirement system as more assets are distributed earlier than anticipated, in the absence of any such Qualified Plan termination and liquidation. In such event, Qualified Plan assets may not be available when most needed, at and after retirement age.

II. OTHER CONCERNS WITH THE SERVICE'S PROPOSED ELIMINATION OF THE DETERMINATION LETTER PROGRAM

A. *Preservation of Rights*

Under Announcement 2015-19, the Service anticipates eliminating the determination letter program for Qualified Plans beginning on January 1, 2017. Without the determination letter program, a Plan Sponsor will no longer be able to secure a determination that its Qualified Plan is qualified in form under the Code, but will instead likely adopt a pre-approved Qualified Plan document provided by a Document Sponsor in order to be able to rely, at least in part, on the opinion or similar letter issued to certain pre-approved plans. Currently, an application for a determination letter may preserve important rights if a provision in such plan is later found to be defective. If the potentially defective provision is specifically identified in the application, Plan Sponsors and administrators can submit a VCP application rather than be subject to correction under the Audit CAP.

The Service currently and expressly allows potential defects to be raised as part of the determination letter application for a Qualified Plan, as follows:

> (3) An Employee Plans examination also includes a case in which a Plan Sponsor has submitted any Form 5300, 5307, or 5310 and the Employee Plans agent notifies the Plan Sponsor, or a representative, of possible failures, whether or not the Plan Sponsor is officially notified of an "examination." This would include a case where, for example, a Plan Sponsor has applied for a determination letter on plan termination, and an Employee Plans agent notifies the Plan Sponsor that there are partial termination concerns. In addition, if, during the review

> process, the agent requests additional information that indicates the existence of a failure not previously identified by the Plan Sponsor, the plan is considered to be under an Employee Plans examination. If, in such a case, the determination letter request under review is subsequently withdrawn, the plan is nevertheless considered to be under an Employee Plans examination for purposes of eligibility under SCP and VCP with respect to those issues raised by the agent reviewing the determination letter application. The fact that a Plan Sponsor voluntarily submits a determination letter application does not constitute a voluntary identification of a failure to the Service. **In order to be eligible for VCP, the Plan Sponsor (or the authorized representative) must identify each failure, in writing, to the reviewing agent before the agent recognizes the existence of the failure or addresses the failure in communications with the Plan Sponsor (or the authorized representative)**.

Section 5.09(3) of Rev. Proc. 2013-12 (emphasis added).

In the past, Plan Sponsors have had the ability to identify potential issues as part of the determination letter process. Many times the agent determines that no qualification defect exists and does not require a VCP application with respect to the Qualified Plan provision at issue. At other times, Plan Sponsors have been permitted to make a VCP application at a much reduced compliance fee as determined under EPCRS, generally between $375 and $25,000 depending upon the number of participants in the Qualified Plan and error at issue. *See generally* Section 12 of Rev. Proc. 2013-12. If the defect is resolved as part of Audit CAP, however, there can be a significant sanction amount based in the worst case on a percentage of total assets of a Qualified Plan. *See generally* Section 13 & 14 of Rev. Proc. 2013-12, as modified by Rev. Proc. 2015-27. Without the determination letter process, Plan Sponsors are left with no good alternatives to raise potential issues prior to audit and avoid these significant sanctions.

A Plan Sponsor's ability to preserve its rights to apply to VCP, rather than being subject to sanctions under Audit CAP, is useful and helps foster compliance with the Code and other applicable law. For instance, a Qualified Plan document may be amended to comply with law changes or certain discretionary changes, but such amendment may not follow a particular model amendment (to meet the particular needs of a Plan Sponsor) or there may be no model amendment to follow. The language of any such amendments may not be compliant and several years may pass before the Service might review such language. Without the determination letter process, this might occur, if at all, during the Service's audit of the Qualified Plan.

If a Service agent reviewing the Qualified Plan document during the determination letter process contests the validity of such amendment or questions whether it was made in "good faith," the Qualified Plan might be eligible for VCP and the reduced fees, rather than the sanctions under Audit CAP, if the potential defect was properly raised by the Plan Sponsor. This process assists the Service, because more difficult issues are timely brought to the Service's attention. Further, Plan Sponsors could make changes to their Qualified Plans without the concern that their Qualified Plan might face disqualification due to the manner in which a particular provision was drafted as long as the issue was properly raised to the attention of the Service.

For instance, certain provisions in a Qualified Plan are commonly changed as a result of collective bargaining agreements between representatives of a union and a Plan Sponsor. Many times those collectively bargained revisions to corresponding Qualified Plans might not be incorporated timely or properly into such Qualified Plans, although arguably the language in the Qualified Plans may otherwise be compliant with applicable laws. If a Plan Sponsor raises the potential issue with respect to the collective bargaining agreement (e.g., approval of increased/lower benefits) as part of the determination letter application, the Service might approve the language or simply allow the Plan Sponsor to submit a VCP application, while holding the determination letter application in abeyance pending approval by the Service of the proposed change.

Further, Plan Sponsors have raised issues as part of a Service determination letter application for a Qualified Plan in cases when a change in the law arguably did not impact the Qualified Plan. Examples are the "employer stock diversification" requirements under section 401(a)(35) or "compensation" changes required under section 415. In some cases, those provisions were arguably inapplicable, because the Qualified Plan held no employer securities, or benefits were not based upon compensation (e.g., a defined benefit plan that provided a fixed dollar amount and/or benefits based only on years of service). In those cases, the Service has permitted Plan Sponsors to proceed to VCP when the potential defect/error had been expressly raised during the determination letter process.

With the contemplated elimination of the determination letter program, Plan Sponsors will not be able to preserve their right to VCP after 2016. We respectfully suggest that non-compliance with the Code will increase substantially without such an avenue to raise potential defects. It is our understanding that under VCP the Plan Sponsor must admit to a Qualified Plan defect to avail itself of this program. *See* Section 10.03 of Rev. Proc. 2013-12 (a Plan Sponsor must identify "failures."). In our experience, the Service typically rejects VCP applications when Plan Sponsors do not admit to qualification failures with respect to the affected Qualified Plans, even when reasonable arguments might exist that no defect exists under the Code or other applicable law.

We respectfully suggest that the Service consider amending EPCRS to allow Plan Sponsors to preserve their rights to VCP for Qualified Plan issues which Plan Sponsors reasonably believe Service agents may question. For example, when a Plan Sponsor is notified that a Qualified Plan is under audit, the Service might permit a Plan Sponsor a reasonable period of time (e.g., 30 to 60 days) to identify document provisions and/or operational provisions that the Plan Sponsor believes may be of concern to the Service or may be potential qualification defects under the Code.

Alternatively, the Service might permit Plan Sponsors to raise issues as part of the Form 5500 filing process either directly on the Form 5500 or to a certified auditor of the Qualified Plan that can be preserved in the event that the Qualified Plan is ever audited by the Service. Finally, the Service may wish to consider establishing a modified VCP program under which an issue may be raised with the Service for its review and comment without the Plan Sponsor admitting that an error exists. As long as the Plan Sponsor specifically identifies an issue, we believe that the Qualified Plan should be protected, or at least eligible for the lower compliance fees of VCP.

In our experience, many Plan Sponsors of individually designed plans generally do their utmost to strive to maintain their Qualified Plans in compliance with the legal requirements. There are instances, however, when Qualified Plans arguably (or actually) fail to be in full compliance due to uncertainty concerning the proper application of the Code or other law. We respectfully ask that the Service consider implementing a substitute compliance program in lieu of section 5.09(3) of Rev. Proc. 2013-12. If the determination letter program is eliminated, we believe that the preservation by of a Plan Sponsor's rights to proceed under VCP (in lieu thereof) will foster further cooperation between all stakeholders interested in the maintenance of such Qualified Plans in compliance with law.

B. *Suggested Leeway with Respect to Plan Language of Concern to the Service*

We are also concerned that without the determination letter program Plan Sponsors may be subject to increased sanctions when amending their Qualified Plans for changes in the law. There is much uncertainty and much room for interpretation in many provisions affecting Qualified Plans depending upon the facts and circumstances at issue. EPCRS has allowed Plan Sponsors an avenue to raise thorny issues with the Service without risk of disqualification. It is for this reason that the Service arguably has provided for a reasonable, good faith compliance standard when a Plan Sponsor amends a Qualified Plan to comply with potentially disqualifying provisions under the Code. *See generally* Section 5 through 7 of Rev. Proc. 20007-44 (the Service discusses reasonable and good faith attempts to comply with provisions added to a Qualified Plan).

There has been a long history of cooperation among practitioners and the Service as it relates to Qualified Plan compliance. We are hopeful that this cooperation will continue to the extent possible, even with the proposed elimination of the determination letter program for Qualified Plans. For example, the Pension Protection Act of 2006 ("PPA") required Qualified Plans with employer securities to allow participants to diversify out of such employer stock. *See* Section 401(a)(35). Many Plan Sponsors did not amend their plans to comply with section 401(a)(35), because their Qualified Plans did not include employer stock as an investment option. During the determination letter submission process, the Service required numerous plans to be amended to include language consistent with section 401(a)(35) even if the Qualified Plan did not invest in employer stock.[6] We cite this example to show that Plan Sponsors may not know what is required without some dialogue between the Service and Plan Sponsors in situations that might be subject to some uncertainty.

Therefore, we respectfully suggest that the Service consider providing some leeway to Plan Sponsors. We agree that Qualified Plans should be required to adopt changes to the law that

[6] We know of instances when Qualified Plans sponsored by partnerships, which cannot offer employer stock as an investment, were required to include such section 401(a)(35) diversification language.

are applicable to such Qualified Plan. However, we respectfully suggest that Qualified Plans and their Plan Sponsors should not be sanctioned for a failure to include a change to the law that is not applicable to such Qualified Plan in operation.

Additionally, the Service may want to consider providing more detailed guidance to Plan Sponsors about required changes to the law. An example of such guidance may include an annual checklist of required provisions similar to the Cumulative List currently provided for determination letter submissions, but with additional information such as whether a law change is:

(i) Required in all such Qualified Plans regardless of applicability in operation;

(ii) Required only if such change is applicable to a Qualified Plan; or

(iii) Optional and only included at the Plan Sponsor's discretion.

The Service has provided such guidance in other circumstances. We suggest that such guidance will be even more critical if the determination letter program is eliminated.

C. *Suggested Maintenance of Rulings on Affiliated Service Groups, Leased Employees, Partial Terminations, and Other Discrimination Issues*

It is unclear from Announcement 2015-19 whether the Service will continue to issue rulings on affiliated service group and leased employee status under section 414, along with partial termination rulings. The Service currently allows for a Plan Sponsor to receive rulings as part of a determination letter application on whether: (i) the employer is a member of an affiliated service group, (ii) leased employees are deemed employees of the employer, and (iii) a partial termination has occurred under section 411(d)(3). *See* Section 5.08 of Rev. Proc. 2015-6.

We respectfully suggest that the Service consider continuing to provide Plan Sponsors an avenue to secure a ruling on those issues and related issues. For example, it is no longer possible to secure a ruling on any coverage or other discrimination issues under sections 401(a)(4) or 410(b). In addition, no such ruling appears possible for a qualified separate line of business ("QSLOB") under section 414(r). For instance, the Service may provide that certain QSLOBs are not discriminatory based upon facts and circumstances, notwithstanding the fact that such Qualified Plan does not meet certain enumerated safe harbors in the Treasury Regulations. *See* Treas. Reg. § 1.414(r)-8(b)(2)(iii)(B) (the Commissioner may determine based upon facts and circumstances that a QSLOB is not discriminatory with respect to a certain coverage test). Currently, there is no readily available way to secure such a ruling for QSLOBs. Further, a Plan Sponsor now may no longer receive any assurance that the process it has adopted in conducting a discriminatory test is compliant with the Code.

As a result, we suggest that the Service consider allowing limited, streamlined determination letter applications on these issues. We would suggest that such rulings not include a review of the Qualified Plan for general compliance with section 401(a) and related provisions.

Rather, we suggest that the Service would review only the facts and circumstances submitted by the Plan Sponsor and provide a determination letter as to the specific, distinct request made by the Plan Sponsor.

D. *Suggested Revisions to Audit CAP*

We are concerned that Qualified Plans may go several years without a review by the Service. During an audit by the Service, the reviewing Service agent would routinely request the Qualified Plan document. Many Qualified Plan documents contain errors or defects that date back several years, if not decades, that may not have been discovered during normal review of such Qualified Plan.

As a result, we respectfully suggest that the Service reduce the Audit CAP sanctions for Qualified Plan document errors or defects with respect to which the Plan Sponsor has complied in reasonable, good faith with changes in the law. If the Plan Sponsor can demonstrate that the Qualified Plan was generally amended on a timely basis for (i) required law, (ii) discretionary changes or (iii) Code changes, but certain provisions were omitted from such amendment or such amendment was otherwise found to be defective, then Audit CAP sanctions should arguably be limited to the VCP fee. We suggest that the VCP fee be used as a cap on any Audit CAP sanction if any amendment was timely adopted by a Plan Sponsor to comply with such law, but such amendment was not compliant in all respects.

For example, the PPA included numerous law changes and required amendments to Qualified Plans. Some Plan Sponsors missed amendments to include a "Roth IRA" as an eligible retirement plan for rollovers. In such case, the plan sponsor complied with all other provisions of the PPA and may have allowed Roth IRA rollovers to such Qualified Plan. We suggest that if overall, general compliance is evidenced with respect to any particular Qualified Plan amendment, then the Plan Sponsor should generally be eligible for a reduced sanction in Audit CAP, which we suggest should be the VCP fee. In this way, as long as a Plan Sponsor has shown that it has generally complied with making amendments timely, the Qualified Plan should not be disqualified simply because some aspect of such amendment was not in compliance with the law.

In particular, we respectfully suggest more leeway for Plan Sponsors for defects and errors that are not specific violations of the Code (compared to violations under section 415 or other provisions of the Code) or which do not benefit "highly compensated employees" as determined under section 414(q) ("HCEs"). *See generally Time Oil Co. v. Comm'r*, 258 F.2d 237 (9th Cir. 1958) (*de minimis* variations should not lead to disqualification); *see also Winger's Dep't Store Inc. v. Comm'r*, 82 T.C. 869 (1984) (discussing case law which suggested that disqualification should occur when a Qualified Plan loan that was non-compliant with such plan benefitted solely the majority shareholder of the employer); *but see Fleming Cardiovascular, P.A. v. Comm'r*, T.C. Memo 2015-224 (Nov. 23, 2015) (concluding that a deviation from terms caused a Qualified Plan to be disqualified, which Qualified Plan was found to also have violated section 415).

Otherwise, we specifically suggest that the Service not disqualify a Qualified Plan solely due to such plan's failure to comply with its terms in form or operation. This is generally consistent with longstanding case law, which we would respectfully suggest the Service consider adopting in light of the fact that the determination letter program may no longer be available.

TAX SECTION
State Bar of Texas

February 8, 2016

By First Class Mail

Ms. Stephanie A. Servoss
Clerk of the Court
United States Tax Court
400 2nd Street, N.W., Room 111
Washington, D.C. 20217

RE: Comments on Proposed Amendments to United States Tax Court Rules of Practice and Procedure

Dear Ms. Servoss:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the United States Tax Court for comments regarding the proposed amendments to the Court's Rules of Practice and Procedure which were announced on January 11, 2016 (the "Proposed Amendments").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE 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 TAX SECTION, 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 TAX SECTION AND PURSUANT TO THE

PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Court for the time and thought that has been put into preparing the Proposed Amendments, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Alyson Outenreath

Alyson Outenreath, Chair
State Bar of Texas, Tax Section

cc: The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

COMMENTS ON PROPOSED AMENDMENTS TO UNITED STATES TAX COURT'S RULES OF PRACTICE AND PROCEDURE ANNOUNCED JANUARY 11, 2016

These comments on the Proposed Amendments ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was Richard L. Hunn, who is Chair of the Tax Controversy Committee of the Tax Section of the State Bar of Texas. The Committee on Government Submissions ("COGS") of the Tax Section of the State Bar of Texas has approved these Comments. Robert Probasco, Co-Chair of COGS, reviewed these Comments. Mary A. McNulty also reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:

Richard L. Hunn
richard.hunn@nortonrosefulbright.com
(713) 651-5293
Norton Rose Fulbright US LLP
1301 McKinney, Suite 5100
Houston, TX 77010-3095

Date: February 8, 2016

These Comments are provided in response to the Court's request for comments regarding the Proposed Amendments to its Rules of Practice and Procedure (the "Rules"). The Tax Section commends the Court for its efforts to improve and modernize its Rules and associated procedures and for the opportunity to provide comments regarding the Proposed Amendments.

The Court noted in its January 11, 2016 press release announcing the Proposed Amendments that the goal is to "pave the way for the electronic filing of petitions and other papers that are not filed electronically at the present time." The Tax Section believes this is a worthy goal that will benefit taxpayers, counsel and the Court.

The Tax Section has only one subject for comment: electronic payment of fees in conjunction with electronic filings. We have two suggestions in that regard.

First, we suggest that the Court consider amending its Rules to allow for electronic payment of fees associated with electronic filings, such as the fee for filing a petition or a notice of appeal. Such an amendment to the Court's Rules could be accomplished by revising the first two sentences of Rule 11 to read as follows:

> Except as otherwise specified in procedures established by the Court, all payments to the Court for fees or charges of the Court shall be made either in cash or by check, money order, or other draft made payable to the order of "Clerk, United States Tax Court", and shall be mailed or delivered to the Clerk of the Court at Washington, D.C. The Court may permit or require that specified fees or charges be paid electronically and/or by credit card pursuant to procedures established by the Court.

Second, we suggest that the Court consider revising its procedures to allow for electronic payment of fees contemporaneously with an electronic filing. As is indicated on its website and on pay.gov, the Court does have procedures in place to allow for electronic payment of certain fees (for example, photocopy charges) by credit card through pay.gov. According to the Court's website, those procedures do not allow for electronic payment of fees contemporaneously with an electronic filing. (However, we note that pay.gov does have a form titled "U.S. Tax Court Fees – Petitions," which is confusing to taxpayers.) We suggest that those procedures be modified to allow for electronic payment of fees contemporaneously with an electronic filing such as a petition or a notice of appeal.

We respectfully suggest that the United States Court of Federal Claims' procedures may provide a useful guide to this Court about how best to revise or implement its own procedures. In 2015, the Court of Federal Claims amended its rules to allow for electronic filing of a complaint. The Court of Federal Claims modified its procedures on its case management/electronic case filing system ("CM/ECF") to integrate electronic payment of the filing fee with electronic filing of the complaint.

We appreciate the opportunity to comment on the Proposed Amendments and to be a part of the Court's efforts to improve and modernize its Rules and associated procedures.

TAX SECTION
State Bar of Texas

March 11, 2016

CC:PA:LPD:PR (REG-134219-08)
Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, DC 20044

RE: Comments on Proposed Regulations Regarding Relief from Joint and Several Liability Under Section 6015

Dear Sirs and Madams:

On behalf of the Tax Section of the State Bar of Texas, I am pleased to submit the enclosed response to the request of the Department of the Treasury ("Treasury") and Internal Revenue Service ("IRS") in the Notice of Proposed Rulemaking (REG-134219-08), 2015-49 I.R.B. 842, issued on November 20, 2015 ("Proposed Regulations"). The Proposed Regulations provide guidance regarding the "Relief from Joint and Several Liability" granted under section 6015 of the Internal Revenue Code of 1986, as amended ("Code").

THE COMMENTS ENCLOSED WITH THIS LETTER ARE BEING PRESENTED ONLY ON BEHALF OF THE TAX SECTION OF THE STATE BAR OF TEXAS. THE 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 TAX SECTION, WHICH HAS SUBMITTED THESE COMMENTS, IS A VOLUNTARY SECTION OF MEMBERS COMPOSED OF LAWYERS PRACTICING IN A SPECIFIED AREA OF LAW.

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THE COMMENTS ARE SUBMITTED AS A RESULT OF THE APPROVAL OF THE COMMITTEE ON GOVERNMENT SUBMISSIONS OF THE TAX SECTION AND PURSUANT TO THE PROCEDURES ADOPTED BY THE COUNCIL OF THE TAX SECTION, WHICH IS THE GOVERNING BODY OF THAT SECTION. NO APPROVAL OR DISAPPROVAL OF THE GENERAL MEMBERSHIP OF THIS SECTION HAS BEEN OBTAINED AND THE COMMENTS REPRESENT THE VIEWS OF THE MEMBERS OF THE TAX SECTION WHO PREPARED THEM.

We commend the Treasury and the IRS for the time and thought that has been put into preparing the Proposed Regulations, and we appreciate being extended the opportunity to participate in this process.

Respectfully submitted,

Alyson Outenreath

Alyson Outenreath, Chair
State Bar of Texas, Tax Section

Cc: The Honorable Mark J. Mazur
Assistant Secretary for Tax Policy
United States Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, D.C. 20220

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW, Ste. 3026
Washington, D.C. 20224

The Honorable Emily S. McMahon
Deputy Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, D.C. 20220

COMMENTS ON PROPOSED REGULATIONS
UNDER SECTION 6015

These comments on the Proposed Regulations ("Comments") are submitted on behalf of the Tax Section of the State Bar of Texas. The principal drafter of these Comments was David Boudreaux. The Committee on Government Submissions (COGS) of the Tax Section of the State Bar of Texas has approved these Comments. Henry Talavera, Co-Chair of COGS, and Jason Freeman, Vice Chair of COGS, reviewed these Comments. Richard Hunn, Chair of the Tax Controversy Committee, also reviewed the Comments and made substantive suggestions on behalf of COGS.

Although members of the Tax Section who participated in preparing these Comments have clients who would be affected by the principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:

David Boudreaux, Jr.
dboudreaux@cricpa.com
(832) 333-7430
2 Riverway, 15th Floor
Houston, Texas 77056

Date: March 11, 2016

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These comments are provided in response to the request of the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS"), contained in their Notice of Proposed Rulemaking in REG 134219-08, 2015-49 I.R.B. 842, for comments on proposed regulations (the "Proposed Regulations"). The Proposed Regulations provide guidance regarding relief from joint and several liability under Internal Revenue Code ("Code") section 6015 and relief from the operation of state community property law under Code section 66. The Tax Section thanks Treasury and the IRS for the opportunity to provide input on the Proposed Regulations. While we largely agree with the Proposed Regulations and believe that they clarify the relief granted under Code sections 6015 and 66, we suggest that Treasury and the IRS consider adding an additional example in section 1.6015-1(e)(4) of the Proposed Regulations to clarify that a taxpayer will not be treated as having "meaningfully participated" in a prior proceeding merely because that taxpayer engaged in multiple acts during that proceeding, as long as those acts did not significantly impact, or evidence significant control over, the outcome of that prior proceeding.

The Meaningful Participation Standard

We respectfully suggest that Treasury and the IRS consider providing an example designed to clarify that a requesting spouse will not be treated as having "meaningfully participated" in a prior proceeding merely because he or she engaged in multiple acts listed in section 1.6015-1(e)(3) of the Proposed Regulations. Because a taxpayer who is deemed to have "meaningfully participated" in a prior tax proceeding is barred from later seeking innocent spouse relief with respect to the years that were at issue in that proceeding, we are concerned that without further clarification the Proposed Regulations may be interpreted to deny relief to some deserving taxpayers whose prior acts did not significantly impact, or evidence significant control over, the prior proceeding.

We are particularly concerned that, under the current proposed examples, some taxpayers may be treated as having "meaningfully participated" in a prior proceeding merely because they passively engaged in several acts listed in section 1.6015-1(e)(3) of the Proposed Regulations. The Proposed Regulations appear to imply that a finding of "meaningful participation" can be predicated upon the mere aggregation of acts, rather than requiring an analysis of the substantive effect (or lack thereof) of those acts on the prior proceeding.

In its current form, subsection (e)(3) of the Proposed Regulations provides that the IRS will take several factors into consideration when determining whether a requesting spouse meaningfully participated in a prior proceeding. Subsection (e)(3) of the Proposed Regulations lists several acts that may be considered and provides that the importance given to each act will vary depending on the facts and circumstances. The Proposed Regulations then provide several examples that illustrate the meaningful participation standard.

While we believe that several of the examples contained in the Proposed Regulations are consistent with previously established case law, we are concerned that the examples may be read to give greater weight to the number of acts engaged in by the taxpayer rather than to the substance of those acts and the impact that they may have had on the prior proceeding.

Neither Congress nor the courts have defined "meaningful participation."[1] However, the Tax Court has identified certain factors as being probative of meaningful participation: (1) exercising exclusive control over the handling of the prior proceeding; (2) having a high level of participation in the prior proceeding; and (3) having had the opportunity to raise a claim for relief from joint and several liability in the prior proceeding.[2]

This case law arguably allows a requesting spouse to seek innocent spouse relief even if he or she engaged in multiple acts during the prior proceeding as long as those acts did not constitute a high level of participation. Thus, we suggest that a requesting spouse who participated in a prior proceeding by engaging in multiple acts should not necessarily be treated as having meaningfully participated in the prior proceeding. However, the Proposed Regulations appear to limit this possibility.

The Proposed Regulations appear to imply that merely engaging in multiple acts during the prior proceeding is sufficient to constitute meaningful participation, even if the requesting spouse, by engaging in those acts, did not significantly impact or control the prior proceeding. We do not recommend that the accumulation of multiple listed acts should be the focus of the inquiry; rather, the inquiry should focus on whether those acts constitute a high level of participation.

We also suggest that an additional example would help clarify that a requesting spouse who engaged in multiple acts during the prior proceeding will not be treated as having "meaningfully participated" in the prior proceeding based merely on the number of acts. We suggest including the following example in the Proposed Regulations:

> In March 2014, the IRS issued a notice of deficiency to H and W determining a deficiency on H and W's joint income tax return for tax year 2011. H and W timely filed a pro se petition in the United States Tax Court for redetermination of the deficiency. W signed the petition. W also provided copies of some of the requested documents in the appeals process that could have been provided by H or W. Further, W signed a motion for continuance of trial and the decision documents entered in the case. H handled all other aspects of the litigation, including discussing the case with the IRS Chief Counsel attorney and negotiating a settlement of the case. Relief under section 6015 was never raised. If W were to later file a claim requesting relief under section 6015, W's claim would not be

[1] *Harbin v. Comm'r*, 137 T.C. 93 (2011).

[2] *Id.*

> barred by res judicata. Considering these facts and circumstances, W's involvement in the prior court proceeding regarding the deficiency did not rise to the level of meaningful participation.

We would like to draw a distinction between this proposed example and Example 3 in the Proposed Regulations. The key difference is that the requesting spouse in Example 3 not only signed multiple documents, but actively participated in discussions with the IRS Chief Counsel attorney. Thus, under Example 3's facts and circumstances, the requesting spouse, by actively participating in discussions that ultimately formed the basis for the settlement, engaged in an act that directly impacted the outcome of, and evidenced significant control over, the prior proceeding. Our suggested example, on the other hand, involves a requesting spouse who engaged in multiple acts, but none of those acts directly impacted or otherwise materially influenced the outcome of the prior proceeding.

TAX SECTION
THE STATE BAR OF TEXAS

LEADERSHIP ROSTER

2015 - 2016

Officers

Alyson Outenreath (Chair)
Texas Tech University School of Law
1802 Hartford Avenue
Lubbock, Texas 79409
806-834-8690
alyson.outenreath@ttu.edu

David E. Colmenero (Chair-Elect)
Meadows, Collier, Reed, Cousins,
Crouch & Ungerman, LLP
901 Main Street, Suite 3700
Dallas, Texas 75202
214-744-3700
dcolmenero@meadowscollier.com

Stephanie M. Schroepfer (Secretary)
Norton Rose Fulbright
1301 McKinney, Suite 5100
Houston, Texas 77010
713-651-5591
stephanie.schroepfer@nortonrosefulbright.com

Catherine Scheid (Treasurer)
Law Offices of Catherine C. Scheid
4301 Yoakum Blvd.
Houston, Texas 77006
713-840-1840
ccs@scheidlaw.com

Appointed Council Members

Robert D. Probasco
Government Submissions (COGS) Co-Chair
The Probasco Law Firm
9113 La Strada Ct
Dallas, Texas 75220
214-335-7549
robert.probasco@probascotaxlaw.com

Henry Talavera
Government Submissions (COGS) Co-Chair
Polsinelli PC
2501 N. Harwood, Suite 1900
Dallas, Texas 75201
214-661-5538
htalavera@polsinelli.com

Juan Vasquez, Jr.
Pro Bono Chair
Chamberlain, Hrdlicka, White, Williams &
Aughtry LLP
1200 Smith Street – 14th Floor
Houston, Texas 77002
713-654-9679
juan.vasquez@chamberlainlaw.com

J. Michael Threet
CLE Chair
Haynes & Boone
2323 Victory Avenue, Suite 700
Dallas, Texas 75219
214-651-5000
michael.threet@haynesboone.com

Michelle Spiegel
Newsletter Editor
Mayer Brown, LLP
700 Louisiana Street. Suite 3400
Houston, Texas 77002
713-238-3000
mspiegel@mayerbrown.com

Christi Mondrik
Leadership Academy Program Co-Director
Mondrik & Associates
11044 Research Blvd., Suite B-400
Austin, Texas 78759
512-542-9300
cmondrik@mondriklaw.com

Elected Council Members

Ira Lipstet
Term expires 2016
DuBois, Bryant & Campbell, LLP
303 Colorado, Suite 2300
Austin, Texas 78701
512-381-8040
ilipstet@dbcllp.com

Melissa Willms
Term expires 2016
Davis & Willms, PLLC
3555 Timmons Lane, Suite 1250
Houston, Texas 77027
281-786-4503
melissa@daviswillms.com

Henry Talavera
Term expires 2016
Polsinelli PC
2501 N. Harwood, Suite 1900
Dallas, Texas 75201
214-661-5538
htalavera@polsinelli.com

Lora G. Davis
Term expires 2017
Davis Stephenson, PLLC
100 Crescent Court, Suite 440
Dallas, Texas 75201
214-396-8801
lora@davisstephenson.com

Robert C. Morris
Term expires 2017
Norton Rose Fulbright
1301 McKinney Suite 5100
Houston, Texas 77010
713-651-8404
robert.morris@nortonrosefulbright.com

Charolette F. Noel
Term expires 2017
Jones Day
2727 North Harwood Street
Dallas, Texas 75201
214-969-4538
cfnoel@jonesday.com

Sam Megally
Term expires 2018
K&L Gates, LLP
1717 Main Street, Suite 2800
Dallas, Texas 75201
214-939-5491
sam.megally@klgates.com

Jaime Vasquez
Term expires 2018
Chamberlain, Hrdlicka, White, Williams & Aughtry LLP
112 East Pecan Street, Suite 1450
San Antonio, Texas 78205
210-507-6508
jaime.vasquez@chamberlainlaw.com

Chris Goodrich
Term expires 2018
Crady, Jewett & McCulley, LLP
2727 Allen Parkway, Suite 1700
Houston, Texas 77019
713-739-7007 Ext 147
cgoodrich@cjmlaw.com

Ex Officio Council Members

Andrius Kontrimas
Immediate Past Chair
Norton Rose Fulbright
1301 McKinney, Suite 5100
Houston, Texas 77010
713-651-5482
andrius.kontrimas@nortonrosefulbright.com

Professor Bruce McGovern
Law School Representative
South Texas College of Law
1303 San Jacinto
Houston, Texas 77002
713-646-2920
bmcgovern@stcl.edu

Sarah Pai
Comptroller Representative
Comptroller of Public Accounts
Tax Policy Division
P.O. Box 13528
Austin, Texas 78711-3528
512-475-5664
Sarah.Pai@cpa.state.tx.us

Abbey B. Garber
IRS Representative
Internal Revenue Service
MC 2000 NDAL
13th Floor
4050 Alpha Road
Dallas, Texas 75244
469-801-1113
abbey.b.garber@irscounsel.treas.gov

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THE STATE BAR OF TEXAS

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2015-2016

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2.	**Continuing Legal Education**	**J. Michael Threet** Haynes & Boone, LLP 2323 Victory Avenue, Suite 700 Dallas, Texas 75219 214-651-5091 michael.threet@haynesboone.com	**Amanda Traphagan** The Seay Law Firm, PLLC 807 Brazos Street, Suite 304 Austin, Texas 78701 512-582-0120 atraphagan@seaytaxlaw.com **Jim Roberts** Glast, Phillips & Murray, PC 14801 Quorum Drive, Suite 500 Dallas, Texas 75254 972-419-7189 jvroberts@gpm-law.com
3.	**Corporate Tax**	**Jeffry M. Blair** Hunton & Williams, LLP 1445 Ross Avenue, Suite 3700 Dallas, Texas 75202 214-468-3306 jblair@hunton.com	**Julia Pashin** Vinson & Elkins LLP 2001 Ross Avenue, Suite 3700 Dallas, Texas 75201 214-220-7883 jpashin@velaw.com

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5.	**Energy and Natural Resources Tax**	**Crawford Moorefield** Strasburger & Price 909 Fannin Street, Suite 2300 Houston, Texas 77010 713-951-5629 crawford.moorefield@strasburger.com	**Todd Lowther** Thompson & Knight LLP 333 Clay St., Suite 3300 Houston, Texas 77002 713-653-8667 todd.lowther@tklaw.com **Shane McDowell** Fluor Corporation 6700 Las Colinas Blvd. Irving, Texas 75039 469-398-7055 shane.mcdowell@fluor.com
6.	**Estate and Gift Tax**	**Celeste C. Lawton** Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, Texas 77010 713-651-5591 celeste.lawton@nortonrosefulbright.com	**R. Glenn Davis** Scott & Hulse, P.C. 1100 Chase Tower 201 E. Main Drive El Paso, Texas 79901 915-533-2493 Gdav@scotthulse.com **Laurel Stephenson** Davis Stephenson, PLLC 100 Crescent Ct., Suite 440 Dallas, Texas 75201 214-396-8800 laurel@davisstephenson.com

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8.	**International Tax**	**John Strohmeyer** Crady, Jewett & McCulley, LLP 2727 Allen Parkway, Suite 1700 Houston, Texas 77019 713-739-7007 jstrohmeyer@cjmlaw.com	**Austin Carlson** Gray Reed & McGraw, PC 1300 Post Oak Blvd. Suite 2000 Houston, Texas 77056 713.986.7213 acarlson@grayreed.com **Benjamin Vesely** BDO USA, LLP 700 N. Pearl St., Suite 2000 Dallas, Texas 75201 214-665-0763 bvesely@bdo.com
9.	**Partnership and Real Estate**	**Chester W. Grudzinski, Jr** Kelly Hart & Hallman LLP 201 Main St, Suite 2500 Fort Worth, Texas 817- 878-3584 chester.grudzinski@khh.com	**Peter Marmo** Crady, Jewett & McCulley, LLP 2727 Allen Pkwy, Suite 1700 Houston, Texas 77019 713-739-7007 pmarmo@cjmlaw.com **Steve Beck** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-749-2401 sbeck@meadowscollier.com
10.	**Property Tax**	**Christopher S. Jackson** Perdue, Brandon, Fielder, Collins & Mott 3301 Northland Drive, Suite 505 Austin, Texas 78731 512-302-0190 cjackson@pbfcm.com	**Rick Duncan** Blackwell & Duncan, PLLC 500 N. Central Expressway, Suite 427 Plano, Texas 75074 214-380-2810 duncan@txproptax.com

COMMITTEE	CHAIR	VICE CHAIR
11. Solo and Small Firm	**Dustin Whittenburg** Law Office of Dustin Whittenburg 4040 Broadway, Suite 450 San Antonio, Texas 78209 210-826-1900 dustin@whittenburgtax.com **Sara A. Giddings** Giddings Law Firm 4421 Oak Grove Blvd. San Angelo, Texas 76904 903-436-2536 sagiddings@gmail.com	**Carolyn Dove, CPA** The Dove Firm PLLC 1321 W. Randol Mill Rd., Suite 102 Arlington, Texas 76012 817-462-0006 carolyn.dove@thedovefirm.com
12. State and Local Tax	**Charolette F. Noel** Jones Day 2727 North Harwood Street Dallas, Texas 75201 214-969-4538 cfnoel@jonesday.com **Sam Megally** K&L Gates, LLP 1717 Main Street, Suite 2800 Dallas, Texas 75201 214-939-5491 sam.megally@klgates.com	**Matt Hunsaker** Baker Botts, L.L.P 2001 Ross Avenue Dallas, Texas 75201 214-953-6828 matt.hunsaker@bakerbotts.com **Olga Jane Goldberg** Sutherland Asbill & Brennan 1001 Fannin, Suite 3700 Houston, Texas 7702 713-470-6121 olga.goldberg@sutherland.com **Stephen Long** Baker & McKenzie LLP 2001 Ross Ave, Suite 2300 Dallas TX 75201 214-965-3086 stephen.w.long@bakernet.com

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13.	**Tax Controversy**	**Richard L. Hunn** Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, Texas 77010 713-651-5293 richard.hunn@nortonrosefulbright.com	**Anthony P. Daddino** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-744-3700 adaddino@meadowscollier.com **David Gair** Gray Reed & McGraw, P.C. 1601 Elm Street, Suite 4600 Dallas, Texas 75201 214.954.4135 dgair@grayreed.com **Ira A. Lipstet** DuBois, Bryant & Campbell, LLP 303 Colorado, Suite 2300 Austin, TX 78701 512-381-8040 ilipstet@dbcllp.com
14.	**Tax-Exempt Finance**	**Peter D. Smith** Norton Rose Fulbright 98 San Jacinto Blvd., Suite 1100 Austin, Texas 78701 512-536-3090 peter.smith@nortonrosefulbright.com	**Irina Barahona** Kemp Smith 221 North Kansas, Suite 1700 El Paso, Texas 79901 915-546-5205 irina.barahona@kempsmith.com
15.	**Tax-Exempt Organizations**	**Terri Lynn Helge** Texas A&M University School of Law Associate Professor of Law 1515 Commerce Street Fort Worth, Texas 76102-6509 817- 429-8050 thelge@law.tamu.edu	**David M. Rosenberg** Thompson & Knight LLP 1722 Routh Street, Suite 1500 Dallas, Texas 75201 214.969.1508 david.rosenberg@tklaw.com **Shannon Guthrie** Stephens and Guthrie 8330 Meadow Road, Suite 216 Dallas, Texas 75231 214-373-7195 shannon@stephensguthrie.com **Frank Sommerville** Weycer, Kaplan, Pulaski & Zuber, P.C. 3030 Matlock Rd., Suite 201 Arlington, Texas 76015 817-795-5046 fsommerville@wkpz.com

COMMITTEE		CHAIR	VICE CHAIR
16.	**Government Submissions**	**Robert D. Probasco** The Probasco Law Firm 9113 La Strada Ct. Dallas, Texas 75220 214-335-7549 robert.probasco@probascotaxlaw.com	**Jeffry M. Blair** Hunton & Williams, LLP 1445 Ross Avenue Suite 3700 Dallas, Texas 75202 214-468-3306 jblair@hunton.com
		Henry Talavera Polsinelli PC 2501 N. Harwood, Suite 1900 Dallas, Texas 75201 214-661-5538 htalavera@polsinelli.com	**Jason Freeman** Meadows, Collier, Reed, Cousins, Crouch & Ungerman, LLP 901 Main Street, Suite 3700 Dallas, Texas 75202 214-749-2417 jfreeman@meadowscollier.com
17.	**Newsletter**	**Michelle Spiegel** Mayer Brown, LLP 700 Louisiana Street, Suite 3400 Houston, Texas 77002 713-238-3000 mspiegel@mayerbrown.com	TBD

	COMMITTEE	CHAIR	VICE CHAIR
18.	**Pro Bono**	**Juan F. Vasquez, Jr.** Chamberlain, Hrdlicka, White, Williams & Aughtry, LLP 1200 Smith Street 14th Floor Houston, Texas 77002 112 East Pecan Street, Suite 1450 San Antonio, Texas 78205 713-654-9679 juan.vasquez@chamberlainlaw.com	**Jaime Vasquez** Chamberlain, Hrdlicka, White, Williams & Aughtry, LLP 112 East Pecan Street, Suite 1450 San Antonio, Texas 78205 210-507-6508 jaime.vasquez@chamberlainlaw.com **Derek Matta** Cantrell and Cantrell 3700 Buffalo Speedway, Suite 520 Houston, Texas 77098 713-333-0555 dmatta@cctaxlaw.com **Joe Perera** Strasburger & Price 2301 Broadway Street San Antonio, Texas 78215 210-250-6119 Joseph.perera@strasburger.com **Vicki L. Rees** Teacher Retirement System of Texas 1000 Red River Austin, TX 78701 512-542-6400 vicki.rees@trs.texas.gov **Tiffany L. Hamil** Law Office of Tiffany L. Hamil, PLLC Turley Law Center, Suite 316 6440 N Central Expy Dallas TX 75206 214-369-0909 info@dfwtaxadvisor.com
19.	**Leadership Academy**	**Christi Mondrik** Mondrik & Associates 11044 Research Blvd., Suite B-400 Austin, Texas 78759 512 542-9300 cmondrik@mondriklaw.com	N/A (Planning Committee)

TAX SECTION
OF
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2015 – 2016 CALENDAR

June 2015	
10 - 12	**Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
18	**2015 – 2016 Tax Section Council Planning Retreat** Grand Hyatt San Antonio San Antonio, TX 1:00pm – 4:00pm
18	**2015 Tax Section Annual Meting Speaker's Dinner** Biga on the Banks San Antonio, TX
19	**2015 Tax Section Annual Meeting Program** Henry B. Gonzales Convention Center San Antonio, TX 8:00 am – 4:40 pm
22	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
23	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
July 2015	
16 - 18	**Texas Bar College** Summer School Galveston, TX
24 - 25	**SBOT Bar Leaders Conference** Westin Galleria Houston, TX
July 30 - Aug. 4	**ABA Annual Meeting** Hyatt Regency Chicago, IL
August 2015	
July 30 - Aug. 4	**ABA Annual Meeting** Hyatt Regency Chicago, IL

7	**SBOT Chair and Treasurer Training** Texas Law Center Austin, TX 10:30am – 2:30pm
17	**Tax Section Officer Planning Retreat** Houston, TX 11:45am – 3:45pm
18	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
September 2015	
11	**Meeting of Council, Committee Chairs, and Committee Vice Chairs** Hosted by Meadows, Collier, Reed, Cousins, Crouch & Ungerman 901 Main Street, Suite 3700 Dallas, TX 75202 214-744-3700 10:30am – 12:30pm Dial-in information will be distributed via email
17	**Deadline for Appointment of Tax Section Nominating Committee** Per Bylaws, posted to Tax Section website in June 2015
17 - 19	**ABA Tax Section Fall Meeting** Sheraton Chicago Hotel & Towers Chicago, IL
21	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court El Paso, TX
21	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
22	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
25	**UT CLE Texas Margin Tax Conference** AT&T Conference Center Austin, TX
28	**Outreach to Law Schools** Texas Tech University School of Law Lubbock, TX

28	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court San Antonio, TX
28	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Lubbock, TX
October 2015	
5	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
5	**State and Local Tax Committee Annual Comptroller Briefing** **Co-Sponsored with TSCPA and TEI** Austin, TX
12	**Submission Deadline - Texas Tax Lawyer (Fall Edition)** Submit to TTL Editor: Michelle Spiegel, mspiegel@mayerbrown.com
15	**Outreach to Law Schools** Southern Methodist University Dedman School of Law Dallas, TX
19	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Dallas, TX
20	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
23	**Council of Chairs Meeting** Texas Law Center Austin TX
26	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Houston, TX
29 - 30	**Advanced Tax Law Course** **Co-Sponsored with TexasBarCLE** Crowne Center Houston – River Oaks Houston, TX
November 2015	
12	**18th Annual International Tax Symposium** **Co-Sponsored with TSCPA** Cityplace Conference Center Dallas, TX

13	**18th Annual International Tax Symposium** **Co-Sponsored with TSCPA and Houston CPA Society** Houston CPA Society Houston, TX
13	**Meeting of Council** Hosted by Norton Rose Fulbright 1301 McKinney Street, Suite 5100 Houston, TX 77010 713-651-5482 10:30am – 12:30pm Dial-in information will be distributed via email
16	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Dallas, TX
17	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
30	**Pro Bono Committee Calendar Call Assistance** U.S. Tax Court Dallas, TX
December 2015	
7	**Pro Bono Committee Calendar Call Assistance** United States Tax Court Houston, TX
15	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
January 2016	
8	**Nomination Period Opens for 2016 Outstanding Texas Tax Lawyer Award** • Nominations due April 1, 2016 • Nomination forms to be posted on website and distributed via eblast • Submit nomination forms to Tax Section Secretary: Stephanie Schroepfer (stephanie.schroepfer@nortonrosefulbright.com)
15	**Application Deadline – Tax Section Leadership Academy**
18	**Application Period Opens For Law Student Scholarship Program**
19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am

22	**Meeting of Council, Committee Chairs, and Committee Vice Chairs Meeting** Hosted by Jones Day 2727 North Harwood Street Dallas, TX 75201 214-220-3939 10:30am – 12:30pm Dial-in information will be distributed via email
28 – 30	**ABA Tax Section Midyear Meeting** JW Marriott LA Live Los Angeles, CA
February 2016	
5	**Submission Deadline - Texas Tax Lawyer (Winter Edition)** Submit to TTL Editor: Michelle Spiegel, mspiegel@mayerbrown.com
3 – 9	**ABA Midyear Meeting** San Diego, California
11	**Tax Law in a Day CLE** Houston, TX
16	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
26	**Council of Chairs Meeting** Texas Law Center Austin, TX
March 2016	
1	**Nomination Deadline for Chair-Elect, Secretary, Treasurer, and 3 Elected Council Members**
7	**Pro Bono Calendar Call-Dallas**
21	**Pro Bono Calendar Call-Houston** **Pro Bono Calendar Call-San Antonio**
22	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
24 - 25	**Leadership Academy Program (1st of 4 programs)** San Antonio, TX
April 2016	
1	**Nominating Committee's Report Due to Council** (Per Bylaws, deadline is at least 10 days before April 15, 2016 Council meeting)

8	**Law Student Scholarship Application Deadline**
15	**Meeting of Council** Hosted by Norton Rose Fulbright 1301 McKinney, Suite 5100 Houston, TX 77010 713-651-5482 10:30am – 12:30pm
15	**Council Vote and Selection of Recipient of 2016 Outstanding Texas Tax Lawyer Award**
19	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
22	**Submission Deadline - Texas Tax Lawyer (Spring Edition)** Submit to TTL Editor: Michelle Spiegel, mspiegel@mayerbrown.com
TBD	**Property Tax Conference** Thompson Conference Center Austin TX
May 2016	
2	**Pro Bono Calendar Call-Houston**
5 – 7	**ABA Tax Section May Meeting** Grand Hyatt Washington, DC
16	**Pro Bono Calendar Call-San Antonio** **Pro Bono Calendar Call-Houston**
23	**Pro Bono Calendar Call-Dallas**
24	**Government Submissions Call (COGS)** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
June 2016	
6	**Pro Bono Calendar Call-Houston**
8 – 10	**Annual Texas Federal Tax Institute** Hyatt Hill Country Resort San Antonio, TX
15 - 17	**Leadership Academy Program (2nd of 4 programs)** Fort Worth, TX
16	**2016 Tax Section Annual Meeting Speaker's Dinner** TBD
16	**Presentation of Law Student Scholarship Awards** Award Presentations at State Bar Annual Meeting, Speakers' Dinner

17	**2016 Tax Section Annual Meeting Program** For Worth Omni and Convention Center Fort Worth, TX
17	**Presentation of 2016 Outstanding Texas Tax Lawyer Award** Award Presentation During Tax Section Annual Meeting Program
21	**Government Submissions (COGS) Call with Committee Chairs** Dial-in: 866-203-7023; Conference Code: 7136515591# 9:00am
TBD	**2016 – 2017 Tax Section Council Planning Retreat**
July & Aug 2016	
July 30 – Aug. 4	**ABA Annual Meeting** San Francisco CA
Sept 2016	
22 - 23	**Leadership Academy (3rd of 4 programs)** Houston, TX
TBD	**Annual Texas Comptroller's Meeting**
Oct 2016	
28-29	**National Association of State Bar Tax Sections ("NASBTS") Annual Meeting-San Francisco, CA**
Jan. 2017	
18	**Leadership Academy (4th of 4 programs)** Austin, TX

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