

# TaxClinic

## PRACTICAL ADVICE ON CURRENT ISSUES

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#### ACCOUNTING METHODS & PERIODS

### When Is a Rebate Liability Fixed and Eligible for the Recurring-Item Exception?

With the passing of April 15, many practitioners will shift their attention to taxpayers under extension, many of which will use the recurring-item exception to deduct expenditures paid subsequent to year end but prior to the filing of the tax return. In recent guidance, the IRS has been scrutinizing the timing of the deduction of rebate payments (expenditures generally eligible for the recurring-item exception) and focusing on whether the related liability is actually fixed by year end and therefore eligible to be deducted even if paid within 8½ months of year end.

#### Background

Under an accrual method of accounting, a liability is incurred and generally taken into account for federal income tax purposes in the tax year in which:

- All the events have occurred that establish the fact of the liability;
- The amount of the liability can be determined with reasonable accuracy; and
- Economic performance has occurred with respect to the liability (Regs. Sec. 1.461-1(a)(2)(i)).

Economic performance occurs for a rebate liability when the taxpayer makes a payment to the person to whom the liability is owed (Regs. Sec. 1.461-4(g)(3)). Accordingly, taxpayers cannot deduct rebates in any tax year prior to the tax year in which they actually pay the rebate,

unless they qualify for the recurring-item exception.

Under the recurring-item exception, economic performance is treated as having been met for the year the rebate liability is fixed and determinable, as long as:

- Payment is made on or before the earlier of the date the taxpayer files a timely tax return (including extensions) for the tax year the rebate liability is fixed and determinable or 8½ months after the close of that tax year; and
- The rebate liability is recurring in nature (Regs. Secs. 1.461-5(b)(1)(ii), (b)(1)(iii), and (b)(3)).

Under the recurring-item exception, the amount of the liability must not be material, or accrual of the liability in the tax year must result in better matching of the liability against the income to which it relates. The matching requirement of the recurring-item exception is deemed satisfied with respect to rebates, and the exception applies to rebate liabilities without regard to materiality (Regs. Secs. 1.461-5(b)(1)(iv) and (b)(5)(ii)).

It is tempting to immediately dismiss the all-events test for rebate payments, move immediately to the economic performance issue, and conclude that since economic performance occurs as rebate payments are made, any rebate payments made within 8½ months of year end are currently deductible under the recurring-item exception. This simple analysis can lead to an incorrect answer. The all-events test, although relatively benign in its language, is heavily dependent on an analysis of the facts and circumstances.

For example, in CCA 200826006, the IRS held that the taxpayer's "net" method of accounting for cash rebates (i.e., the reduction of gross receipts by the amount of estimated rebate payments) was not permitted under Regs. Sec. 1.461-4(g)(3). The IRS determined that under Regs. Sec. 1.461-4(g)(3), the taxpayer could not treat its liability for a cash rebate as incurred prior to payment of the rebate. While neither the taxpayer nor the IRS addressed the taxpayer's potential eligibility for the recurring-item exception under Regs. Sec. 1.461-5, it is possible the taxpayer may have been allowed a deduction

in the current year for rebates that were paid by the due date of the tax return or within 8½ months of year end, whichever was earlier, depending on the facts and circumstances and whether the taxpayer's liability was fixed by year end.

In CCA 200834019, the IRS addressed the eligibility of the taxpayer's cash rebate payments for the recurring-item exception. Because the taxpayer's liability to pay the rebates did not become fixed until the customer subsequently complied with the cash rebate program's requirements, the IRS held that the taxpayer, an accrual-method retailer of consumer products, could not treat its liability to pay cash rebates as incurred on the date it sold a product by adopting the recurring-item exception.

### Details Behind the Ruling

Under the facts of CCA 200834019, the taxpayer offered cash rebates in conjunction with the sale of a product and contracted with a third-party administrator to process the rebates. Under the cash rebate program, a customer would pay full price for an item and receive a rebate form. To be entitled to a cash rebate, the customer had to complete the rebate form, cut out and attach a copy of the UPC code from the item, attach a copy of the sales receipt, and mail the rebate request to the third-party administrator within 30 days of the date of purchase. Based on these facts, the IRS determined that the taxpayer's liability to pay a cash rebate was not fixed prior to the time the customer complied with the requirements of the cash rebate program.

Furthermore, because the recurring-item exception is available only for qualifying payment liabilities that are fixed and determinable by the end of the taxpayer's tax year, the IRS ruled that the taxpayer

may not treat its cash rebate liability as incurred on the date of the sale of the product to which the liability relates by adopting the recurring item exception of § 461(h)(3) because that liability is not fixed until the customer later complies with the rebate requirements.

In other words, a liability must be fixed and determinable before the recurring-

item exception can be used. The fact that payment is made within 8½ months of year end does not fix the liability for such payment at year end. See also *Bigler*, T.C. Memo. 2008-133 (a remanufacturer of automobile parts could not offset amounts invoiced to customers by estimated credits to the customers for returns of automobile part cores), and Rev. Rul. 2007-3 (the recurring-item exception does not apply if the fact of the liability is not established by year end).

The IRS's determination that a customer's compliance with the cash rebate program requirements was the event necessary to fix the taxpayer's liability is in line with existing authority addressing the all-events test and nonministerial versus ministerial acts. Where the submission of a claim form is not merely the mechanism for payment but rather a condition precedent to payment, the sale of goods or performance of services does not establish the fact of the liability. Compare, for example, *General Dynamics Corp.*, 481 U.S. 239 (1987) (the submission of a claim form by an employee under the employer's self-insured medical plan represented the last event that fixed the employer's liability because some employees might neglect to file the claim form or choose not to submit it because of fear of disclosing a medical condition), with:

- Rev. Rul. 98-39 (once services are performed under an agreement, establishing the fact of the liability is not delayed by an additional requirement that a claim or documentation be submitted for payment as long as the claim's submission is merely a ministerial act);
- *Dally*, 227 F.2d 724 (9th Cir. 1955) (a contractor accrued income at the time it delivered houses rather than at the time it submitted a properly certified invoice as required under the government contract); and
- *Hughes Properties, Inc.*, 476 U.S. 593 (1986) (a casino had fixed liability for guaranteed payment amounts on progressive slot machines that were not yet won because its liability was fixed by state gaming regulations after the slot machine's last play of the year).

In its analysis in CCA 200834019, the IRS determined that the taxpayer's rebate

program liability was more in the nature of the employer's self-insured medical expense liability in *General Dynamics* than the casino's jackpot liability in *Hughes Properties*, based on the fact that there was no state law requiring the taxpayer to set aside funds to cover its rebate liability. Further, in analogizing the taxpayer's situation with the facts in *General Dynamics*, the IRS noted that "the last event fixing Taxpayer's liability for cash rebates occurs when the customer mails a properly completed rebate form with the required attachments" and that the actual processing and issuance of a rebate constituted a ministerial act.

### Implications

CCA 200834019 highlights the importance of taxpayers' ensuring that a liability meets the all-events test before applying the economic-performance rules. Furthermore, while automatic consent is available under Rev. Proc. 2008-52 for a qualifying accrual-method taxpayer that wants to change its accounting method for treating its liability for rebates to the recurring-item exception method under Sec. 461(h)(3) and Regs. Sec. 1.461-5 (see Rev. Proc. 2008-52, Appendix §19.07), practitioners must take time to review a taxpayer's rebate program terms to ensure that the related liability is fixed by year end before filing an automatic consent request to apply the recurring-item exception. If a taxpayer files a Form 3115, Application for Change in Accounting Method, to use the recurring-item exception for a rebate liability that is not fixed by year end and the form is selected for post-consent review by the IRS National Office or reviewed as part of an examination, the taxpayer could subsequently lose the method change and consequently be subject to interest and penalties.

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#### CORPORATIONS & SHAREHOLDERS

### IRS Issues Helpful Regs. on the Interplay of Active Trade and Hot Stock

In response to changes made to the active trade or business requirement in the

Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222 (TIPRA), the Service recently issued temporary and proposed regulations harmonizing the Sec. 355 "hot stock" rule with the TIPRA changes (T.D. 9435, REG-150670-07).

### Background

Under Sec. 355(a), a distributing corporation (*D*) may distribute the stock of a controlled corporation (*C*) to its shareholders without causing either *D* or its shareholders to recognize income, gain, or loss. However, Sec. 355(a)(3)(B) provides that *C* stock acquired by *D* by reason of any taxable transaction that occurs within five years of the stock distribution will not be treated as *C* stock but as other property (hot stock). As a result, the distribution of hot stock results in potential gain recognition to both the shareholders and *D*.

There are a number of requirements for qualifying a distribution under Sec. 355(a). One such requirement is the active trade or business (ATB) requirement found in Sec. 355(a)(1)(C). To satisfy the ATB requirement, both *D* and *C* must engage in an ATB immediately after the distribution (Sec. 355(b)(1)(A)). In addition, Sec. 355(b)(1)(B) provides that a corporation meets the ATB requirement if, immediately after the distribution, substantially all of its assets consist of stock and securities of a corporation controlled by it that is so engaged. However, as discussed below, the enactment of Sec. 355(b)(3) overrides the application of Sec. 355(b)(1)(B). In addition, each ATB must have been conducted throughout the five-year predistribution period and must not have been acquired within the predistribution period in a transaction in which gain or loss was recognized, in whole or in part (Secs. 355(b)(2)(B) through (D)).

TIPRA amended the statute by adding the Sec. 355(b)(3) affiliated group rules for determining satisfaction of the ATB requirement. Sec. 355(b)(3)(A) provides that for purposes of determining whether a corporation is engaged in an ATB, all members of the corporation's separate affiliated group (SAG) are treated as one corporation. Sec. 355(b)(3)(B) provides that for purposes of Sec. 355(b)(3), with respect to any corporation, the term

"SAG" refers to the affiliated group that would be determined under Sec. 1504(a) if the corporation were the common parent and Sec. 1504(b) did not apply. Sec. 355(b)(3)(C) provides that if a corporation becomes a SAG member as a result of one or more taxable transactions, any trade or business conducted by the corporation (at the time the corporation became a member) will be treated for purposes of Sec. 355(b)(2) as acquired in a taxable transaction.

### Expansion Through Stock Acquisition

In general, a corporation is considered to expand an existing ATB rather than acquire a new ATB through an asset acquisition when the facts clearly establish that the acquired assets are in the same line of business as the existing ATB (Regs. Sec. 1.355-3(b)(3)(ii)). However, it was previously unclear whether a stock acquisition could represent an expansion.

The changes made in TIPRA seem to answer that question affirmatively. As a result, in certain circumstances, the acquisition of stock could represent an expansion of an existing trade or business. This conclusion is confirmed by the legislative history, which provides that "such an acquisition is subject to the provisions of section 355(b)(2)(C), and may qualify as an expansion of an existing active trade or business conducted by the distributing corporation or the controlled corporation, as the case may be" (Joint Committee on Taxation, *Description of the Tax Technical Corrections Act of 2007 as Passed by the House of Representatives 5* (JCX-119-07) (December 18, 2007)). The proposed ATB regulations further confirm this result by treating the acquisition of control of a subsidiary as the acquisition of the subsidiary's underlying assets and, as such, potentially an expansion of the existing business (see Prop. Regs. Sec. 1.355-3(b)(3)(ii)).

The statutory changes provide for an interesting result whereby *D* could distribute the stock of a recently acquired *C* in a qualifying Sec. 355 transaction if the acquisition of *C* represented an expansion of the *D* business (Prop. Regs. Sec. 1.355-3(d)(2), Examples (20) and (21)).

However, this result would appear to conflict with the hot stock rule discussed above, which would cause the seemingly absurd result of a qualifying tax-free distribution that is taxable to the shareholder and potentially taxable to the distributing corporation. Congress realized this and added Sec. 355(b)(3)(D), which provides regulatory authority for the modification of the hot stock rule, in the Tax Technical Corrections Act of 2007.

### Temp. Regs. Modify Application of the Hot Stock Rule

Acting upon this regulatory authority, Treasury issued temporary regulations modifying the application of the hot stock rule to the SAG. The regulations provide that C stock purchased within the five-year predistribution period is not treated as hot stock if C is a member of the distributing corporation's separate affiliated group (DSAG) at any time after the acquisition but before the distribution of C (Temp. Regs. Sec. 1.355-2T(g)(2)(i)). In essence, these regulations reflect the congressional intent that the hot stock rule should not apply to any acquisition of C stock where C is a DSAG member at any time after the acquisition. This is the case whether D owned C stock prior to the predistribution period, acquired stock representing Sec. 1504(a) control in a single transaction, or acquired stock in multiple transactions (Temp. Regs. Sec. 1.355-2T(g)(5), Example (2)). The following examples show how the temporary regulations apply in various situations.

**Example 1:** D is a bank holding company that wholly owns S, which has operated a bank for more than five years. In year 6, D acquires C, which has operated a bank for more than five years, in a taxable acquisition. Assuming the activities are virtually the same, the acquisition represents an expansion of the DSAG business. In year 8, D distributes C to X in exchange for X's D shares. Assuming all other requirements are met, the distribution of C qualifies as a Sec. 355 split-up despite the fact that C was acquired in a taxable transaction within the prior five years.

**Example 2:** The facts are the same as in Example 1, except that D acquired 50% of C in year 2 in a taxable transaction and acquired the remaining 50% in year 6 in a separate taxable transaction. Assuming all other requirements are met, the distribution of C qualifies as a Sec. 355 split-up despite the fact that 50% of C was acquired in a taxable transaction within the prior five years.

**Example 3:** The facts are the same as in Example 1, except that D acquired Sec. 368(c) control of C in year 4 in a taxable transaction and acquired the remaining ownership in year 6. Assuming all other requirements are met, the distribution of C qualifies as a Sec. 355 split-up.

In addition, and consistent with the SAG rule that treats the DSAG as a single corporation, transfers of C stock owned by DSAG members immediately before and immediately after the transfer are disregarded and not treated as acquisitions for purposes of the hot stock rule. Finally, the temporary regulations retain the affiliate acquisitions exception under Regs. Sec. 1.355-2(g), which provides that the hot stock rule does not apply for acquisitions of controlled corporation stock from another member of the affiliated group.

### Conclusion

The recently issued temporary regulations provide welcome confirmation to taxpayers on their ability not only to expand a business through a stock acquisition, but also to distribute the acquired stock without fear of the stock being considered hot stock.

From Kwajo Sarfoh, J.D., LL.M., New York, NY, and Nick Gruidl, CPA, MBT, Minneapolis, MN

### New Continuity-of-Interest Regs. Expand Definition of Qualifying Stock Recipients in a Reorg.

Treasury recently finalized regulations, effective for transactions occurring after December 12, 2008, for applying the continuity-of-interest (COI) requirement to insolvent corporations (T.D. 9434).

These regulations expand the Sec. 368(a)(1)(G) COI provisions by providing that stock issued to a creditor in reorganizations both inside and outside bankruptcy proceedings will generally represent qualifying consideration when determining whether the reorganization satisfies the COI requirement.

### Background

COI is both a regulatory and a judicial requirement. The requirement first appeared in its current form in *Cortland Specialty Co.*, 60 F.2d 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1932), where the Second Circuit explained the purpose of Section 203 of the Revenue Act of 1926, a precursor to Sec. 368, in terms very similar to the current regulations. *Cortland* was followed shortly thereafter by two U.S. Supreme Court decisions that further explained the requirement. In the pre-Sec. 368 reorganization decision, *Pinellas Ice & Cold Storage Co.*, 287 U.S. 462 (1933), the Court, citing *Cortland*, held that target shareholders must acquire an interest in the acquirer for the merger to qualify as a reorganization because, without receipt of such interest, the transaction was in substance a sale. In *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935), the Court went a step further than it had in *Pinellas*, holding not only that a continuing interest is required, but also that such interest must be substantial compared with the interest exchanged. This position is perhaps the first mention of the necessary degree of continuity in a reorganization.

The current regulatory continuity requirement adopts the judicial language, stating that the reorganization provisions under Sec. 368 are intended to apply only to reorganizations, "which effect only a readjustment of continuing interest in property under modified corporate forms" (Regs. Sec. 1.368-1(b)). Further defining the requirement, the regulations go on to state:

A proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation (as defined in [Regs. Sec.

1.368-1(b)), it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or it otherwise continues as a proprietary interest in the target corporation. [Regs. Sec. 1.368-1(e)(1)(i)]

In a bankruptcy workout of an insolvent corporation, the historic debtor corporation's shareholders are often eliminated in the workout. As such, barring special rules to the contrary, many bankruptcy reorganizations under Sec. 368(a)(1)(G) would fail the COI requirement. In the case of an insolvent corporation in bankruptcy, the Supreme Court held that the debtor corporation's creditors became the proprietors for purposes of determining COI (*Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942)).

In March 2005, Treasury issued proposed regulations to address when and to what extent creditors of a corporation would be treated as proprietors in determining COI in a potential reorganization (REG-163314-03). The proposed regulations provided that creditors of an insolvent target corporation not in a title 11 (bankruptcy) or similar case could be treated as holding a proprietary interest in the corporation (Prop. Regs. Sec. 1.368-1(e)(6)). The proposed regulations also provided specific guidance on how to quantify the proprietary interest of the target corporation so that taxpayers could determine whether the COI requirement was met (Prop. Regs. Sec. 1.368-1(e)(6)(ii)).

### Final Regs.

In order to facilitate the rehabilitation of troubled corporations, Congress expanded the application of the G reorganization rules (transfer of assets to another corporation in a bankruptcy or similar case under a qualified plan) to reorganizations of insolvent corporations outside bankruptcy. The final regulations adopt the rules proposed for creditors of an insolvent target corporation outside a title 11 or similar case in Regs. Sec. 1.368-1(e)(6) with only minor modifications and clarifications (T.D. 9434).

Under Regs. Sec. 1.368-1(e)(6)(i), a creditor's claim against a target corporation may represent a proprietary interest if the

target is in a title 11 or similar bankruptcy case or if the target is insolvent immediately prior to the reorganization. Under the new rules, senior and junior creditors are viewed differently, although each type of creditor may receive qualifying stock in exchange for their claims (see Regs. Sec. 1.368-1(e)(6)(ii)).

For a claim of the most senior class of creditors and any equal class of creditor receiving a non-*de minimis* proprietary interest in the issuing corporation, the value of the proprietary interest in the target corporation represented by the creditor's liability is described by the following equation:

$$V = C \times \frac{P}{M + O}$$

V is the value of the proprietary interest in the target corporation represented by the claim. C represents the fair market value (FMV) of the senior creditor's claim. P represents the aggregate FMV of proprietary interests received (i.e., the value of stock received in the aggregate by senior creditors). M + O represents the aggregate sum of the money and other consideration (including the proprietary interests in the issuing corporation) received by the senior creditors (Regs. Sec. 1.368-1(e)(6)(ii)(A)). By contrast, for claims of junior classes of creditors receiving stock, the value of the proprietary interest in the target organization is the FMV of the junior creditor's claim (Regs. Sec. 1.368-1(e)(6)(ii)(B)).

**Example 1:** T, an insolvent corporation, has two senior creditors (A and B), each with a \$200 claim. In a nonbankruptcy reorganization, A receives \$50 in stock of P, the issuing (i.e., acquiring) corporation, and \$150 in cash, while B receives \$200 in cash.

Applying the above equation, \$25 of each creditor's claim represents a proprietary interest [ $\$200 \times 50 \div (50 + 350) = \$25$ ], and the aggregate consideration allocated to the proprietary interests is \$50 (\$25 of stock received by A plus \$25 of cash received by B). COI in the reorganization is 50%, calculated by dividing the \$25 value of the stock allocated as a proprietary interest by the \$50 of aggregate

consideration allocated to the proprietary interests of the creditors.

**Example 2:** Under the same facts as Example 1, assume that T also had a junior creditor with a claim with an FMV of \$100. The creditor received \$65 in cash and \$35 in P stock.

COI in the reorganization is 40%, calculated by comparing the aggregate \$60 value of the stock allocated as proprietary interests to the senior and junior creditors (\$60 = \$25 deemed received by A and \$35 received by T) to the \$150 of aggregate consideration allocated to the proprietary interests of the creditors (\$25 of stock received by A, \$25 of cash received by B, and the entire \$100 claim of the junior creditor).

### Conclusion

As with past economic downturns, many corporations are facing debt workouts and restructurings. The final regulations provide insolvent debtor corporations with the same favorable COI rules as corporations in bankruptcy and thereby provide greater flexibility to corporations looking to restructure debt. However, the broadening of the rules could also make it more difficult for creditors to recognize a loss in a workout because receipt of stock in a qualified reorganization is covered by Sec. 354, which defers the recognition of gain or loss (although a taxable event will occur under Sec. 354(a)(2)(B) to the extent the stock received is attributable to accrued interest). Also worthy of note is that while the regulations may expand the ability to qualify a workout as a reorganization, they do not eliminate the amount or defer the timing of cancellation of indebtedness income that the corporation may recognize through the application of Sec. 108(e)(8).

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### Personal Goodwill: Alive and Well?

A pair of recent decisions calls into question whether the sale of personal

goodwill is still available as a tax planning strategy. In both *Solomon*, T.C. Memo. 2008-102, and *Muskat*, No. 08-1513 (1st Cir. 1/29/09), the courts held that the purported sales of personal goodwill were in fact compensatory payments under covenants not to compete.

So is personal goodwill dead? No. A closer look at each case shows that with the correct set of facts and the proper planning, personal goodwill remains a viable tax planning idea for owner-managed businesses. However, these cases give taxpayers and advisers fair warning that the IRS is willing and able to attack bad fact patterns, shortcuts, and last-minute tax advice.

## Background

The sale of personal goodwill held directly by the selling shareholder avoids corporate-level tax and results in long-term capital gain (assuming the goodwill has been held by the taxpayer for more than 12 months). With current corporate and top individual tax rates of 35%, the benefits of the sale of personal goodwill are often quite significant to the seller. Similarly valuable to the buyer is the amortizable step-up in asset basis obtained upon the acquisition of personal goodwill from the seller that would not be available if the entire consideration were paid for the stock of the corporation.

As a result of double taxation of corporate earnings, the identification of personal goodwill as a separate asset occurs most often within the context of the sale of closely held corporations (either closely held C corporations or S corporations within the 10-year Sec. 1374 built-in gain period).

True to its name, the asset personal goodwill must meet the definition of goodwill from a tax perspective, and it must be owned by an individual. Goodwill is defined in legislative history, regulations, and numerous court decisions. The consensus is that goodwill represents the intangible qualities that bring with them continued patronage. (See H.R. Rep't 103-111, 103d Cong., 1st Sess., House Committee Report to the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66; Regs. Secs. 1.197-2(b)(1) and (2); *Houston Chronicle*

*Pub. Co.*, 481 F.2d 1240 (5th Cir. 1973), *cert. denied*, 414 U.S. 1129; *Winn-Dixie Montgomery, Inc.*, 444 F.2d 677 (5th Cir. 1971); *Killian*, 314 F.2d 852 (5th Cir. 1963); *Nelson Weaver Realty Co.*, 307 F.2d 897 (5th Cir. 1962); *Karan*, 319 F.2d 303 (7th Cir. 1963).)

Tax Court precedent establishes that when an individual does not have an employment contract, the individual's personal relationships and other assets constituting goodwill are assets distinct from corporate goodwill. (See, e.g., *Norwalk*, T.C. Memo. 1998-279; *Martin Ice Cream Co.*, 110 T.C. 189 (1998); *Schilbach*, T.C. Memo. 1991-556; *Estate of Taracido*, 72 T.C. 1014 (1979); *Cullen*, 14 T.C. 368 (1950); *MacDonald*, 3 T.C. 720 (1944); *Providence Mill Supply Co.*, 2 B.T.A. 791 (1925).) The two cases cited most frequently by tax practitioners are *Norwalk* and *Martin Ice Cream*.

One of the earliest cases dealing with personal goodwill clearly distinguished personal goodwill from corporate intangibles, stating that "good will does not adhere to a business or profession dependent solely on the personal ability, skill, integrity or other personal characteristics of the owner." [Citation omitted.] It is different from, and is not to be 'confused with, "going value" or "going concern value" of a business'" (*MacDonald*, 3 T.C. 720, 727 (1944) (quoting 38 *Corpus Juris Secundum* 949 and 952 (1943))).

## Recent Decisions

As mentioned earlier, the *Solomon* and *Muskat* decisions each held against the taxpayers' contentions that they had sold personal goodwill, holding instead that the payments received represented compensation taxed at ordinary income rates. It is interesting to note that the Service argued in each case that the payments were compensatory in nature rather than disguised payments for the corporate assets. As a result, neither decision resulted in double taxation of the proceeds paid to the shareholders. This may have been the result of the facts in each case; however, it is worth consideration when determining the risk associated with taking a personal goodwill position.

**Solomon:** The *Solomon* decision is a good example of bad facts leading to a

taxpayer loss. The taxpayers attempted to claim that the proceeds they received related to the sale of customer lists, which they argued were their personal assets. The business in *Solomon* was iron ore processing, a far cry from the relationship-driven businesses in *Martin Ice Cream* and other favorable decisions. In fact, the court cited a communication from the taxpayers' accountant stating that the goodwill arguably was more related to the entity than the shareholders.

In ruling against the taxpayers, the court cited three primary reasons. First, nothing in the agreement between the parties made reference to the sale of personal goodwill or the customer lists by the taxpayers. Second, unlike *Martin Ice Cream*, the facts did not support that the value of the business was attributable to the taxpayers' personal attributes and relationships. Third, though the taxpayers entered into noncompete agreements, the lack of employment or consulting agreements arguably showed that the intent was not the purchase of personal goodwill.

**Muskat:** While *Solomon* was a case of bad facts, *Muskat* took poor decision making to a new level. The taxpayer in *Muskat* originally filed his return reporting compensation upon entering into a covenant not to compete upon the sale of his business. The taxpayer subsequently filed an amended return claiming that the payment was in fact for his personal goodwill.

While the facts related to the business operations in *Muskat* appeared more in line with *Martin Ice Cream* and other cases holding for the existence of personal goodwill, nothing in the agreement between the parties supported the taxpayer's claim. The existence of the taxpayer's personal goodwill or sale of such goodwill was never discussed, and the purchase agreement allocated all goodwill to the company. Following its application of the "strong proof" rule, the court held that the taxpayer's assertions were not enough to overcome the intent as expressed in the form of the agreement (*Muskat*, No. 00-cv-30-JD (D.N.H. 4/2/08)). One could argue that the court applied a form-over-substance argument.

In affirming the lower court's decision, the First Circuit looked at ownership of

the goodwill as well. The court agreed with the lower court's exclusion of expert testimony, stating:

If [the CPA expert witness] planned to testify that Muskat possessed personal goodwill separate from [the company's] goodwill, his testimony arguably may have been relevant to that issue. But according to the proffer, [the CPA] would not have testified to that effect; rather, he would have testified that a large slice of [the company's] goodwill was attributable to Muskat. This is a significant distraction. All of [the company's] goodwill, including any portion attributable to Muskat, was sold under the asset purchase agreement. Thus, [the CPA]'s testimony would have shed no light on the meaning of the noncompetition agreement. [*Muskat*, No. 08-1513 (1st Cir. 1/29/09)]

On a more disturbing and potentially far-reaching note, the lower court made the statement that it is not clear that saleable personal goodwill exists in situations like those in *Muskat*. However, such a statement should not be looked at as a repudiation of the long line of Tax Court decisions that embrace the existence of personal goodwill.

## Conclusion

With the right facts, personal goodwill appears to remain a viable strategy. However, to withstand scrutiny by the Service, it is important that taxpayers and advisers alike clearly establish and document both the existence of personal goodwill and the value of such goodwill. The rewards are large (avoiding corporate-level tax while obtaining long-term capital gain), but as these recent cases show, the risks are many.

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### EMPLOYEE BENEFITS & PENSIONS

## Qualified Plans: Partial Plan Terminations

Employers that sponsor qualified plans must monitor those plans for compliance with the Code's requirements on partial

plan terminations. Partial plan terminations occur when, by virtue of employer action, a plan realizes a significant decrease in the number of covered participants. In the case of a partial termination, a special 100% vesting rule applies.

Sec. 411(d)(3) provides in part that in order to be qualified, a plan must include a provision stating that in the case of a partial termination, all affected employees have a nonforfeitable right (100% vesting) to their funded accrued benefit, in the case of a defined benefit plan, or their account balance, in the case of a defined contribution plan.

The Code does not define partial termination or affected employee. However, Regs. Sec. 1.411(d)-2 does provide guidance on what is and what is not a partial plan termination. Partial terminations occur as a result of employer action to:

- Terminate employees (a reduction in force, for example);
- Exclude, by plan amendment, a group of employees from future coverage under the plan; or
- In the case of a defined benefit plan, reduce significantly or cease future benefit accruals that result in a potential reversion to the employer.

Unlike most of the IRS's qualified plan regulations, this regulation does not provide any sort of bright-line test. Instead, it requires the IRS to consider all facts and circumstances surrounding a plan and the employer sponsoring the plan in determining whether a plan has incurred a partial termination.

## When Does Partial Termination Occur?

Most partial terminations occur because of employer-initiated turnover. Courts have generally held that termination of a number of employees does not constitute a partial termination unless there is a significant reduction in plan participants (see *Weil v. Retirement Plan Admin. Comm. of the Terson Co.*, 933 F.2d 106 (2d Cir. 1991)). Historically, the IRS has used a 20% or greater turnover factor as a rebuttable presumption that a partial termination has occurred. When the turnover factor is greater than 20%, the IRS will require the employer to

demonstrate why a partial termination has not occurred.

The IRS approach to determining the turnover rate is to divide the number of participating employees who had an employer-initiated severance from employment during the applicable period by the sum of all participating employees at the start of the applicable period plus the employees who became participants during the applicable period. For example, if a plan with 100 participating employees at the plan year's beginning had 35 employees terminate and added 40 new participants, the plan's initial turnover factor would be 25% ( $35 \div (100 + 40)$ ). Even though there is a net growth of employment at the company, an employer with a plan in this circumstance would have to demonstrate why a partial termination has not occurred. The employer can do so by identifying how many employees in the numerator terminated voluntarily as opposed to by employer-initiated action.

The number of participating employees reflected in both the numerator and the denominator described above includes all participants, whether vested or not. The applicable period for the computation is generally the plan year. However, the IRS's position is that it may extend the period in the case of a short plan year or other appropriate circumstances. For example, a period longer than a plan year may be part of the applicable period where there is a series of related terminations from services. The rationale supporting the IRS's position is that a taxpayer should not be able to use the intervention of the end of a plan year in between two or more related corporate events to argue that a partial termination did not occur.

## Rev. Rul. 2007-43

The courts generally have supported the IRS's approach to:

- Using 20% as a guideline as to whether a partial termination may have occurred;
- Including vested participants in the count; and
- Expanding the applicable period beyond the plan year (see *Matz v. Household Int'l Tax Reduction Inv. Plan*, 265 F.3d 572 (7th Cir. 2001)).

While not a party to *Matz*, the IRS used the Seventh Circuit's holding in a later appeal in the *Matz* case (*Matz v. Household Int'l Tax Reduction Inv. Plan*, 388 F.3d 570 (7th Cir. 2004)) in drafting Rev. Rul. 2007-43. This revenue ruling was an opportunity for the IRS to issue more comprehensive guidance on this subject.

Under Rev. Rul. 2007-43, the IRS's view of an employer-initiated severance is very broad and includes any severance from employment other than severance that is on account of death, disability, or normal retirement. Even if the severance from employment is for reasons beyond the employer's control, such as the result of bad economic times, the IRS considers the termination from employment an employer-initiated severance. In other words, even if someone just quits, the IRS will consider the termination to be employer-initiated unless the employer can demonstrate otherwise.

However, an employer can rebut this presumption of involuntary termination. One factor the IRS will consider is a showing by the employer that the turnover rate for an industry is high (as in retail or food service, for example). An employer can also provide information from its employee personnel files to demonstrate the voluntary nature of the termination. The employer can present information on the terminated employee's prior acceptance of another job, the employer's immediate search to replace the terminated employee, etc., as evidence.

If a partial termination occurs, the affected participants are those participants that were, during the applicable period, part of an employer-initiated severance from employment or the subject of a plan amendment that resulted in either their exclusion from the plan or a reduction in their accrued benefit (that leads to the potential for a reversion to the employer). The plan's established vesting schedule will continue to apply to employees not affected by the partial termination.

### Consequences of a Partial Termination Finding

The consequences of the IRS's finding that a partial termination has occurred

where a plan has been otherwise administered can be particularly difficult for a defined contribution plan. Affected employees may have received a distribution of their vested account balance and forfeited the unvested portion. In the course of a plan's administration, forfeitures are often reallocated to other participants, used to reduce future employer contributions, or used for the payment of plan expenses.

If the IRS subsequently finds that a partial termination occurred, the employer must determine which plan participants would have required an acceleration of their vesting due to the partial termination. Participants who incurred the improper forfeiture of their account balance would be due additional plan benefits. Thus, to the extent the plan has reallocated these forfeitures to other participants or otherwise used them, the employer will be responsible for the "short-fall" to these participants' accounts.

An employer may request a determination letter on the issue of whether or not the plan has a partial termination. However, because the determination letter process can be lengthy and burdensome, an employer may choose to internally assess whether a partial plan termination has occurred and take action to vest the affected employees.

### Implications

When the economy moves downward, partial plan terminations tend to trend upward. The worst-case consequence of failing to identify a partial plan termination is the disqualification of the plan sponsor's qualified plan. Plan sponsors need to carefully consider whether any plan they sponsor may have undergone a partial plan termination. Fortunately, the IRS is unlikely to propose the drastic consequence of disqualification. However, in the case of an audit and any related closing agreement process, the IRS will require the plan sponsor to pay a monetary sanction and reinstate any forfeited benefits or account balances of the affected participants. Even this best-case scenario of correcting the error with IRS supervision would be an expensive and time-consuming process that an

employer could avoid through better upfront monitoring.

From Nancy J. Manary, CPA, Davenport, IA, and William P. O'Malley, J.D., CPA, Peoria, IL

## EXEMPT ORGANIZATIONS

### Transfers Between Controlled Entities Can Provide Surprises Under Sec. 512(b)(13)

Many tax-exempt organizations are growing into complex multi-entity groups including both nonprofit corporations that are tax exempt under Sec. 501(c) and for-profit entities, which are taxed accordingly. Typically, members of a multi-entity structure enter into contracts with one another regarding matters such as management agreements, real property leases, lending facilities, and licenses of intellectual property. Sometimes these relationships can create undesired tax consequences caused by Sec. 512(b)(13), which can lead to unrelated business taxable income (UBTI) for tax-exempt members of a group.

### UBTI

In a standard application of Sec. 512(b)(13), a subsidiary entity will make a deductible payment of interest, rent, royalty, or annuity to a parent exempt organization. Under Secs. 512(b)(1), (2), and (3), receipt by (tax-exempt) Sec. 501(c) entities of interest, rents, royalties, and annuities is generally excluded from UBTI. However, under Sec. 512(b)(13), the parent exempt organization is subject to UBTI. (The subsidiary is not affected by Sec. 512(b)(13).) Thus, Sec. 512(b)(13) treats a parent exempt organization more harshly in its contractual relationships within its related group than in similar relationships with unrelated third parties.

Sec. 512(b)(13)(A) provides that if a tax-exempt organization (controlling organization) receives or accrues a "specified payment" from a "controlled entity," the resulting income will be UBTI to the controlling organization to the extent it would reduce the net unrelated income or increase the net unrelated loss of the controlled entity.

Under Sec. 512(b)(13)(D), a controlling organization is deemed to control a taxable controlled entity if it owns:

- More than 50% of a corporation's stock;
- More than 50% of the profits or capital interest in a partnership; or
- More than 50% of the beneficial interest in any entity.

Sec. 318 constructive ownership rules apply, including the rules regarding attribution of indirect ownership.

A specified payment is defined under Sec. 512(b)(13)(C) to include "interest, annuity, royalty, or rent."

Sec. 512(b)(13)(B) defines "net unrelated income or loss" differently depending on whether the controlled entity is tax exempt or taxable. For a tax-exempt controlled entity, net unrelated income is equal to the controlled entity's UBTI before deducting the specified payment. For a taxable controlled entity, net unrelated income is equal to the amount of its taxable income, which would be UBTI (before deducting the specified payment) if the controlled entity had the same exempt purpose as the controlling organization.

Regs. Sec. 1.512(b)-1(l)(3) adds that the taxable income of a taxable controlled entity equals the greater of taxable income or taxable income less any income that would not be unrelated business income of the controlling organization (excess taxable income). Thus, if the controlled entity operated an activity that would be considered an exempt activity, any loss generated by the activity would increase taxable income for these purposes to an amount in excess of the actual taxable income. This regulation keeps the related loss from knocking the calculation of net unrelated income out of parity.

### Applying the Rules

The following examples show the application of these rules. *E* is a philanthropy group consisting of *H*, a Sec. 501(c)(3) public charity; *F*, a type I Sec. 509(a)(3) supporting organization of *H*, which does not carry out any unrelated activities; and *G*, a wholly owned C corporation of *H*. *G*'s activities would be

unrelated business income if carried on by *H*.

Since *F* is a type I supporting organization (i.e., it is operated, supervised, and controlled by *H*), *H* is deemed to control 100% of *F*, which in turn is considered akin to 100% ownership of the beneficial interest of *F* under Sec. 512(b)(13)(D). Therefore, *F* is a controlled entity. *G* is a controlled entity because *H* owns 100% of its stock, which is more than the 50% stock ownership required under Sec. 512(b)(13)(D).

**Example 1:** *H* owns the building in which the group is housed. *H* entered into separate written leases on January 1, 2008, with *F* and *G* for use of the building.

Rent payments are considered specified payments under Sec. 512(b)(13)(C). *G*'s activities would all be unrelated business income if carried out by *H*. Therefore, payments of rent from *G* to *H* would reduce *G*'s "net unrelated income or loss" under Sec. 512(b)(13)(B). Hence, rents received from *G* will be considered UBTI to *H*. However, *F* does not conduct unrelated activities. Thus, when *F* pays rent to *H*, the payment does not reduce *F*'s "net unrelated income or loss" (which remains \$0). As such, rent received from *F* will not be considered UBTI to *H*.

**Example 2:** On January 1, 2008, *H* enters into a license agreement with *G* for use of its trade names, trademarks, and related intellectual property. *G* agrees to pay *H* a royalty equal to 4% of *G*'s gross revenue. *G*'s 2008 gross revenue is \$12,500,000, resulting in a royalty of \$500,000. Separately, *H* transfers to *G* one of its exempt activities. In 2008, *G* has \$750,000 of taxable income (before deducting the royalty), consisting of \$375,000 each from unrelated and exempt activities.

*H* will recognize \$250,000 of the \$500,000 royalty payment as UBTI. Since 50% of *G*'s taxable income would be earned in activities in furtherance of *H*'s exempt purpose, the other 50% of *G*'s revenue would be considered net unrelated income. *H*

would have UBTI of \$250,000 (50% of \$500,000). See Regs. Sec. 1.512(b)-1(l)(3)(iii), Example (1).

### Arm's-Length Transfer

The Pension Protection Act of 2006, P.L. 109-280, added an important exception (which applies to the concepts provided above) in reference to Sec. 512(b)(13). Under Sec. 512(b)(13)(E), a qualifying specified payment that meets the Sec. 482 arm's-length transfer standards will be excluded from the application of Sec. 512(b)(13). A qualifying specified payment is any specified payment made under a contract in force as of August 16, 2006, or a contract that is a renewal under terms substantially similar to those entered into under a prior contract in force as of August 16, 2006. There is a penalty for valuation misstatement equal to 20% of the excess of the appropriate fair value. This provision was originally to sunset on December 31, 2007, but has been extended until December 31, 2009.

In the Pension Protection Act, Congress also enacted Sec. 6033(h)(1), which requires taxpayers to report on payments between controlling organizations and controlled entities (see 2007 Form 990, Part XI). After assessing information provided by taxpayers in Part XI, Treasury is required to report to Congress in 2009 about the provision.

**Example 3:** The facts are the same as in Example 1, except now the lease agreements are entered into on January 1, 2006. Since the leases were entered into prior to August 16, 2006, assuming *H* meets the Sec. 482 fair value standard, the rental payments from *G* will be considered qualifying specified payments and as such are excluded from UBTI.

This exception is valued and welcomed by exempt organizations and practitioners. Hopefully, following the submission of the Treasury report, Congress will amend Sec. 512(b)(13) as a whole to allow exempt organizations arm's-length receipts from their subsidiaries in all instances without being subject to UBTI.

It is important to note that, notwithstanding Sec. 512(b)(13)(E), there is no

fair value standard for specified payments between controlled entities. However, payments made at below-market value from taxable or noncharitable entities to charitable entities are inherently instances of private inurement and can subject organizations to the risk of sanction, including loss of exemption for the charitable organization.

### Circumventing Sec. 512(b)(13)

In some instances, the provisions of Sec. 512(b)(13) can be circumvented. Sometimes organizations work with unrelated for-profit enterprises on for-profit activities. In these instances, it can be possible for the for-profit enterprise to own 50% or more of an entity and the tax-exempt organization less than 50% of the entity. Thus, the for-profit enterprise is not a controlled entity. Since the receipt of interest is otherwise excluded from UBTI under Sec. 512(b)(1), the organization can provide financing to the entity and lock in a steady return without paying any tax because the level of ownership is not more than 50%.

In other instances, Sec. 512(b)(13) can be a tool in expending tax attributes. A tax-exempt organization with a controlled entity may have significant net operating loss carryovers or tax credits that it cannot otherwise utilize. By structuring an arrangement whereby the controlled entity makes specified payments to a parent exempt organization and generates UBTI, the controlled entity will be able to generate a tax deduction while the exempt organization will offset its UBTI with net operating losses or tax credits.

### Conclusion

Sec. 512(b)(13) is an important Code section for practitioners involved in multi-entity tax-exempt groups—especially groups with both taxable and nontaxable entities. These rules pose a significant roadblock to contractual relationships among the group members. However, in some instances these roadblocks can be overcome by careful planning.

From David Lowenthal, CPA, LL.M., Washington, DC

## New Subpart F Regs. Address Manufacturing Exception and Branch Rules

On December 29, 2008, Treasury published final, temporary, and proposed regulations under Sec. 954 addressing the treatment of contract manufacturing arrangements and the branch rules applicable to foreign base company sales income (FBCSI), a type of subpart F income applicable to the sale of inventory (T.D. 9438, REG-150066-08). The new regulations leave the original regulations largely intact, provide an additional test for the “manufacturing exception” (the substantial contribution test), and provide a protocol for administering the branch rules. The new regulations also eliminate the “its defense,” which is described in the preamble as being contrary to existing law and representing an incorrect reading of the FBCSI rules. These regulations are generally effective for tax years of controlled foreign corporations (CFCs) beginning after June 30, 2009, and the corresponding tax years of U.S. shareholders.

In general, the FBCSI rules impose U.S. tax on income derived by a CFC in connection with the sale of products purchased from a related party and sold outside the CFC’s country of organization (Sec. 954(d)). Exceptions exist for products manufactured in the CFC’s country of organization, *de minimis* transactions, and transactions subject to high rates of foreign tax. An additional exception exists for products that are manufactured by the CFC (the manufacturing exception). In many cases, the selling CFC may perform some but not all of the manufacturing functions in connection with the property it sells. These new regulations address the issue of what level of manufacturing activities a CFC must perform to become eligible for the manufacturing exception.

Two alternative tests are available under the existing regulations to determine if a CFC has performed sufficient manufacturing activities to satisfy the manufacturing exception. The first is the substantial transformation test, under which property is considered manufactured

if it is substantially transformed prior to sale. The regulations give as illustrations of substantial transformation examples such as converting wood pulp into paper, steel rods into screws and bolts, and fresh fish into canned tuna (Regs. Sec. 1.954-3(a)(4)(ii)). The second is the substantive test/safe harbor, under which property is considered manufactured if the CFC purchases components and performs substantial operations that are generally considered to be manufacturing activities (Regs. Sec. 1.954-3(a)(4)(iii)). A safe harbor is available if the conversion costs (direct labor and factory burden) incurred by the CFC in the integration process account for 20% or more of the total cost of goods sold. Packaging, repackaging, labeling, or minor assembly will in no event constitute manufacturing. The new regulations refer to these two tests collectively as the physical manufacturing tests.

Arguably, another basis for claiming the manufacturing exception is available under the statute, which provides that FBCSI is defined as “income . . . derived in connection with the purchase of personal property from . . . any person and its sale to a related person” (Sec. 954(d)(1); emphasis added). Taxpayers have taken the position, commonly referred to as the “its defense,” that as long as the property purchased and the property sold by the CFC is not the same property, its sale does not give rise to FBCSI. CFCs relying on this defense take and hold title to raw materials, work in process, and finished goods inventories, while a related third party performs the manufacturing processes on a contract fee basis.

### Branch Rules

The branch rules are intended to prevent circumvention of the FBCSI rules by taxpayers that conduct business through a branch, thereby eliminating the intercompany sale that would otherwise give rise to FBCSI.

**Example:** *H* is a CFC based in Hong Kong, which in turn owns *C*, a manufacturing CFC based in the People’s Republic of China (PRC). *H* purchases products from *C* and resells them to customers outside Hong Kong.

Such sales would give rise to FBCSI. However, if *C* were instead structured as a branch of *H* (either as a branch in fact or as a disregarded entity), the intercompany sale of products from *C* to *H* would be a mere transfer from a branch to the remainder of the CFC (remainder). Absent the branch rules, FBCSI would be avoided. However, if the branch rules apply, the branch is treated as a CFC separate from the remainder, and the branch transfer becomes an intercompany sale resulting in FBCSI.

The branch rules are triggered based on the disparity in tax rates between the branch and the remainder of the CFC. The manufacturing branch rule applies if the sales or procurement function attributed to the remainder is subject to tax at an effective rate that is less than 90% of, and at least five percentage points less than, the tax rate that would apply to that income if it were subject to tax in the manufacturing branch's home country (Regs. Sec. 1.954-3(b)(1)(ii)(b)).

Returning to the example, if the effective tax rate in Hong Kong is 17.5% and the effective tax rate in the PRC is 25%, the Hong Kong rate is less than 90% of the PRC rate ( $90\% \times 25\% = 22.5\%$ ) and less than the PRC rate minus five percentage points ( $25\% - 5\% = 20\%$ ). Accordingly, the manufacturing branch rule applies.

Similarly, the sales or procurement branch rule applies if the branch's income is subject to tax at an effective rate less than 90% of, and at least five percentage points less than, the tax rate that would apply to such income if it were subject to tax in the remainder's home country (Regs. Sec. 1.954-3(b)(1)(i)(b)). In both tests, the branch rule is triggered by the sales or procurement function being subject to a lesser tax rate than the manufacturing function, with the presumption being that the purpose of separating the relatively mobile sales or procurement function from the relatively fixed manufacturing function is to gain the advantage of the lower tax rate.

The branch rules have grown increasingly unwieldy as a result of globalization, segmentation of manufacturing practices, and the proliferation of foreign

branches resulting from U.S. check-the-box elections. Today it is not uncommon for multinational corporations to employ multiple manufacturing facilities around the world, each manufacturing different components or performing final product assembly and test functions. At the same time, modern multinational corporations employ procurement, sales, and distribution entities in many countries. Check-the-box elections are often made to treat some or all of these entities as either disregarded entities or branches of one or more foreign holding companies.

These new and complex structures, which were not envisioned when the original regulations were published, have raised important questions with respect to the application of the branch rules. For example, if multiple entities are involved in the manufacture of a product, which entity is deemed to be the manufacturer, and where is the location of manufacture? If a CFC has multiple sales and manufacturing branches, how is the tax rate disparity test administered? The new FBCSI regulations attempt to address such issues.

### **New Regs.: Substantial Contribution Test**

If a CFC does not meet one of the physical manufacturing tests, the new regulations provide a new test, the substantial contribution test, whereby the CFC may qualify for the manufacturing exception if it makes a substantial contribution through the activities of its employees to the manufacture, production, or construction of personal property (Regs. Sec. 1.954-3(a)(4)(iv)).

Only the activities performed by the CFC's employees are considered. The regulations provide a nonexclusive list of activities to be considered in determining whether the substantial contribution test is met based on the facts and circumstances:

- Oversight and direction of manufacturing activities or processes. Although the regulations single out this activity as being important in most cases, the regulations qualify that the performance of this activity may not be required in every case, depending on the facts.

- Activities considered in, but insufficient to satisfy, the physical manufacturing tests.
- Material selection, vendor selection, or control of the raw materials, work in process, or finished goods.
- Management of manufacturing costs or capacities. This includes activities that help ensure that a plant is run in an economically efficient manner, such as optimizing plant capacity, reducing waste, managing the risk of loss, working on cost reduction or efficiency initiatives associated with the manufacturing process, demand planning, production scheduling, or hedging raw material costs. Not all corporate managerial decisions are intended to be considered in the test because many decisions are not "directly related to the manufacture of the personal property."
- Control of manufacturing-related logistics. This includes, for example, arranging for delivery of raw materials to a contract manufacturer but excludes, for example, delivery of finished goods to a customer.
- Quality control; for example, sample testing or establishment of quality control standards.
- Developing, or directing the use or development of, product design and design specifications, as well as trade secrets, technology, or other intellectual property for the purpose of manufacturing, producing, or constructing the personal property. Only manufacturing-related activities are considered.

The location of manufacture is based on where the employees perform the activities, rather than where the CFC is located. For this purpose, the definition of an employee generally includes certain nonpayroll workers (such as certain seconded workers, part-time workers, and contractors) who are considered common-law employees under Regs. Sec. 31.3121(d)-1(c). The definition does not go so far as to include anyone in an agency relationship, as this may create unintended branch rule issues.

In connection with the substantial contribution test analysis, all CFC employee functions that contribute to the manufacture of the personal property

are considered in the aggregate and are weighted based on the economic significance of such functions to the manufacturing activities. The performance (or lack thereof) of any particular activity is not determinative, and there is neither one activity that must be performed in all cases nor any minimum number of activities or a performance threshold (Regs. Sec. 1.954-3(a)(4)(iv)(c)). (Note that eleven examples in the regulations in which the test is satisfied involve at least three, and often four, of the factors listed above.)

The fact that other persons make a substantial contribution to the manufacturing activities does not preclude the CFC from making a substantial contribution of the same activities through its employees. Therefore, in applying the test, each CFC takes into account its own employees' individual activities, considers all functions performed by the employees, and weights the functions based on the facts and circumstances of the particular business in order to determine if sufficient activity has been performed.

The mere right to perform these activities is not sufficient; the CFC's employees must actually exercise their right and perform the activities. Thus, contractual rights, legal title, tax ownership, or assumption of economic risk are not determinative. The substantial contribution test is administered on a product-by-product basis. For this purpose, a product is defined by reference to the distinctions made by the CFC in its business operations and in its books and records, not by a third-party definition or industry classification (e.g., SIC code). There is no special documentation required in connection with the substantial contribution test.

### New Branch Rules

The new regulations provide a protocol for applying the branch rules to modern multinational business models. This protocol may be best addressed by way of a summary of its principles:

- Each branch's functions stand on their own for purposes of determining if a manufacturing test is met. (An exception applies to multiple branches in the

same country, which are considered in aggregate.)

- The location of a manufacturing activity is determined based on where employees perform such activity.
- The functions of branches not treated as separate CFCs under the tax rate disparity tests are attributed back to the remainder.
- The hypothetical effective tax rate, for purposes of the tax rate disparity test, takes into account any uniformly available tax incentives available in the foreign jurisdiction.
- In a case in which sales, procurement, and manufacturing functions are performed through branches (e.g., the remainder is a pure holding company), the tax rate disparity test is applied on a branch-to-branch basis.
- If multiple branches (or one or more branches and the remainder) independently satisfy a manufacturing test, the location of manufacture is determined based on the jurisdiction that imposes the lowest effective tax rate.
- If the CFC as a whole is determined to satisfy the substantial contribution test, but no branch individually satisfies a manufacturing test, the manufacturing location is determined using an approach that employs both a functional analysis and a comparison of effective tax rates.

### Effective Date

These regulations are generally effective for tax years of CFCs beginning after June 30, 2009, and for tax years of U.S. shareholders in which or with which such tax years of the CFC end (e.g., 2010 for calendar-year taxpayers). Taxpayers may elect retroactive application to all open tax years, and the regulations expire in three years.

### Conclusion

The new FBCSI regulations largely succeed in updating the regulations to address modern business models. The new substantial contribution test provides a welcome third alternative to the existing physical manufacturing tests. The revised branch rules also provide a greater degree of clarity and certainty, albeit at the

cost of additional complexity. Taxpayers that may be adversely affected by these regulations include those that have relied on the "its defense" and those employing foreign holding company/check-the-box structures. All taxpayers involved in cross-border trade should revisit their structures in light of these new regulations and be mindful of permanent establishment, transfer pricing, and other foreign implications arising from any operating modifications made to comply with the new regulations.

From Bert J. Hawkins, CPA, MST, and Cari A. Koval, CPA, Los Angeles, CA

### Transfer Pricing: The New Temporary Cost-Sharing Regs.

On December 31, 2008, the IRS introduced new temporary cost-sharing regulations (T.D. 9441) that replace the old cost-sharing regulations introduced in 1995. The goal of the new regulations is to ensure that cost-sharing arrangements and platform contribution transactions are consistent with Sec. 482's commensurate with income (CWI) principle. To achieve that goal, the IRS has introduced three new methods—the income method, the acquisition price method, and the market capitalization method—to ensure arm's-length pricing in all cost-sharing transactions. The comparable uncontrolled transaction (CUT) method and a revised residual profit split (RPS) method are also included as specified methods.

### The Nature of the CSA and CSA Transactions

The new regulations apply only to cost-sharing arrangements (CSAs) meeting the standards identified in Temp. Regs. Sec. 1.482-7T and platform contribution transactions (as defined in the new CSA regulations). Other transactions involving intangibles should be analyzed using Regs. Sec. 1.482-4. To ensure consistency with CWI, the new CSA regulations apply the concept of an investor model based on the opportunity cost principle from standard microeconomics. In economic theory, when people make economic decisions they select the option they believe will provide the greatest net

gain. The opportunity cost of that option is the next best alternative forgone. In the new CSA regulations, the investor model requires the CSA participants to look at realistic, alternative investment options that would provide the same results as the CSA but with different risk and functional fact patterns.

A CSA is an arrangement in which controlled participants to the CSA share in the cost of developing cost-shared intangibles in proportion to the share of reasonably anticipated benefits (RABs) each participant expects to receive (Temp. Regs. Sec. 1.482-7T(b)). In the CSA, controlled participants must make payments to each other to ensure that their cost contributions to intangible development activities (IDAs) reflect their respective RABs. The scope of the IDAs includes all activities that could reasonably be anticipated to contribute to developing the reasonably anticipated cost-shared intangibles.

The new CSA regulations introduce the concept of a platform contribution transaction (PCT) to replace the overly broad “external contributions” from the 2005 proposed regulations. In a PCT, one CSA participant contributes to a CSA an intangible that will be used to help develop the CSA’s cost-shared intangible. Other members of the arrangement (the PCT payors) must make arm’s-length PCT payments to the participant who contributes the PCT intangible (the PCT payee). The temporary regulations require the PCT payor to compensate the PCT payee only for platform contributions that can reasonably be anticipated to contribute to the CSA activity in the PCT payor’s division. The temporary regulations adopt a presumption that a PCT payee provides any resource, capability, or right to the IDA on an exclusive basis (Temp. Regs. Secs. 1.482-7T(b)(1)(ii) and (c)).

The new CSA regulations require the CSA participants to segment the interests of each CSA member into exclusive divisions. In a division, each controlled participant must receive a nonoverlapping interest in the cost-shared intangibles without further obligation to compensate another participant for such interest. For example, a CSA can segment interests by assigning exclusive territories where each

participant is the sole beneficiary of sales in its exclusive region (Temp. Regs. Secs. 1.482-7T(b)(1)(iii) and (b)(4)(ii)).

The new CSA regulations allow the divisions to be created on nonterritorial bases. One method a taxpayer can use is to identify specific fields of use for the intangible and assign each participant exclusive control over a field or set of fields. In the field of use division, each controlled participant must own clearly defined consumer uses for the intangible from which to earn its RAB. An intangible product could have multiple market uses generating multiple income streams. Each unique income stream would need to be identified and assigned to a controlled participant. Income from uses not yet identified would need to be assigned to one participant as well (Temp. Regs. Sec. 1.482-7T(b)(4)(iii)).

### **Intangible Development Costs**

The basis of any CSA is how to divide intangible development costs (IDCs) of performing an IDA. Costs included in IDCs are determined by the scope of IDA activity. The IDA is the activity undertaken by the CSA participants to develop or attempt to develop reasonably anticipated cost-shared intangibles. The scope of the IDA includes all the controlled participants’ activities that could reasonably be anticipated to contribute to developing the reasonably anticipated cost-shared intangibles (Temp. Regs. Sec. 1.482-7T(d)(1)(i)).

The IDCs that result from the IDAs include all costs, in cash or in kind (including stock-based compensation, as described in Temp. Regs. Sec. 1.482-7T(d)(3)), incurred by the CSA participants. Thus, controlled participants to the CSA must include in the IDCs the costs they incurred in attempting to develop reasonably anticipated cost-shared intangibles, regardless of whether such costs fail to develop those intangibles, unexpectedly develop other intangibles, or produce no intangibles (Temp. Regs. Sec. 1.482-7T(d)(1)(iii)).

The new CSA regulations are clear about the requirement to include stock options in the IDCs. The cost attributable to stock-based compensation is equal to

the amount the controlled participant is allowed to take as a deduction for federal income tax purposes with respect to that stock-based compensation and is taken into account as an IDC for the tax year for which the deduction is allowable. The CSA participants should value the stock-based compensation as of the grant date (Temp. Regs. Sec. 1.482-7T(d)(1)(iii)).

The new CSA regulations are based on the investor model and the analysis of realistic alternatives to the proposed CSA (Temp. Regs. Sec. 1.482-7T(g)(2)(ii)). The PCT payor is investing in the CSA activity with cost-sharing payments and PCT payments to realize a return over time that is consistent with the riskiness of the project. The realistic alternatives to the investor represent the opportunity cost of the project that a third-party investor would have to consider before moving forward with the CSA. The returns are measured using a present value calculation.

The measurement of arm’s-length results requires a complete best method analysis. To ensure that CSA results are consistent with the arm’s-length standard, expected returns to particular functions and risks in the investor model assumed in intangible development should be assessed in light of the facts and circumstances. The facts and circumstances of the transaction will dictate the selection of a best method.

The results of a best method analysis performed in connection with certain methods or forms of payment may depend on the rate or rates of return used to convert projected results of transactions to present value. Discount rate selection plays a central role in the present value analysis. The allocation of costs and establishment of cost contributions rely on forecasts of future anticipated business activities and financial results (Temp. Regs. Sec. 1.482-7T(g)(2)(v)).

The new CSA regulations recognize that different realistic alternatives may carry different risk profiles and require different discount rates. A single method may require the use of multiple rates. When selecting rates for inclusion in the best estimate of a present value calculation, the taxpayer must identify the rate(s) that most reliably assess the market risks

of activities and transactions. The new CSA regulations endorse the use of an iterative approach when multiple rates are used to establish an arm's-length range (Temp. Regs. Sec. 1.482-7T(g)(2)(ix)).

### CSA Arm's-Length Calculation Using the RAB Method

For the arm's-length allocation for IDCs under a CSA, taxpayers should use the RAB method (Temp. Regs. Sec. 1.482-7T(a)(1)). When determining RAB shares at any given time, reasonably anticipated benefits must be estimated over the entire period, past and future, of exploitation of the cost-shared intangibles. A controlled participant's RAB share is equal to its RAB divided by the sum of the RABs of all the controlled participants (Temp. Regs. Sec. 1.482-7T(e)(1)(i)).

Reasonably anticipated benefits are measured either on a direct basis, by reference to estimated benefits to be generated by the use of cost-shared intangibles (generally based on additional revenues plus cost savings less any additional costs incurred), or on an indirect basis, by reference to certain measurements that reasonably can be assumed to relate to benefits to be generated (Temp. Regs. Sec. 1.482-7T(e)(2)). Indirect bases for measuring anticipated benefits from participation in a CSA include units used, produced, or sold; sales; or operating profit. In some circumstances, other bases for measuring anticipated benefits may be appropriate.

The reliability of an estimate of RAB shares also depends upon the reliability of related projections. Projections required for this purpose generally include:

- A determination of the time period between the inception of the research and development activities under the CSA and the receipt of benefits;
- A projection of the time over which benefits will be received; and
- A projection of the benefits anticipated for each year in which it is anticipated that the cost-shared intangible will generate benefits.

A projection of the relevant basis for measuring anticipated benefits may require a projection of the underlying factors. For example, a projection of operating

profits may require a projection of sales, cost of sales, and operating expenses (Temp. Regs. Sec. 1.482-7T(e)(2)(iii)).

### Income Method

Under the new income method (Temp. Regs. Sec. 1.482-7T(g)(4)), a proposed CSA advances a cost-sharing scenario between a PCT payor and PCT payee, where the PCT payor makes payments for its share of the platform intangible contributed by the PCT payee, and the parties to the CSA agree to share in the costs of the IDAs. The present value of the PCT payor's cost-sharing alternative is the present value of the stream of the reasonably anticipated residuals, over the duration of the CSA activity, of divisional profits or losses, minus operating cost contributions, minus intangible cost contributions, minus PCT payments (Temp. Regs. Sec. 1.482-7T(g)(4)(ii)).

The income method uses realistic alternatives to measure the opportunity cost of the proposed CSA. The method employs the CUT method and the comparable profits method (CPM) to build up specified types of comparable sets for the realistic alternatives. The income method evaluates whether the amount charged in a PCT is determined at arm's length by reference to a controlled participant's best realistic alternative to entering into a CSA. Under this method, the arm's-length charge for a PCT payment will be an amount where the present value of the controlled participant's cost-sharing alternative, at the date of the PCT, equals the present value of the next best realistic alternative.

In general, the PCT payor's best realistic alternative to entering into the CSA would be to license intangibles to be developed by an uncontrolled licensor that undertakes the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA. Similarly, the PCT payee's best realistic alternative to entering into the CSA would be to commit to bear the entire risk of intangible development that would otherwise have been shared under the CSA and license the resulting intangibles to an uncontrolled licensee (Temp. Regs. Sec. 1.482-7T(g)(4)(i)(A)).

The new CSA regulations discuss two applications of the income method licensing scenario, one using a CUT method and one using a CPM. The licensing alternative is derived on the basis of a functional and risk analysis of the cost-sharing alternative, but with a shift of the risk of cost contributions to the licensor. The PCT payor's licensing alternative consists of entering into a license with an uncontrolled party, for a term extending for what would be the duration of the CSA activity, to license the make-or-sell rights in to-be-developed resources of the licensor. Under such license, the licensor would undertake the commitment to bear the entire risk of intangible development that would otherwise have been shared under the CSA.

The present value of the PCT payor's licensing alternative may be determined using the CUT method, as described in Regs. Secs. 1.482-4(c)(1) and (2). In this case, the present value of the PCT payor's licensing alternative is the present value of the stream, over what would be the duration of the CSA activity under the cost-sharing alternative, of the reasonably anticipated residuals of the divisional profits or losses that would be achieved under the cost-sharing alternative, minus operating cost contributions that would be made under the cost-sharing alternative, minus the licensing payments as determined under the CUT method (Temp. Regs. Sec. 1.482-7T(g)(4)(iii)(A)).

The present value of the PCT payor's licensing alternative may be determined using the CPM, as described in Regs. Sec. 1.482-5. In this case, the present value of the licensing alternative is the same as in the CUT scenario, except that the PCT payor's licensing payments are determined to be a lump sum, as of the date of the PCT, equal to the present value of the stream, over what would be the duration of the CSA activity under the cost-sharing alternative, of the reasonably anticipated residuals of the divisional profits or losses that would be achieved under the cost-sharing alternative, minus operating cost contributions that would be made under the cost-sharing alternative, minus market returns for routine contributions (Temp. Regs. Sec. 1.482-7T(g)(4)(iii)(B)).

## Acquisition Price Method

The acquisition price method (Temp. Regs. Sec. 1.482-7T(g)(5)) applies the CUT method of Regs. Sec. 1.482-4(c) or the comparable uncontrolled services price (CUSP) method described in Temp. Regs. Sec. 1.482-9T(c) to evaluate whether the amount charged in a PCT is determined at arm's length by reference to the amount charged (the acquisition price) for the stock or asset purchase of an entire organization or portion thereof (the target) in an uncontrolled transaction. The acquisition price method is ordinarily used where substantially all the target's nonroutine contributions made to the PCT payee's business activities are covered by a PCT. Under this method, the arm's-length charge for a PCT is equal to the adjusted acquisition price, as divided among the controlled participants according to their respective RAB shares.

## Market Capitalization Method

The market capitalization method (Temp. Regs. Sec. 1.482-7T(g)(6)) applies the CUT method of Regs. Sec. 1.482-4(c) or the CUSP method described in Temp. Regs. Sec. 1.482-9T(c) to evaluate whether the amount charged in a PCT is determined at arm's length by reference to the average market capitalization of a controlled participant (PCT payee) whose stock is regularly traded on an established securities market. The market capitalization method is ordinarily used where substantially all the PCT payee's nonroutine contributions to the PCT payee's business are covered by a PCT.

Under the market capitalization method, the arm's-length charge for a PCT covering resources, capabilities, and rights of the PCT payee is equal to the adjusted average market capitalization, as divided among the controlled participants according to their respective RAB shares. The average market capitalization is the average of the daily market capitalizations of the PCT payee over a period beginning 60 days before the date of the PCT and ending on the date of the PCT.

## Residual Profit Split Method

The RPS method (Temp. Regs. Sec. 1.482-7T(g)(7)) evaluates whether the

allocation of combined operating profit or loss attributable to one or more platform contributions subject to a PCT is determined at arm's length by reference to the relative value of each controlled participant's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity (relevant business activity) of the controlled participants for which data are available that includes the CSA activity. The residual profit split method may not be used where only one controlled participant makes significant nonroutine contributions (including platform or operating contributions) to the CSA activity.

The relative value of each controlled participant's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity. Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled participants engaged in the relevant business activity.

Under the RPS method, the present value of each controlled participant's residual divisional profit or loss attributable to nonroutine contributions (nonroutine residual divisional profit or loss) is allocated among the controlled participants that furnish significant nonroutine contributions (including platform or operating contributions) to the relevant business activity in that division (Temp. Regs. Sec. 1.482-7T(g)(7)(iii)(A)).

The present value of nonroutine residual divisional profit or loss equals the present value of the stream of the reasonably anticipated residuals, over the duration of the CSA activity, of divisional profit or loss, minus market returns for routine contributions, minus operating cost contributions, minus cost contributions, using a discount rate appropriate to such residuals. The present value of nonroutine residual divisional profit or loss in each controlled participant's

division must be allocated among all the controlled participants based upon the relative values (determined as of the date of the PCTs) of the PCT payor's PCT payments as compared with the PCT payee's nonroutine contributions to the PCT payor's division (Temp. Regs. Sec. 1.482-7T(g)(7)(iii)(B)).

## Comparable Uncontrolled Transaction Method

The CUT method described in Regs. Sec. 1.482-4(c) and the CUSP method described in Temp. Regs. Sec. 1.482-9T(c) may be applied to evaluate whether the amount charged in a PCT is determined at arm's length by reference to the amount charged in a CUT (Temp. Regs. Sec. 1.482-7T(g)(3)). When applied in the manner described in Regs. Sec. 1.482-4(c) or Temp. Regs. Sec. 1.482-9T(c), the CUT or CUSP method will typically yield an arm's-length total value for the platform contribution that is the subject of the PCT. That value must then be multiplied by each PCT payor's respective RAB share in order to determine the arm's-length PCT payment due from each PCT payor.

From Jeffrey B. Kaufman, Phoenix, AZ

### GAINS & LOSSES

## Discharge of Indebtedness: Conversion vs. Contribution of Indebtedness

As a result of the credit crunch and economic slowdown, an increasing number of businesses are facing difficulties in meeting the payment obligations on their indebtedness. In an effort to de-leverage, more and more creditors, particularly those also holding an equity position, are willing to accept repayment for less than the face amount of the debt. Apart from settling the debt in cash for less than its face value, there are other methods debtors and creditors may use to modify, reduce, or even eliminate debt. Depending upon the method, the tax implications may vary.

In general, satisfaction of debt for less than its adjusted issue price (within the meaning of Regs. Sec. 1.1275-1(b)) generates cancellation of debt (COD) income.

This item addresses the federal income tax implications for debtors and creditors where:

1. A shareholder-creditor (or partner) contributes a debt obligation of the debtor corporation (or partnership) as a contribution of capital; or
2. The debtor corporation (or partnership) converts the debt owed to a creditor into stock (or a partnership interest).

This item is limited in scope to the above issues and will not address the application of the Sec. 108(a) COD exclusions for insolvent corporations and corporations in bankruptcy or similar proceedings.

### Capital Contribution of Corporation's Indebtedness: Sec. 108(e)(6)

Sec. 108(e)(6) overrides the provisions of Sec. 118 (which exclude contributions of capital from the gross income of the corporation) and provides that a capital contribution by a shareholder of the corporation's own debt is treated as if the debtor corporation satisfied the debt with an amount of money equal to the shareholder's adjusted basis in the debt. Thus, if the shareholder-creditor's basis in the contributed debt is at least equal to the adjusted issue price of the debt, the debtor corporation will avoid COD income upon contribution of such debt. However, if the shareholder's basis in the debt is less than the adjusted issue price of the debt, the debtor corporation will recognize COD income.

**Example 1:** Corporation *D* owes \$100 to *C*, the sole shareholder of *D*. The adjusted issue price of the debt and *C*'s basis in the debt equal \$100. In order to meet certain debt covenants related to outstanding third-party debt, *C* contributes the debt to capital. *C*'s contribution of the debt to capital does not trigger COD income to *D* because *C*'s basis in the contributed debt is equal to the adjusted issue price of the debt.

In situations in which the shareholder contributing the debt is not the sole shareholder, compensation and gift issues may

## As a result of the current economic conditions, many third-party creditors are looking to de-leverage.

arise if the benefiting shareholders are employees or are related to the contributing shareholder.

### Special Rule for S Corps.

Under Sec. 1367(b)(2), if an S corporation is indebted to a shareholder, the shareholder's basis in the debt is reduced for excess losses deducted by virtue of Sec. 1366(d)(1)(B). If the shareholder later contributes such debt to the S corporation, absent any provision to the contrary, the COD income of the S corporation would be computed with reference to the shareholder's reduced basis in the debt. In order to prevent this outcome, Sec. 108(d)(7)(C) provides that for the purposes of Sec. 108(e)(6), a shareholder's adjusted basis in debt of an S corporation will be determined without regard to any adjustments made under Sec. 1367(b)(2).

**Example 2:** *D*, an S corporation, owes \$100 to one of its shareholders, *C*, who had \$100 basis in that debt. *C*'s basis in his *D* stock is \$50. *C*'s share of *D*'s tax loss for the year is \$80. Under Sec. 1367(b)(2), *C*'s basis in the debt is reduced by \$30 (excess of *C*'s share of *D* loss over *C*'s adjusted basis in *D* stock). *C* subsequently contributes the debt to *D*.

Under Sec. 108(d)(7)(C), the reduction in *C*'s basis in the debt under Sec. 1367(b)(2) is ignored for purposes of Sec. 108(e)(6). *D* does not recognize COD income because the adjusted issue price of the debt (\$100) is equal to *C*'s basis in the debt (ignoring any reduction under Sec. 1367(b)(2)).

### Issuance of Stock for Debt: Sec. 108(e)(8)

Sec. 108(e)(8) provides that when a debtor corporation transfers stock to a creditor in satisfaction of its debt, the debtor corporation is treated as having satisfied the debt with an amount of money equal to the stock's fair market value (FMV). Thus, if the FMV of the

stock issued to the creditor is less than the adjusted issue price of the debt instrument, the excess of the adjusted issue price of the debt instrument over the stock's FMV is COD income for the debtor corporation. The provisions of Sec. 108(e)(8) will apply at the corporate debtor level whether or not the exchange of stock for debt qualifies as a valid reorganization under Sec. 368(a)(1)(E).

**Example 3:** *T*, an unrelated third party, holds a \$100 *D* bond. *D* issues stock worth \$60 in full satisfaction of the bond. *D* recognizes \$40 of COD income (excess of adjusted issue price of the debt, \$100, over FMV of stock issued, \$60). *D* recognizes the COD income whether the exchange represents a Sec. 368(a)(1)(E) reorganization or is a taxable exchange.

**Recapture of gain on subsequent sale of stock:** Sec. 108(e)(7) contains special recapture provisions that state that if *T* takes a bad debt deduction on the debt prior to the exchange or recognizes a loss on the exchange, and subsequently disposes of the stock at a gain, the gain is "recaptured" as ordinary income under the rules of Sec. 1245 up to the amount of the bad debt deduction taken or loss recognized by *T*.

### Sec. 108(e)(6) vs. Sec. 108(e)(8): Comparative Analysis

While Sec. 108(e)(8) exchanges require issuance of new stock to the creditor, no such stock is issued to the creditor in the case of contribution of corporate debt in a Sec. 108(e)(6) transaction. This difference may prove to be an important planning tool, especially with closely held corporations.

A sole shareholder's interest in the corporation remains unaffected whether he or she receives additional stock from the corporation in exchange for the corporation's debt or contributes the corporation's

debt as additional capital. Since the computation of COD income follows different rules depending upon whether the income is due to a contribution to capital or exchange of stock for debt, the sole shareholder of the corporation may structure the transaction in the most tax-efficient manner (though the IRS may challenge the form if the substance of the transaction differs from its form).

**Example 4:** Assume the same facts as in Example 1, except that *D* issues additional stock with a value of \$80 to *C* in exchange for the note. Unlike Example 1, *D* recognizes COD income of \$20 on the exchange (excess of adjusted issue price of the debt, \$100, over FMV of stock issued, \$80).

Since *C* continues to own 100% of *D* stock whether the debt is exchanged for additional stock or is contributed to capital, the tax implications are vital in structuring the transaction.

Another difference between Sec. 108(e)(6) and (e)(8) transactions is that while a contribution of capital as envisaged under Sec. 108(e)(6) is required to be from an existing shareholder of the debtor corporation, the issuance of stock as provided under Sec. 108(e)(8) may be to any creditor of the corporation, whether or not the creditor is an existing shareholder of the corporation.

Further, as discussed later, while the statute and recently proposed regulations address Sec. 108(e)(8) in a partnership context, the applicability of rules similar to Sec. 108(e)(6) in the partnership context is unclear.

### Tax Treatment for the Creditor

A shareholder-creditor contributing the debtor corporation's debt as a capital contribution generally does not recognize gain or loss on that contribution. However, the shareholder's adjusted basis in the debtor corporation's stock is increased by the shareholder's adjusted basis in the contributed debt. The Supreme Court confirmed this treatment in *Fink*, 483 U.S. 89 (1987), providing that "the shareholder is entitled to increase the basis of his shares by the amount of

his basis in the property transferred to the corporation" and that "[t]his rule applies not only to transfers of cash or tangible property, but also to a shareholder's forgiveness of a debt owed to him by the corporation."

In the case of stock for debt transactions, the tax treatment of the creditor receiving stock in exchange for corporate debt depends upon whether the exchange qualifies for nonrecognition treatment under Sec. 354 or 351. If it does, the creditor generally will not recognize any gain or loss on exchange of stock for debt, and the basis in the stock received will generally equal basis in the exchanged debt under Sec. 358(a)(1). If the transaction does not qualify for nonrecognition treatment, the creditor generally recognizes gain or loss equal to the difference between the FMV of stock received and the adjusted basis in the debt exchanged. In such a case, the creditor's basis in the stock received will be equal to the stock's FMV under Sec. 1012. If a creditor receives stock in exchange for accrued interest, nonrecognition treatment under Sec. 354 or 351 is generally not available (see Secs. 354(a)(2)(B) and 351(d)(3)). Further, if the creditor is a cash-basis taxpayer and thus has no basis in accrued interest, the creditor will have income equal to the FMV of the stock received.

### Applicability of Secs. 108(e)(6) and 108(e)(8) in the Partnership Context

The foregoing analysis discussed the COD implications for corporate debtors in cases of contribution of capital or exchanges of stock for debt. This section discusses the applicability of Secs. 108(e)(6) and (e)(8) if the debtor is a partnership.

Regarding the exchange of equity for debt in the partnership context, Sec. 108(e)(8) provides that when a debtor partnership transfers a capital or profits interest to a creditor in satisfaction of recourse or nonrecourse debt, that partnership is treated as satisfying the debt with an amount of money equal to the FMV of the interest. Sec. 108(e)(8) further provides that COD income recognized in the exchange is included in the distributive

shares of partners who were partners in the partnership immediately before the discharge of debt.

Recently issued proposed regulations would, if finalized in their current form, provide that, in general, the FMV of a partnership interest equals the liquidation value, which is the amount of cash or property that the creditor would receive with respect to such equity interest if, immediately after the transfer, the partnership sold all its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the FMV of those assets and then liquidated (Prop. Regs. Sec. 1.108-8(b)(1)). Such liquidation value may be used in determining the FMV of a partnership interest only if certain conditions are met (see Prop. Regs. Secs. 1.108-8(b)(1)(i)-(iv)). If such conditions are not satisfied, the FMV of the transferred partnership interest is based on all the facts and circumstances.

An unfortunate consequence of an exchange under the proposed regulations is the deferral of any loss on the exchange. As addressed above in the corporate context, a creditor could recognize a loss as long as the exchange is not covered under Sec. 354; however, the proposed regulations treat the debt as property contributed to the partnership and as such would, if finalized, defer gain or loss. (See the preamble to the proposed regulations, REG-164370-05.)

**Example 5:** *AB* Partnership has \$1,000 of outstanding debt owed to *C*, who is not currently a partner. *C* agrees to cancel the \$1,000 debt in exchange for an interest in *AB*. The liquidation value of the interest received is \$700. Under Regs. Sec. 1.704-1(b)(2)(iv)(b), *C*'s capital account is increased by \$700 as a result of the equity-for-debt exchange.

Assuming the requirements of Prop. Regs. Sec. 1.108-8(b)(1) are satisfied, the FMV of the equity interest received by *C* is \$700. Under Sec. 108(e)(8), *AB* will recognize COD income of \$300 (excess of adjusted issue price of the debt, \$1,000 over the FMV of equity interest transferred to *C*). The \$300 of COD income

is allocated to the AB partners who were partners before the exchange.

Regarding Sec. 108(e)(6), neither the Code nor the regulations provide any guidance as to whether similar rules apply in a partnership context where a partner contributes partnership debt to a partnership. In the absence of any clear authority, this issue is debatable; however, experts have pointed to the lack of a partnership carve-out in the statute and legislative history as perhaps indicating that COD income would occur upon such a contribution. See McKee et al., *Federal Taxation of Partnerships and Partners* ¶4.02[3] (Warren, Gorham & Lamont 2007). In such a case, presumably the COD income will be calculated following the rules under Sec. 108(e)(8) (id. at ¶9.02[2](a)).

### Sec. 108(e)(4): Trap for the Unwary

As a result of current economic conditions, many third-party creditors are looking to de-leverage and are more likely than ever to extinguish debt at a discount. To many debtors, this is a mixed blessing in that the satisfaction of the debt at a discount will generally result in COD income. To avoid recognition of COD income, owners of the debtor corporation or partnership may attempt to acquire third-party debt and rely on either Sec. 108(e)(6) or (e)(8) to avoid COD income. In such situations, Sec. 108(e)(4) may contain a trap for the unwary by providing that the acquisition of debt by a person related to the debtor (as defined under Sec. 267(b) or 707(b)(1)) from a person who is not so related will be considered an acquisition of such debt by the debtor.

In the case of an acquisition of debt prior to becoming related, the regulations provide for a facts-and-circumstances test for determining whether debt was acquired by a holder in anticipation of becoming related to the debtor (see Regs. Sec. 1.108-2). However, a holder of debt is presumed to have acquired the debt in anticipation of becoming related if the holder acquires the debt less than six months before the date the holder becomes related (Sec. 1.108-2(f)). If Sec. 108(e)(4) applies, the amount of COD income is generally measured by reference to the related

holder's adjusted basis in the debt but may be measured against the debt's FMV (Secs. 1.108-2(f)(1) and (2)). Further, if the debt remains outstanding, the debt is treated as newly issued to the related holder, and such deemed reissuance may result in the creation of original issue discount under Sec. 1273(a)(1) (Sec. 1.108-2(g)).

### Conclusion

When contemplating a debt restructuring, debtor corporations and partnerships need to pay close attention to Sec. 108(e), which provides planning opportunities as well as traps for the unwary.

From Vikas Sekhri, CPA, New York, NY, and Nick Gruidl, CPA, MBT, Minneapolis, MN

#### PARTNERS & PARTNERSHIPS

### Target or Waterfall: Partnership Allocations

In recent years, more and more partnership agreements have been drafted using the targeted capital account approach for allocating partnership items of income or loss (targeted capital approach) versus the typical Sec. 704(b) economic effect approach (waterfall approach). Deals are increasingly complicated, investors are increasingly savvy, and partnership agreements have become significantly more complex to adjust to investor demands. As partnership agreements have evolved, the income allocation and cash distribution provisions in these agreements have become more complicated as well. This item describes two approaches to allocating partnership items of income and loss.

Because of the increasing complexity of allocations in partnership agreements, many practitioners believe that the targeted capital approach for allocating income is a simpler, more user-friendly method to follow than the traditional waterfall approach. The increasing complexity of profit allocation and cash distribution provisions in traditional partnership agreements makes it easier for errors to be made when drafting agreements.

Some practitioners feel the targeted capital approach provides for allocations that more closely resemble the true

economic realities of partnership agreements, as the allocations of partnership income/loss follow the cash distribution and liquidating provisions in the agreements. Other practitioners argue that the targeted capital approach would not be respected under the substantial economic effect provisions of Regs. Sec. 1.704-1.

Another perceived downside to the targeted capital approach is that often the partnership agreement does not adequately address nonrecourse deductions, depreciation recapture, and minimum gain. While there is some controversy among tax practitioners as to whether the targeted capital approach would be respected under Regs. Sec. 1.704-1, use of the targeted capital approach to allocations has become quite common when drafting partnership agreements because this method reflects the economic arrangements of the partners in the deal.

### Agreement Using the Waterfall Approach

A typical partnership agreement drafted using a waterfall approach contains several tiers of income/loss allocations that define the priority in which partnership items of income/loss are to be allocated. These agreements also contain several tiers of cash distribution provisions that define how partnership cash gets distributed to the partners.

The agreement typically contains key provisions that extract language from the regulations to allow the allocations of the partnership to meet the substantial economic effect test, thus allowing the allocations to be respected under Sec. 704(b). Failure to follow the rules under Sec. 704(b) when drafting a partnership agreement can result in adjustments by the IRS to reflect what it believes is the economic arrangement of the partners.

An agreement using the waterfall approach might look like this:

1. Profit Allocations
  - First, to reverse all cumulative allocations of net loss;
  - Second, to the partners in proportion to their percentage interests (as defined in section x) until each partner receives a preferred return

of 12% on his or her unreturned capital;

- Third, 75% to class A partners and 25% to class B partners until class A partners' capital account balances are increased to a level at which an immediate distribution of such capital account balance to a class A partner would cause a class A partner to receive a preferred return of 16%;
  - Fourth, the balance 50% to class A partners and 50% to class B partners.
2. Loss Allocations
    - First, among all partners to offset in reverse order all prior income allocations on a cumulative basis;
    - Any remainder shall be allocated to the partners in proportion to their percentage interests (as defined in section x).
  3. Cash Distributions
    - First, 100% to the partners in proportion to their percentage interest (as defined in section x) until each partner receives a preferred return of 12%;
    - Second, 75% to class A partners and 25% to class B partners until class A partners receive distributions that yield a preferred return of 16%;
    - Third, the balance 50% to class A partners and 50% to class B partners.

**Caution:** Drafting partnership agreements is a legal matter that should be undertaken by legal counsel familiar with partnerships.

### Agreement Using the Targeted Capital Approach

Companies that employ the targeted capital approach make income/loss allocations based on a determination of each partner's capital account balance at the end of the year—a target. Each partner's capital balance at the end of each year is determined by calculating how much cash each partner is entitled to upon liquidation of the partnership. In essence, the income/loss allocations are “backed into” by forcing the ending capital account

balances to be what the partners would receive upon liquidation of the partnership. Agreements written using the targeted capital approach do not contain the same Sec. 704(b) wording that is contained in a waterfall approach agreement.

An agreement using the targeted capital approach might look like this:

1. Profits and Losses

Net profits are first allocated to the partners having negative capital account balances, in proportion to their adjusted negative capital accounts. The remaining profits or net losses shall be allocated to the partners to create capital account balances for the partners that are equal to the amount of cash that would be distributed under the cash distribution provisions of this agreement. If an allocation of net losses exceeds the positive capital account balances of the partners, the excess shall be allocated in accordance with the partners' percentage interests (as defined in section x).

2. Cash Distributions

- First, 100% to the partners in proportion to their percentage interests until each partner receives a preferred return of 12%;
- Second, 75% to class A partners and 25% to class B partners until class A partners receive distributions that yield a preferred return of 16%;
- Third, the balance 50% to class A partners and 50% to class B partners.

**Caution:** Drafting partnership agreements is a legal matter that should be undertaken by legal counsel familiar with partnerships.

### Sec. 704(b) Regs.: Economic Effect

Partnership allocations will generally be respected under Sec. 704(b) if the allocations meet one of two tests:

1. The allocations have substantial economic effect; or
2. The allocations are in accordance with the partner's interest in the partnership.

The substantial economic effect analysis has two parts that evaluate whether an

allocation both has economic effect and is substantial. The regulations maintain that the allocations will have economic effect if (1) the partners' capital accounts are maintained in accordance with the capital accounting rules; (2) upon liquidation, distributions are required to be made in accordance with positive capital account balances; and (3) there is an unconditional obligation to restore the deficit balance if a partner has a deficit capital account balance following the liquidation of his or her interest (also known as a deficit restoration obligation (DRO) (Regs. Sec. 1.704-1(b)(2)(ii)(b)).

If the allocations do not meet the economic effect test, the regulations provide an alternative economic effect test (Regs. Sec. 1.704-1(b)(2)(ii)(d)). Under the alternative test, allocations will be respected if the partners' capital accounts are maintained in accordance with the capital account maintenance rules under Sec. 704(b) and liquidating distributions are required to be made in accordance with positive capital account balances. Instead of a DRO, for allocations to qualify under the alternative test the agreement must include a qualified income offset provision. A qualified income offset provision maintains that if a partner unexpectedly receives a distribution or loss allocation that causes the partner's capital account to go below zero, that partner will be allocated items of income and gain in an amount sufficient to eliminate the deficit balance in the partner's capital account as quickly as possible.

### Sec. 704(b) Regs.: Substantiality

In addition to having to meet the economic effect provisions of the regulations, the partnership allocations must be “substantial” in order to be respected under Sec. 704(b) (Regs. Sec. 1.704-1(b)(2)). Substantiality largely requires a facts-and-circumstances analysis. Agreements should be reviewed to ensure that allocations are substantial—that is, according to the regulations, where there is “a reasonable possibility that the allocation . . . will affect substantially the dollar amounts to be received by the partners from the partnership independent of tax consequences” (Sec. 1.704-1(b)(2)(iii)).

## Partners' Interest in the Partnership

If allocations do not meet the substantial economic effect test, they are then determined according to Sec. 704(b) by looking at the partners' interests in the partnership, which involves taking into account all the facts and circumstances relating to the economic arrangement of the partners. Some of the factors considered include the partners' relative contributions to the partnership, the partners' interests in economic profits and losses (if different than in taxable income or loss), the partners' interests in cashflow and other nonliquidating distributions, and the partners' rights to distributions of capital upon liquidation.

### Analysis

One practitioner argument, albeit simplified, against using the targeted capital approach is that the allocations in this approach do not meet the "substantial economic effect" test of Regs. Sec. 1.704-1 and may not be respected under IRS audit. Targeted capital approach partnership agreements are typically not written with a provision that liquidation will occur in accordance with positive capital accounts, nor do they contain a DRO or a qualified income offset provision. Practitioners who favor the targeted capital approach argue that the approach more closely reflects the economic arrangements of the partners in the partnership and for this reason should be respected because it reflects the partners' interests in the partnership. Although the targeted capital account approach might not satisfy the Sec. 704(b) regulations under the substantial economic effect test, it may qualify under the partners' interest in the partnership test. It should be noted that in newer targeted capital agreements, drafters make a conscious attempt to word the agreements to pass the substantial economic effect test.

### Computing Income Allocations

Following are some examples of computing income allocations under the waterfall and targeted capital approaches.

*Example 1—traditional waterfall approach:* Partner A of AB Partnership

#### Exhibit 1: Year 1 capital accounts in Example 1

	A	B	Total
Initial capital contribution	100,000	50,000	150,000
Tier 1 profit (preferred return)	5,000	2,500	7,500
Tier 2 profit (50/50)	26,250	26,250	52,500
Tier 1 cash (preferred return)	(5,000)	(2,500)	(7,500)
Tier 2 cash (return of capital)	<u>(35,000)</u>	<u>(17,500)</u>	<u>(52,500)</u>
End of year capital	<u>91,250</u>	<u>58,750</u>	<u>150,000</u>

#### Exhibit 2: Year 2 capital accounts in Example 1

	A	B	Total
Beginning capital	91,250	58,750	150,000
Tier 1 profit (preferred return)	3,250	1,625	4,875
Tier 2 profit (50/50)	2,563	2,562	5,125
Tier 1 cash (preferred return)	(3,250)	(1,625)	(4,875)
Tier 2 cash (return of capital)	(65,000)	(32,500)	(97,500)
Tier 3 cash (50/50)	<u>(3,813)</u>	<u>(3,812)</u>	<u>(7,625)</u>
End of year capital	<u>25,000</u>	<u>25,000</u>	<u>50,000</u>

#### Exhibit 3: Capital accounts prior to current-year income allocation in Example 2

	A	B	Total
How cash would go on liquidation			
Initial capital contribution	100,000	50,000	150,000
Current-year cash distribution (preferred return of 5% on initial capital)	(5,000)	(2,500)	(7,500)
Current-year cash distribution (return of capital)	<u>(35,000)</u>	<u>(17,500)</u>	<u>(52,500)</u>
Capital account prior to income allocation	<u>60,000</u>	<u>30,000</u>	<u>90,000</u>

contributes \$100,000 cash to AB, and partner B contributes \$50,000 cash. The partnership agreement dictates that profits are allocated to each partner first to the extent of a 5% cumulative annual preferred return on unreturned capital and second 50% to A and 50% to B. Losses are allocated first to the extent of positive capital account balances and second 50% to A and 50% to B. Cash is first disbursed to pay the preferred return, second to pay any unreturned capital, and last 50% to A and 50% to B. In year 1, AB had net income from ordinary operations of \$60,000 and distributed the entire \$60,000 in cash. Under this traditional waterfall allocation, the capital accounts would resemble Exhibit 1.

Profit allocations in year 1 to A would be \$31,250 and to B would be \$28,750, for a total income allocation of \$60,000.

In year 2, the partnership has \$10,000 of income and distributes \$110,000. Profit allocations in year 2 to partner A would be \$5,813 and to partner B would be \$4,187, for a total income allocation of \$10,000. (See Exhibit 2.)

*Example 2—targeted capital account approach:* Partner A of AB Partnership contributes \$100,000 cash to AB and partner B contributes \$50,000 cash. The partnership agreement states that net profits are first allocated to the partners having negative capital account balances, in proportion to their adjusted negative capital accounts.

#### Exhibit 4: Current-year income allocations in Example 2

	A	B	Total
Remaining return of capital (initial contribution of \$150,000 less \$35,000 and \$17,500 distributed)	65,000	32,500	97,500
Remainder 50/50	26,250	26,250	52,500
Targeted end of year capital	91,250	58,750	150,000
Less: capital account prior to income allocation	<u>(60,000)</u>	<u>(30,000)</u>	<u>(90,000)</u>
Profit allocation	<u>31,250</u>	<u>28,750</u>	<u>60,000</u>

#### Exhibit 5: Year 2 capital accounts in Example 2

	A	B	Total
How cash would go on liquidation			
Year 2 beginning capital	91,250	58,750	150,000
Current-year cash distribution (preferred return of 5% on \$65,000 and \$32,500 unreturned capital)	(3,250)	(1,625)	(4,875)
Current-year cash distribution (return of remaining unreturned capital)	(65,000)	(32,500)	(97,500)
Current-year cash distribution (50/50)	<u>(3,813)</u>	<u>(3,812)</u>	<u>(7,625)</u>
Capital account prior to income allocation	<u>19,187</u>	<u>20,813</u>	<u>40,000</u>

#### Exhibit 6: Year 2 income allocation in Example 2

	A	B	Total
Remaining return of capital (it was all returned in year 1)	0	0	0
Remainder 50/50	25,000	25,000	50,000
Targeted end of year capital	25,000	25,000	50,000
Less: Capital account prior to income allocation	<u>(19,187)</u>	<u>(20,813)</u>	<u>(40,000)</u>
Profit allocation	<u>5,813</u>	<u>4,187</u>	<u>10,000</u>

The remaining profits or net losses are allocated to the partners to create capital account balances for the partners that are equal to the amount of cash that would be distributed under the cash distribution provisions of the agreement. If an allocation of net losses exceeds the positive capital account balances of the partners, the excess is allocated in accordance with the partner's percentage interest. Cash is disbursed first to pay the preferred return (5% cumulative annual on unreturned capital), second to pay any unreturned capital, in proportion to the

unreturned capital account balances, and last 50% to A and 50% to B. In year 1, AB had net income from ordinary operations of \$60,000 and distributed the entire \$60,000 in cash.

Under the targeted capital approach, the capital accounts would resemble Exhibit 3 prior to the current-year income allocation.

Total capital to target allocate would be \$150,000, which is equal to the \$150,000 initial contribution plus the \$60,000 income allocation less the \$60,000 current-year cash distribution. If

the partnership were to liquidate with a balance of \$150,000 of cash and capital, the first \$65,000 would go to A as the return on capital that has yet to be distributed, and \$32,500 would go to B. The remaining \$52,500 would be split 50/50 in accordance with the final tier of cash distributions listed in the partnership agreement. Income allocations would therefore be \$31,250 to A and \$28,750 to B to force the ending capital to be \$91,250 to A and \$58,750 to B. (See Exhibit 4.)

In year 2, the partnership has \$10,000 of income and distributes \$110,000. (See Exhibit 5.)

Total capital to target allocate would be \$50,000, which is equal to the \$150,000 beginning balance plus the \$10,000 income allocation less the \$110,000 current-year cash distribution. If the partnership were to liquidate with a balance of \$50,000 in the capital accounts, the balance would be allocated 50% to A and 50% to B because at this point in year 2, all the preferred return and capital amounts have been returned. Income allocations would therefore be \$5,813 to A and \$4,187 to B to force the ending capital to be \$25,000 to A and \$25,000 to B. (See Exhibit 6.)

Under both approaches, the income allocations are the same. However, if an error was made using the waterfall approach, the error would not self-correct in year 2. If an error was made using the targeted capital approach, the error would self-correct in year 2.

Although both approaches illustrated above produced the same result, many practitioners believe that the targeted capital account approach more clearly reflects the economic arrangement agreed to by the partners. It is up to the drafters, practitioners, and partners to determine which method works best for them.

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#### EditorNotes

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