

TaxClinic

PRACTICAL ADVICE ON CURRENT ISSUES

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Unless otherwise noted, contributors are members of or associated with Grant Thornton LLP.

For additional information about these items, contact Mr. Fairbanks at (202) 521-1503 or greg.fairbanks@gt.com.

ACCOUNTING METHODS & PERIODS

Taxpayers Should Be Proactive When Filing Accounting Method Changes

A sigh of relief usually follows when a tax practitioner informs a client that a particular accounting method change request can be filed under the automatic accounting method change procedures. That is because Rev. Proc. 2008-52, §6.02(3), allows a taxpayer to file an automatic accounting method change request as late as the extended due date for the taxpayer's federal income tax return for the year of change.

A taxpayer does not, however, have to wait until the extended due date of its tax return to do so because Rev. Proc. 2008-52 also allows taxpayers to file an automatic accounting method change request as early as the first day of the year of change. While it is understandable why taxpayers (and their service providers) routinely wait until the last minute to complete and file automatic accounting method change requests, there are numerous reasons to file such requests as early as possible.

Among these reasons is the possibility that a taxpayer will come under IRS examination before it has the opportunity to file its accounting method change request. For the same reason, taxpayers planning on filing nonautomatic accounting method change requests (under Rev. Proc. 97-27) need not wait until the last day of their tax years to file accounting method change requests.

Both Rev. Proc. 2008-52 and Rev. Proc. 97-27 provide that a taxpayer under examination may file a request for a change

in accounting method only if it meets the requirements of: (1) the 90-day window (described below); (2) the 120-day window; or (3) the director consent provisions. In order for a taxpayer to use either the 90-day or the 120-day window, the issue for which the accounting method change is being requested must not be “an issue under consideration.” The determination of whether an issue is under consideration may present significant challenges.

This item discusses the difficulties that arise when trying to determine whether an issue is under consideration for purposes of the 90-day or 120-day windows. Specifically, it examines a recently released technical advice memorandum that illustrates the complex nature of this problem in the context of a nonautomatic accounting method change request.

Issue Under Consideration

The IRS National Office discussed the “issue under consideration” topic in a recent technical advice memorandum (TAM 200843031). The IRS stated that a taxpayer was not allowed to file a request for a nonautomatic change in method of accounting for royalty expenses under Sec. 263A because the treatment of royalty expenses was considered an issue under consideration.

The taxpayer in the TAM was under examination at the time it filed a request to change its method of accounting for royalty expenses under Sec. 263A. The taxpayer sought to file using the 90-day window. Prior to filing the request, the taxpayer received an information document request (IDR) that asked for both “year-end inventory workpapers” and “year-end 263A workpapers” for several years. The IRS examining agents argued that the taxpayer was not allowed to file its request for change in accounting method because the treatment of royalty expenses under Sec. 263A was an issue under consideration by the IRS at the time the taxpayer filed the request. The taxpayer disagreed.

A taxpayer generally may not request a change in accounting method if the taxpayer is under examination (Rev. Proc. 97-27, §6.01(1)). Rev. Proc. 97-27 and Rev. Proc. 2008-52 provide several exceptions to this rule, one of which is

known as the 90-day window and another as the 120-day window. This item focuses on the 90-day window.

Section 6.01(2) of Rev. Proc. 97-27 describes the 90-day window. It provides that a taxpayer under examination may request a change in accounting method if the taxpayer has been under examination for at least 12 consecutive months as of the first day of the tax year, and if the taxpayer files the request within the first 90 days of that tax year. A taxpayer may not, however, use the 90-day window if the method of accounting (for which the taxpayer seeks consent) is an issue under consideration.

Section 3.08(1) of Rev. Proc. 97-27 provides that a particular method of accounting is an issue under consideration if:

1. The taxpayer receives written notification from the examining agent; and
2. The written notice specifically cites the treatment of an item as an issue under consideration.

Rev. Proc. 97-27 provides two examples illustrating when an item would be an issue under consideration. The first provides that a taxpayer’s LIFO pooling methodology is not an issue under consideration as a result of an examination plan that broadly identifies LIFO as a matter to be examined. The second example, however, provides that a taxpayer’s method of determining costs to be inventoried under Sec. 263A is an issue under consideration as a result of an IDR that requests documentation supporting the costs included in the taxpayer’s costs to be capitalized to inventory.

The taxpayer in TAM 200843031 argued that in order for an item to be an issue under consideration, the written notification to the taxpayer must:

1. Refer to a class or type of revenue or expense to which a method of accounting applies; and
2. Specifically cite the manner in which the taxpayer accounts for that item.

The taxpayer argued further that where the class of accounting methods identified is particularly broad in comparison to the matters purportedly placed under consideration, the specificity required under Rev. Proc. 97-27, §3.08(1), has not been satisfied.

The IRS rejected the taxpayer’s arguments. First, the IRS stated that the IDR

did refer to a particular class or type of expense by referring to costs capitalized to inventory under Sec. 263A. The TAM states that the IRS is not obliged to refer to a specific cost within the Sec. 263A calculation in order to place that item under consideration. By asking for the taxpayer’s year-end Sec. 263A workpapers, the IRS contended that they would reasonably expect to receive workpapers that contain information supporting how the taxpayer identifies costs and adds them to tax basis inventory for purposes of Sec. 263A. The IRS differentiated between a cost and an item, in this case pointing out that the item is not the cost capitalized to inventory but the method of identifying those costs.

Second, the IRS stated that it did not need to specifically cite in a written notice the way a taxpayer treats an item in order to place that item under consideration. The TAM states that by providing written notice that the “treatment of an item” is an issue under consideration, the IRS is giving the required notice that the taxpayer’s method of accounting for the costs associated with that item is an issue under consideration. The TAM goes on to state that there is no requirement under Rev. Proc. 97-27, §3.08, to explicitly or correctly cite the particular method of accounting that the taxpayer is actually or purportedly applying to the item.

Third, the TAM stated that the IRS was not required to identify a specific submethod under Sec. 263A in order to place the taxpayer’s method of treating royalty expenses under consideration. The IRS argued that the taxpayer categorizes the method of identifying costs required to be capitalized to inventory under Sec. 263A as a submethod of its method of capitalizing actual costs to inventory under Sec. 263A. The IRS asserted, however, that the method of determining costs required to be capitalized under Sec. 263A is not a submethod but rather one of two required allocations—the first being the allocation of costs to various activities (including production activities) and the second being the allocation of costs assigned to production activities to inventory items produced by the taxpayer during the year.

Citing the treatment of costs under Sec. 263A in an IDR would include both

methods of allocation because the taxpayer's method of accounting for capitalizing costs to inventory under Sec. 263A would include both its method of determining costs required to be capitalized and its method of allocating costs required to be capitalized to inventory.

Conclusion

Given the IRS's interpretation in this TAM of what constitutes an item under consideration for purposes of the 90-day or 120-day window, if a taxpayer is planning on filing an accounting method change request and is not currently under exam, it would be advantageous to file that method change with the IRS National Office as soon as it can be completed rather than waiting until the time the return is filed. By the time the return is filed, the taxpayer could potentially be under IRS examination and will be afforded only the methods of filing for an accounting method change described in Rev. Proc. 2008-52, §6.03, which are the 90-day window, the 120-day window, and filing with director consent (which involves obtaining the director's consent and attaching a signed statement to the Form 3115, Application for Change in Accounting Method). Not only are the procedures for filing under one of these methods more cumbersome, but ultimately the taxpayer may not be able to make the method change at all.

Taxpayers and practitioners alike would certainly agree that it is better to avoid going through the process of identifying an issue under consideration and filing under one of the window periods altogether in order to file a Form 3115 to change a method of accounting. In this case, if the information is available, it is better to be safe than sorry.

From Ellen Fitzpatrick, CPA, Washington, DC

Treatment of Gift Card/Certificate Sales: No Answers, More Questions

Gift card sales are becoming more and more a part of our retail shopping experience. The IRS is aware that the popularity of gift cards has increased "at a remarkable rate in recent years" (LMSB-04-0507-039).

Gift card sales raise a variety of interesting federal income tax questions. The answers to these questions may depend on who is selling the gift card and for whom. For example, certain federal income tax issues arise with the use of gift card managing subsidiaries (gift card companies, described in more detail below) to sell gift cards and also with the sale of cross-redeemable gift cards.

The IRS announced that it plans to focus more on this area. Given the level of gift card sales and the surrounding tax issues, one might think that the IRS would have resolved some of the questions. But as of the writing of this item, the IRS has not yet provided answers—only more questions.

This item highlights certain issues raised by a recent IRS Large and Mid-Size Business (LMSB) Division directive dated October 3, 2008, about the treatment of revenue from the sale of gift cards (IDD No. 2). Before discussing IDD No. 2, however, this item discusses a March 26, 2007, field attorney advice (FAA) (released July 11, 2008) discussing the proper treatment of gift card sales and a prior LMSB directive (IDD No. 1) discussing gift cards dated May 23, 2007.

Proper Treatment of Gift Card Sales by a Gift Card Company

FAA 20082801F addressed several revenue recognition issues that arise in connection with the sale of gift cards by a gift card company. The company described in the FAA was a separate wholly owned subsidiary of the taxpayer and did not have any inventory of its own. The FAA addressed specifically:

1. Whether the gift card company had income from the sale of gift cards;
2. When proceeds from the sale of gift cards were to be included in income; and
3. When the gift card company could take a deduction in connection with the redemption of gift cards.

The FAA first discussed whether the money received by the gift card company constituted income to that company. The FAA stated that the gift card company received the money under claim of right and therefore had income from the sale of

gift cards. The FAA held that the amounts received by the company were not in the nature of a deposit because such amounts were not generally refundable to either the retail stores or the customers who purchased the gift cards. The FAA stated that the gift card company "will keep the proceeds from the gift card purchases unless, and until, the consumer redeems the gift cards (a condition subsequent)."

The FAA next held that a gift card company may not rely on Regs. Sec. 1.451-5 to defer the recognition of income because the amount collected for the gift cards is not an advance; the cards will not be redeemed for goods held for sale by the gift card company. The FAA also held that, under the facts presented, the taxpayer could not rely on Rev. Proc. 2004-34 to defer revenue recognition because the gift card company was unable to determine the extent to which it would recognize the amounts received as revenue in the gift card company's applicable financial statements in a particular year.

However, the FAA and the language of Rev. Proc. 2004-34 seem to support the idea that a gift card company can use Rev. Proc. 2004-34 to defer revenue recognition despite the fact that the company has no inventory of its own. The FAA stated that the gift card company had a "liability to provide gift card customers with . . . products."

It is important that the IRS viewed the gift card company as having the liability to provide goods in the future because Rev. Proc. 2004-34 defines an "advance payment" as including a payment received for the sale of goods. In other words, the language of Rev. Proc. 2004-34 supports that a taxpayer with no inventory can obligate itself to sell goods (and can therefore receive an advance payment for goods). Specifically, Rev. Proc. 2004-34, §5.02(5), provides that any deferred revenue relating to the advanced payment will be accelerated once the underlying liability is satisfied (by another party). Therefore, when a retailer satisfies the gift card company's obligation to provide goods, the gift card company would recognize the deferred revenue associated with that gift card (assuming it has not been recognized earlier under Rev. Proc. 2004-34).

IDD No. 1

IDD No. 1 (LMSB-04-0507-039) identifies two categories: Part A issues and Part B issues. The directive requires examining agents to raise Part A issues during an examination and to contact an LMSB Food and Beverage or Retail technical adviser. The Part A issues in IDD No. 1 involve the application of Regs. Sec. 1.451-5.

The first Part A issue raised in the IDD was whether the IRS should deny a taxpayer the use of Regs. Sec. 1.451-5 if the taxpayer fails to include the information schedule required by Regs. Sec. 1.451-5(d). The practical answer in the IDD seems to be that examining agents may overlook noncompliance in situations in which a “taxpayer inadvertently left off the information schedule” but should “pursue the issue” where the taxpayer consistently did not include the information return as required.

The second Part A issue raised by the IDD was whether a taxpayer must complete a Form 3115, Application for Change in Accounting Method, to change to the deferral method. The IDD states that the treatment of gift cards is a “material item” and that a change to a deferral method of accounting (under either Rev. Proc. 2004-34 or Regs. Sec. 1.451-5) would require the filing of a Form 3115.

The IDD clarifies that gift cards and gift certificates are essentially the same item and that the transition from gift certificates to gift cards does not create a “new item” that would allow a taxpayer to adopt a method of accounting for that item (as opposed to requesting a change in accounting method).

The third Part A issue raised by the IDD was whether a taxpayer may use estimates to determine the amount of unredeemed gift cards. The IDD indicates that a taxpayer may not use estimates for this purpose.

The IDD goes on to list, but does not discuss, a number of other issues that are categorized as Part B issues: gift cards versus gift receipts; reloadable gift cards; deposits; gift cards as refunds; dormancy fees; escheatment to states; bulk sales discounts; promotional gift cards; charitable contribution of gift cards; estimated cost of goods sold; franchisee/franchisor gift cards; expiration dates; and Rev. Proc. 2004-34. Several of these

issues are highlighted in IDD No. 2, which was issued on October 3, 2008.

IDD No. 2

Like IDD No. 1, IDD No. 2 (LMSB 4-0808-042) contains two categories: Part A issues (these must be raised during the examination and contact must be made with technical advisers) and Part B issues (contact should be made with the technical advisers). The sole Part A issue discussed in IDD No. 2 involves the use of a gift card company (as in the FAA described above) to sell gift cards/certificates. IDD No. 2 states that the primary issue in this context is whether the gift card company has goods available for sale in the ordinary course of its trade or business and is therefore eligible to use a revenue deferral method under either Regs. Sec. 1.451-5 or Rev. Proc. 2004-34. IDD No. 2 then points out that FAA 20082801F provides a legal analysis of these issues.

It is not surprising that the directive chose to treat the use of Regs. Sec. 1.451-5 as a Part A issue. It is surprising, however, that the directive uses language indicating that there may be an inventory requirement associated with the use of the deferral method under Rev. Proc. 2004-34, given the fact that FAA 20082801F and the language in Rev. Proc. 2004-34 support that a taxpayer with no inventory can use Rev. Proc. 2004-34.

IDD No. 2 raises, but provides no conclusions on, several Part B issues. The following are some (but not all) of the Part B issues raised:

Reloadable gift cards: These are cards that allow value to be added after the initial purchase. IDD No. 2 states that examining agents should verify that the taxpayer’s accounting system tracks the actual dates when money is added to the card for purposes of income deferral.

Deposits: The issue is whether proceeds from the sale of a gift card/certificate could be viewed as a deposit (as opposed to income). IDD No. 2 states that if a taxpayer excludes gift card/certificate proceeds from taxable income (i.e., treats proceeds as a deposit), the issue needs to be brought to the attention of a Retail technical adviser.

Gift cards as refunds: The issue is whether a taxpayer can “void” the original

sale of goods where a customer later returns the goods and receives a gift card in lieu of cash. IDD No. 2 states that the technical advisers are currently formulating a position on this issue.

Sale of gift cards/certificates by unrelated third parties: Numerous retail and restaurant outlets sell gift cards/certificates through unrelated third parties. The issue is whether a taxpayer that sells gift cards/certificates on behalf of an unrelated entity has income on the receipt of the gift card/certificate proceeds and, if so, whether it can use a revenue deferral method under either Regs. Sec. 1.451-5 or Rev. Proc. 2004-34. IDD No. 2 asks examining agents to contact a technical adviser if faced with this issue.

IDD No. 2 raises several other issues and asks that examining agents faced with such issues contact a technical adviser.

Conclusion

Although the two industry directives are not official pronouncements of the law or the position of the IRS and cannot be used, cited, or relied on as such, the directives put taxpayers on notice that the IRS is planning to focus more attention on the issues raised by the sale of gift cards. Unfortunately, taxpayers currently are left with no firm answers in the form of official guidance as to how the IRS will rule on any of these issues; however, guidance on the treatment of gift cards is an item on the Treasury and IRS business plan.

From Richard Shevak, J.D., Washington, DC

EMPLOYEE BENEFITS & PENSIONS

Determining the Correct FMV of Private Company Stock When Stock Options Are Granted

When a stock option is granted to an employee, great care must be taken to ensure that the exercise price is equal to or greater than the stock’s fair market value (FMV) on the option’s grant date. If the exercise price is lower than the FMV, resulting in a “discounted” option, the option is subject to the Sec. 409A rules for nonqualified deferred compensation plans.

This produces an undesirable result for an option because in order to comply with these rules, the option may be exercised only upon a change in control, separation from service, disability, death, an unforeseeable emergency, or a specified fixed date in the future (Sec. 409A(a)(2)(A)). The decision as to which event will trigger the exercise must be made when the option is granted. Moreover, if any errors are made in fully complying with Sec. 409A, the employee will be subject to a 20% additional tax, over and above regular income tax, on the option's value. Thus, in order for the option to be exercised in the normal fashion of an option (i.e., the option can be exercised at any time in the future, at the discretion of the employee), great care should be taken to ensure that the option is not a discounted option.

The correct determination of a stock's FMV is a particular challenge for private companies because there generally is no market for the stock. Fortunately, the regulations under Sec. 409A provide guidance for determining the stock's FMV. The regulations set forth factors that must be taken into account in determining FMV, including the value of assets (both tangible and intangible), the present value of anticipated future cashflows, the market value of stock or equity interests in similar corporations, or equity interests in similar corporations or other entities engaged in substantially similar trades or businesses (Regs. Sec. 1.409A-1(b)(5)(iv)(B)(1)). In addition, the valuation may reflect control premiums or discounts for lack of marketability. The valuation may be used for up to 12 months, but it must be updated to reflect information that materially affects the corporation's value, such as the resolution of litigation or the issuance of a patent.

The regulations also provide safe-harbor valuation methods. When one of these safe harbors is used in lieu of the general valuation approach describe above, the valuation is presumed to be reasonable. The IRS may rebut the presumption only if the valuation is "grossly unreasonable."

There are three safe-harbor methods under Regs. Sec. 1.409A-1(b)(5)(iv)(B)(2):

1. Appraisal by an independent party;
2. Appraisal by a qualified individual who does not have to be independent

(available only for start-up companies); and

3. Formula value.

Independent Appraisal

The independent appraisal safe harbor is largely self-explanatory. The regulations provide that in applying this safe harbor, the standards for the appraisal of stock held by an employee stock ownership plan under Sec. 401(a)(28)(C) and its accompanying regulations should be used (Regs. Sec. 1.409A-1(b)(5)(iv)(B)(2)(i)). Sec. 401(a)(28)(C), however, simply states that the valuation must be performed by an independent appraiser, and the regulations provide no additional guidance. Thus, this safe harbor appears to rest solely on having an appraiser who is independent. The only additional guidance on this safe harbor is a requirement that in order for the valuation to be used, it must be as of a date within the past 12 months.

Nonindependent Appraisal

Under the second safe harbor, an appraisal is required but the party performing the valuation need not be independent. The appraisal must take into account all the factors described above in the discussion of general valuation principles. This safe harbor is available only for a corporation that has conducted its trade or business for fewer than 10 years (a start-up corporation) (Regs. Sec. 1.409A-1(b)(5)(iv)(B)(2)(iii)). Thus, this safe harbor exists so a newer corporation can avoid the cost of an independent appraisal.

The second safe harbor is not available if either the employer or the employee reasonably anticipates that the corporation will undergo a change in control event in the next 90 days or an initial public offering within the next 180 days. The rationale appears to be that such events have the potential to cause a major change in the corporation's value (most likely an upswing). In addition, this safe harbor may not be used if the stock is subject to any put, call, or other right to purchase the stock, other than a right of first refusal upon an offer to purchase by an unrelated third party or a nonpermanent right to sell or buy the stock at a formula value (a lapse restriction).

Although the individual who performs the valuation does not have to be independent, he or she must be qualified to perform the valuation. The individual's qualifications are based on his or her knowledge, experience, education, or training. "Experience" generally means at least five years of relevant experience in valuations, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the corporation operates.

Formula Value

The final safe harbor is the use of a formula value (Regs. Sec. 1.409A-1(b)(5)(iv)(B)(2)(ii)). At first, this may appear to be a very useful safe harbor, especially in light of the fact that many private companies have typically used a formula to determine FMV. However, a taxpayer may use this method only if certain very restrictive conditions are met.

First, if the employee wishes to sell the stock, he or she must offer to sell it to the prospective buyer at the formula value. A party that buys the stock from the employee also must offer to sell it to a prospective buyer at the formula value. If anyone else holds stock in the same or a similar class of stock, that individual must also use the formula value whenever he or she sells the stock to the company or to someone who owns more than 10% of the voting power of the stock. All of the foregoing restrictions must be permanent, except that the restrictions are lifted for an arm's-length transaction involving the sale of all or substantially all of the company's stock.

Conclusion

Given the inexact science of determining the FMV of a private company's stock for purposes of setting the exercise price of a stock option, it is important to understand the regulatory guidance for making the determination. Careful consideration should be given to using one of the safe-harbor methods because the IRS may challenge the valuation only if it is shown to be a grossly unreasonable valuation.

From G. Edgar Adkins Jr., CPA, and Jeffrey A. Martin, CPA, Washington, DC

Subsequent Deferral Elections May Bring Surprises Under Sec. 409A

Now that the transition relief under Sec. 409A has expired and the Sec. 409A final regulations have gone into effect, nonqualified deferred compensation must comply with a vast set of new rules for nonqualified plans. This may include the subsequent deferral election rules, which could bring unpleasant surprises for employers and employees. When the transition relief was in effect, employers and employees could change the time and form of payment under deferred compensation plans without complying with very restrictive rules. Now a change to the time and form of payment may be made only if the agreement allows for the change and the subsequent deferral election rules are followed.

Subsequent Deferral Election Rules in General

Subsequent deferral elections are changes made to the time and form of payment under a deferred compensation plan after the initial election. Employers often want to allow such changes to provide flexible payment alternatives. The new rules for nonqualified deferred compensation under Sec. 409A allow subsequent deferral elections, but the elections will have to meet rigid requirements under Regs. Sec. 1.409A-2(b).

A change in the time and form of payment would include, for example:

- A change from a lump-sum payment to an annuity payment;
- A change from a life annuity to a lump-sum payment;
- A change in the length or commencement date of an installment payment;
- The addition of a new payment trigger; and
- A change in the payment date of a lump-sum payment.

The general rule under Regs. Sec. 1.409A-2(b)(1) provides that:

- The subsequent deferral election must be made at least 12 months before the originally scheduled payment date;
- The subsequent deferral election may not go into effect until at least 12 months after the election is made; and

- The new payment date must be at least five years after the originally scheduled payment date.

The payment date cannot be accelerated under these rules. For example, if the original payment terms provided for a lump-sum payment at age 60, the subsequent deferral election must be made before the employee becomes 59 and the payment date cannot be earlier than age 65.

The five-year delay requirement does not apply if the employer or employee elects to add a payment trigger for death, disability, or an unforeseeable emergency. However, if made part of a subsequent deferral election, these payment dates may not be effective until at least 12 months after the election is made (Regs. Sec. 1.409A-2(a)(5)).

Installment Payments

When the employee is initially scheduled to receive a series of installment payments, those payments are generally treated as one payment (Regs. Sec. 1.409A-2(b)(2)(iii)). Therefore, the subsequent election must be made at least one year before the first installment payment date, and all the installment payments must be deferred for at least an additional five years (Regs. Sec. 1.409A-2(b)(1)).

A plan may explicitly state from the plan's inception that each installment payment, other than an installment payment under a life annuity, is treated as a separate payment. In this case, the employer or employee could then subsequently elect to further defer a portion of the installment payments, rather than all of them. For example, consider a deferred compensation plan that provides for five equal annual installments beginning on the employee's normal retirement age of 60. The plan designates each installment payment as a separate payment. If the payments are made by age 59, the employee may elect to receive the first three installment payments annually beginning at age 65 and still receive the fourth and fifth installment payments at ages 63 and 64, respectively.

Special consideration must be given if the employer or employee wishes to change the form of payment from installments to a lump-sum payment, if the plan provides that each installment is treated

as a separate payment. The lump-sum payment date must be at least five years after the final installment payment date. For example, consider a plan that provides for the payment of five equal annual amounts, each of which is designated as a separate payment. The first installment is scheduled for January 1, 2011, and the last is scheduled for January 1, 2015. The employee wishes to receive the payment in a lump sum. Provided the election is made on or before December 31, 2009, the earliest the employee may receive the lump-sum payment is January 1, 2020, which is five years after the last scheduled installment payment under the original election. If the plan did not provide that each installment payment was treated as a separate payment, the lump-sum payment could be made as early as January 1, 2016 (i.e., five years after the initial installment payment) (Regs. Sec. 1.409A-2(b)(9), Example (20)).

Life Annuities

Special rules apply to life annuities (Regs. Sec. 1.409A-2(b)(2)(ii)). Unlike installment payments, a plan may not provide that each individual annuity payment is a single payment. In all cases, the life annuity is treated as a single payment. Accordingly, a subsequent deferral election must be made at least 12 months prior to the first life annuity payment and must delay the payments at least five years from the originally scheduled commencement date of the life annuity. An employer or employee may change the form of the annuity payment from one life annuity to another life annuity before any annuity payments have been made without being subject to the subsequent deferral elections. The new life annuity must commence on the same date as the original annuity, and the life annuities must be actuarially equivalent. The regulations provide certain rules that apply when determining if the life annuities are actuarially equivalent.

Short-Term Deferrals

The subsequent deferral election rules may apply if an employer or employee elects to defer compensation that would otherwise be a short-term deferral under

Regs. Sec. 1.409A-1(b)(4). A short-term deferral is a plan under which the payment will be made to the employee within 2½ months after the end of the tax year in which the employee's right to the compensation vests. Short-term deferrals are exempt from Sec. 409A. The employer or employee may elect to defer the short-term deferral as long as the election meets the subsequent deferral election rules. This election would cause the deferred compensation to be subject to Sec. 409A. For this purpose, the date the compensation vests is treated as the originally scheduled payment date.

Consider a bonus plan entered into on January 1, 2010. Under the terms of the bonus, the employee vests on December 31, 2011, and the payment would otherwise be made on March 1, 2012. This would qualify as a short-term deferral, thus exempting the bonus from Sec. 409A. The employee decides in 2010 to receive the payment in a year beyond 2012. Provided that the election to defer is made before December 31, 2010, the employee may elect to receive the payment on or after December 31, 2016, which is five years after the date the employee vests in the bonus payment.

Multiple Payment Triggers

If multiple payment triggers are initially included in a plan, the subsequent deferral election rules apply separately to each payment trigger. For example, a deferred compensation plan could provide for a lump-sum payment upon the earlier of age 60 or the employee's separation from service. In this case, the employer or employee could change the age trigger to 65 or a later date without changing the payment date with respect to separation from service. As long as the subsequent deferral election was made prior to the employee's reaching age 59, the plan would not violate Sec. 409A.

Adding a trigger in a subsequent election, however, will affect other triggers. If a payment trigger is added, the general restrictions on subsequent deferral elections will apply to all the original payment triggers, and the payment must be made upon the latest of the payment triggers. For example, consider a plan that originally

provided for a lump-sum payment upon separation from service. If the employee subsequently elects to add a specified age as a payment trigger, the plan must provide that the separation from service trigger is pushed back five years. Thus, the payment will be made at the later of five years after a separation from service or the specified age.

Conclusion

The subsequent deferral election rules under Sec. 409A can result in unexpected consequences if employers and employees are not prepared. For example, adding a new payment trigger to a plan after the initial election may result in an unanticipated delay in payment. To avoid this, employers and employees may wish to consider including all the permissible payment triggers (such as death, disability, separation from service, change in control, specified date, and unforeseeable emergency) in the initial deferral election. Employers and employees need to be aware of the rules so they do not encounter any unpleasant surprises now that the Sec. 409A final regulations are in effect.

From G. Edgar Adkins Jr., CPA, and Jeffrey A. Martin, CPA, Washington, DC

ESTATES, TRUSTS & GIFTS

Be Careful Making Disclaimers Where Trusts Are Involved

Disclaimers are very useful tools for estate planners, especially in postmortem planning. Disclaimers allow interests in property to pass to parties other than the original object of a donation or bequest. In postmortem planning, a disclaimer is often used to qualify an interest for an estate tax deduction (e.g., marital or charitable) or to more efficiently use a decedent's estate tax applicable credit amount or generation-skipping transfer (GST) exemption amount. However, if an estate planner is not diligent in the planning and execution of a disclaimer, it can have adverse transfer tax consequences.

Disclaimers are governed by both state and federal law. State law disclaimers determine how property interests pass to other parties as the result of a disclaimer. Under many states' disclaimer laws, if the

requirements of a disclaimer are met, disclaimed property interests flow as if the disclaimant had predeceased the donor or decedent.

Under federal tax law, if a person makes a "qualified disclaimer" with respect to an interest in property under Sec. 2518, the disclaimed interest is treated for gift, estate, and GST tax purposes as if the interest had never been transferred to that person. Thus, if a person makes a qualified disclaimer, that person will not incur transfer tax consequences as a result of the qualified disclaimer because he or she is disregarded for transfer tax purposes. Note, however, that unlike many states' disclaimer laws, the federal law does not treat the disclaimant as if he or she had predeceased the decedent.

Sec. 2518 provides that a qualified disclaimer is an irrevocable and unqualified refusal by a person to accept an interest in property, but only if: (1) the disclaimer is in writing; (2) the disclaimer is received by the transferor of the interest, his or her legal representative, or the holder of the legal title to the property to which the interest relates not later than nine months after the later of (a) the date on which the transfer creating the interest in the person is made or (b) the day on which the person attains age 21; (3) the person has not accepted the interest or any of its benefits; and (4) as a result of the disclaimer, the interest passes without any direction on the part of the person making the disclaimer and passes either to the decedent's spouse or to a person other than the person making the disclaimer.

Assuming an estate planner is aware of the requirements, he or she should not have difficulty in executing a qualified disclaimer. However, a recent Tax Court case and a recent letter ruling highlight how tricky it can be to meet the fourth requirement for a qualified disclaimer when disclaimed property passes to a trust, and the negative tax consequences that may occur if the requirements of a qualified disclaimer are not met.

Estate of Christiansen

In *Estate of Christiansen*, 130 T.C. No. 1 (2008), the decedent left the residue of her estate (which included interests in

two family limited partnerships) to her daughter. The daughter made a partial disclaimer of the bequest to the extent the value of the residue exceeded a formula amount determined by reference to a fraction, the numerator of which was the fair market value (FMV) of the gift (before the payment of debts, expenses, and taxes) on the date of the decedent's death less \$6,350,000, and the denominator of which was the FMV of the gift (before the payment of debts, expenses, and taxes) on the date of the decedent's death "as such value is finally determined for federal estate tax purposes."

The decedent's will provided that if the daughter disclaimed any portion of the bequest, 75% of the disclaimed portion would go to a charitable lead annuity trust (CLAT) (the annuity interest passing to the family foundation and the remainder interest passing to the daughter, if living at the end of the annuity term) and 25% would go to the family foundation outright.

The decedent's estate claimed an estate tax marital deduction for the present value of the income interest in the CLAT passing to the family foundation. The IRS disallowed the deduction because the disclaimer was not a qualified disclaimer as defined in Sec. 2518. Specifically, the IRS argued that the daughter's disclaimer did not meet the requirement that the disclaimed property must pass without any direction on the part of the disclaimant and must pass to someone other than the disclaimant.

The Tax Court agreed with the IRS. It noted that:

- The daughter was not a surviving spouse of the decedent;
- The daughter received a specific bequest of a fee simple interest in her mother's property under the mother's will;
- As a result of the disclaimer, such property passed to a trust in which the daughter had a remainder interest; and
- The daughter did not disclaim that remainder interest.

Finding that the daughter's disclaimer was not a qualified disclaimer, the Tax Court held that the annuity interest in the CLAT passing to charity did not qualify for the estate tax charitable deduction under Sec. 2055.

For state law purposes, it is likely that the disclaimer was valid and the disclaimed property passed to the CLAT. Because the daughter's disclaimer was not a qualified disclaimer for federal gift tax purposes, the daughter is deemed to have transferred the property passing via the disclaimer to the CLAT. Although not addressed in *Christiansen*, one possible silver lining in the case was that the daughter should be entitled to a gift tax deduction under Sec. 2522 for the present value of the annuity interest passing to the family foundation (a silver lining that was absent in the letter ruling discussed below).

Letter Ruling 200846003

In Letter Ruling 200846003, the children of the decedent disclaimed their interests as beneficiaries of an individual retirement account (IRA). The IRA custodial agreement provided that if the children predeceased the decedent, the decedent's estate would be the beneficiary of the IRA. As a result of the disclaimer and by operation of state law, the children were treated as having predeceased the decedent.

The decedent's will specifically provided that the IRA was to pass to a trust for the benefit of the decedent's spouse during his life (Trust 1). Upon the death of the decedent's spouse, the assets of Trust 1 were to pass to another trust (Trust 2) of which the children were the beneficiaries. The children failed to disclaim their interests in Trust 2. The objective of the children's disclaimers was to have the IRA pass to Trust 1, which would qualify for the estate tax marital deduction under Sec. 2056.

The IRS noted that because the children did not disclaim their interests in Trust 2, the children had not disclaimed their entire interests in the IRA. Thus, the IRS ruled that the children's disclaimers were not qualified disclaimers for purposes of Sec. 2518. The IRS also noted that in order for Trust 1 to qualify for the marital deduction, the IRA must have passed from the decedent. Thus, the IRS ruled that for gift tax purposes, the children had made a taxable gift of the IRA's FMV. Accordingly, for estate tax purposes, the IRA passed from the children, not the decedent. Therefore, the decedent's estate

was not entitled to a marital deduction for the IRA passing to Trust 1.

Conclusion

This letter ruling highlights the "double whammy" that may occur if a disclaimer is not properly executed. Not only was the property that was the subject of the disclaimer taxable for estate tax purposes, it was also taxable for gift tax purposes.

The *Christiansen* case and the letter ruling emphasize the importance of mapping the flow of a property interest that is the subject of a proposed disclaimer. Remember that when a disclaimer results in the property interest passing to a trust, you must look through the trust until the property rests in the hands of a natural person. Failure to do so may lead to adverse tax consequences for your client.

From Justin Ransome, CPA, J.D., MBA, Washington, DC

FOREIGN INCOME & TAXPAYERS

IRS Crackdown on Form 5471: A Sign of Things to Come?

In August 2008, the IRS began sending "soft" letters to corporate taxpayers warning that beginning in 2009, the Service would automatically assert penalties on any late-filed Forms 1120, U.S. Corporation Income Tax Return, that include a Form 5471. Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations, is required for certain U.S. persons who are officers, directors, or shareholders of controlled foreign corporations. (For more on preparing Form 5471, see Jacobs and Pasmanik, "Tips for Preparing the Form 5471 for Controlled Foreign Corporations," p. 114.)

Penalty Exposure

The penalties involved can be quite substantial. Sec. 6651(a)(1) provides a monthly penalty of 5% of the tax required to be shown on the return up to 25% for failure to file an income tax return (including a Form 1120) by the due date. For the Sec. 6651(a)(1) penalty to apply, a tax must be due.

In addition, Sec. 6038(b)(1) provides for a \$10,000 monetary penalty for each Form

5471 filed after the due date of the income tax return (including extensions). This penalty also applies if the return does not include the complete and accurate required information. In addition to the monetary penalty, Sec. 6038(c) imposes a 10% reduction of the foreign taxes available for credit under Secs. 901, 902, and 960 for a late Form 5741. A tax need not be due for the penalty under Sec. 6038(c) to apply.

Reasonable Cause

Corporate taxpayers can ask for reasonable cause relief from the IRS for such late filings. It is not entirely clear what impact this new approach of automatic penalties will have on the IRS's consideration of reasonable cause requests for late-filed Forms 5471. The applicability of the reasonable cause exception to a penalty is determined on a case-by-case basis after all relevant facts and circumstances are taken into account.

Things to Come?

The new IRS policy on late-filed Forms 5471 could be an indication of even more automatic foreign information return penalties to come. The IRS may be considering automatically imposing penalties on noncorporate taxpayers (i.e., partnerships and individuals) who fail to timely file Form 5471. The Service also could be considering this approach for other foreign information reporting forms that a taxpayer does not file timely or properly complete. These forms could include Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business, Form 8858, Information Return of U.S. Persons with Respect to Foreign Disregarded Entities, and Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships.

Conclusion

This new IRS penalty policy is a departure from past practices. Although the IRS has always had the authority to impose penalties in these situations, it had not been its administrative practice to automatically impose penalties as a matter of course. Accordingly, taxpayers should review their entity structures to ensure

that all required Forms 5471 (and other foreign information reporting returns) are being properly filed.

From Walter Goldberg, J.D., LL.M.,
Washington, DC

IRS Provides a Simplified Method for Late Filing Relief

A common scenario faced by many taxpayers under the Foreign Investment in Real Property Tax Act, P.L. 96-499 (FIRPTA), relates to the failure to rebut the general presumption found in Sec. 897 that a domestic corporation is a U.S. real property holding company (USRPHC). For example, assume that a foreign parent sells the stock of a domestic corporation to a third party in a taxable transaction and that the domestic corporation has never held any U.S. real property interest (USRPI). If the detailed requirements of FIRPTA are not met in a timely manner, the presumption that the domestic corporation is a USRPHC applies, and Sec. 1445 generally imposes a withholding tax liability on the third party transferee, in addition to possible interest and penalties. Further, taxpayers often will transfer a USRPHC or USRPI in transfers that qualify for nonrecognition but fail to file the appropriate statements or notices required under Secs. 897 and 1445.

In Rev. Proc. 2008-27, the IRS has provided a simplified method to request relief for certain late filings under Secs. 897 and 1445. Prior to the effective date of the revenue procedure (i.e., requests for relief after June 26, 2008), a taxpayer seeking relief had to request a private letter ruling under Regs. Sec. 301.9100-3. The revenue procedure streamlines the relief process and eliminates the user fee.

Specifically, the revenue procedure provides a simplified method to request relief for failure to file the statements and/or notices required by Regs. Secs. 1.897-2(g)(1)(ii)(A) (statement from a corporation), 1.897-2(h) (notice requirements applicable to corporations), 1.1445-2(c)(3)(i) (non-USRPI statement provided), 1.1445-2(d)(2) (USRPI transferred in a nonrecognition transaction), 1.1445-5(b)(2) (withholding obligations for specific entities on nonrecognition

transactions), and 1.1445-5(b)(4) (property transferred is not USRPI).

A taxpayer is eligible for relief for certain late filings if the statement or notice was not provided to the relevant person or the IRS by the specified deadline and the taxpayer has reasonable cause for the failure to make a timely filing. The revenue procedure provides that the taxpayer must file a completed statement or notice with the appropriate person or the IRS, as applicable. Moreover, with respect to a completed statement or notice required to be filed with the IRS under Regs. Secs. 1.897-2(h), 1.1445-2(d)(2), or 1.1445-5(b)(2), as applicable, the taxpayer must attach an explanation describing why the taxpayer's failure to timely file the statement or notice was due to reasonable cause. In addition, within the explanation, the taxpayer must provide that it filed with, or obtained from, an appropriate person the statements or notices required under Regs. Secs. 1.897-2(g)(1)(ii)(A), 1.1445-2(c)(3)(i), 1.1445-2(d)(2)(i)(A), or 1.1445-5(b)(4)(iii)(A), as applicable.

If the IRS denies a taxpayer relief under Rev. Proc. 2008-27 for certain late filings, the taxpayer may seek relief by requesting a private letter ruling under Regs. Sec. 301.9100-3.

From Tracy Watkins, J.D., LL.M.,
Washington, DC

Requirements for the Creation of Permanent Establishment in Germany

The Bundesfinanzhof, Germany's federal tax court, ruled in a recent decision that use of business premises or a plant does not constitute a permanent establishment under §12 of the *Abgabenordnung* (general tax code), subject to taxation in Germany, when the foreign company does not have certain authority over the business premises or plant in which it operates (Bundesfinanzhof, June 4, 2008, IR 30/07, published September 10, 2008). The Bundesfinanzhof clarified, in distinction from previous rulings, that it is not sufficient for the creation of a permanent establishment if the foreign company just conducts its operations on the premises of a German enterprise, even if the activity continues for several years.

Background

In 2004, the Bundesfinanzhof (July 14, 2004, IR 106/03) held that a U.S. enterprise created a permanent establishment in Germany when it used premises provided to it for conducting its business. In this case, a U.S. company provided training over several years to U.S. army personnel on using defense systems installed at a U.S. army base in Germany. The Bundesfinanzhof held that the U.S. enterprise had certain authority over the premises, which led to the conclusion that a de facto lease agreement was established in connection with the service agreement.

In contrast to the 2004 decision, the Bundesfinanzhof held in IR 30/07 that a Dutch enterprise cleaning aircraft on the premises of a NATO air base in Germany is not deemed to have created a permanent establishment in Germany. The Dutch company was a subcontractor for cleaning services and employed several workers who had access to the air base premises (including identification cards and keys to recreation rooms and working space with telephone and fax facilities).

In this case, the Bundesfinanzhof held that it is not sufficient to create a permanent establishment if a foreign enterprise is just conducting its business on the premises of a German enterprise when fulfilling its service obligations. To create a permanent establishment, it must also be a lessee or, without having a separate lease agreement in place, at least be in the position of a de facto lessee, which comes close to such a lease agreement. A de facto lessee would have possessory rights, such as nondeniable access to (certain) premises. This position can be summarized by saying that it is not sufficient for the creation of taxable nexus in Germany when a foreign enterprise is only treated as a visitor on the premises of a German company, even when the relationship is maintained over a long period and in connection with services.

Conclusion

Although there has been no decision on tax treaty provisions similar to Article 5 (Permanent Establishment) of the Organisation for Economic Co-operation and Development's Model Tax Convention (OECD MC), it seems that the Bundesfinanzhof

decision may back Germany's rejection of the example in Article 5, ¶4.5, of the OECD *Commentaries on the Model Tax Convention* (July 2008). Article 5 defines "permanent establishment" as "a fixed place of business through which the business of an enterprise is wholly or partly carried out."

In the example from the commentary, for two years a painter spends three days a week in his client's office building. The painter's presence in the office building performing "the most important functions of his business (i.e. painting)" is sufficient to constitute a permanent establishment. Article 5, ¶4.6, of the OECD *Commentaries* adds, "The words 'through which' must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose."

This Bundesfinanzhof decision provides an opportunity to avoid permanent establishment in Germany and thus avoid additional tax and compliance costs in certain cases. Practitioners should carefully review the terms of service agreements, especially where such agreements regulate access to the premises of a German company.

From Rüdiger Urbahns, M. Int'l Tax., Certified Tax Adviser, Hamburg, Germany (not affiliated with Grant Thornton LLP)

INTEREST INCOME & EXPENSE

Casting Doubt on the Accrual of Interest

Due to the recent turmoil in the credit markets, creditors and borrowers alike are evaluating the tax treatment of interest accruals related to troubled loans. Generally under Regs. Sec. 1.446-2(a), interest is taken into account by a taxpayer according to the taxpayer's regular method of accounting. Beyond the specific rules for accrual-method taxpayers, there are established rules for determining:

- Whether interest related to troubled loans is a deductible expense to the borrower (the issuer of a note) as it accrues; and
- Whether interest related to troubled loans is income to the lender (the holder of a note) as it accrues.

This item summarizes the current law related to interest accruals and further addresses the uncertainties and recent developments related to the tax law.

Whether Interest Is Deductible to the Borrower as It Accrues

Taxpayers may generally deduct interest paid or accrued within a tax year under Sec. 163(a). Accrual-method taxpayers deduct interest under Regs. Sec. 1.461-1(a)(2) when:

1. All events have occurred that establish the interest as a liability;
2. The amount of the interest can be determined with reasonable accuracy; and
3. Economic performance has occurred with respect to the interest.

Economic performance occurs as interest economically accrues (Regs. Sec. 1.461-4(e)).

If the borrower experiences financial hardship, can the borrower deduct interest that it may not be able to pay? Case law provides that the lack of ability to pay is not sufficient to prevent an issuer's accrual and deduction. In *Zimmerman Steel Co.*, 130 F.2d 1011 (8th Cir. 1942), the Eighth Circuit allowed a taxpayer's deduction of interest despite the fact that the taxpayer's liabilities exceeded its assets for the period that such interest accrued. (See also *Cohen*, 21 T.C. 855 (1954).)

Even though the lack of ability to pay is not enough to prevent an issuer's deduction, issues may arise when a taxpayer is under bankruptcy proceedings. The IRS ruled in Rev. Rul. 70-367 that a taxpayer in bankruptcy could deduct interest as it accrues despite there being no reasonable expectancy that it would pay such interest in full. The ruling states, "The doubt as to the payment of such interest is not a contingency of a kind that postpones the accrual of the liability until the contingency is resolved."

Subsequently, courts have held that taxpayers could not deduct interest related to pre-bankruptcy debt that accrues after the issuer enters bankruptcy (postpetition interest) when the taxpayer did not have sufficient assets to pay the interest (*In re Continental Vending Machine Corp.*, No. 63-B-663 (E.D.N.Y. 11/22/76), and *Kellogg*, 54 F.3d 1194 (5th Cir. 1995)). The courts distinguished both *Continental*

Vending and *Kellogg* from Rev. Rul. 70-367 because the bankruptcy proceedings in each were under a different bankruptcy law than the taxpayer in Rev. Rul. 70-367. (See Henderson and Goldring, *Tax Planning for Troubled Corporations*, §302 at 19 (CCH 2006).) However, in *In re Dow Corning Corp.*, 270 B.R. 393 (Bankr. E.D. Mich. 2001), the court allowed a taxpayer to deduct postpetition interest as it accrued when the creditors had a contractual right to receive postpetition interest.

The IRS recently affirmed its agreement with the holding in *Dow Corning* through the issuance of Chief Counsel Advice (CCA) 200801039 (1/4/08). The CCA provides that a corporation may deduct postpetition interest in its consolidated tax return on behalf of the contractual borrowings of a subsidiary member. The CCA primarily addresses whether the postpetition interest is fixed rather than the reasonable accuracy and economic performance requirements. The CCA concluded that the corporation may deduct such postpetition interest until the confirmation of the reorganization plan in the bankruptcy proceeding. The Service provides that “while Subsidiary’s filing of a bankruptcy petition created doubt as to the likelihood of the payment of interest on the Subsidiary’s contractual borrowings, the bankruptcy petition did not change Subsidiary’s obligation to pay the interest.” It should be noted that the CCA also provides that the taxpayer must recognize interest income under the tax benefit rule when the deduction in an earlier tax year is determined not to be owed and payable in a later tax year.

Based on the above cases and IRS guidance, a borrower may deduct interest as it accrues despite uncertainty that it will actually pay such interest. In this case, the borrower still incurs a liability that enables the borrower to deduct the interest under the accrual method.

Whether Interest Is Income to the Lender as It Accrues

Regs. Sec. 1.451-1(a) provides that an accrual-method taxpayer must recognize income when (1) all events have occurred to fix the right to receive such income and (2) the amount can be determined with

reasonable accuracy. Thus, an accrual-method holder generally recognizes interest income as it is earned over the term of a loan.

As the certainty for payment from the borrower diminishes, must the holder continue to recognize interest income as it accrues? In *Corn Exchange Bank*, 37 F.2d 34 (2d Cir. 1930), the court did not force an accrual-method taxpayer to recognize interest income arising after the borrower went into receivership. The court noted that income is taxed on a reasonable expectancy that it will be received and the taxpayer did not have income if there is no such reasonable expectancy. Because the borrower was in receivership, the taxpayer could not collect the interest in due course. The court stated:

A taxpayer, even though keeping his books upon an accrual basis, should not be required to pay a tax on an accrued income unless it is good and collectable, and, where it is of doubtful collectability or it is reasonably certain it will not be collected, it would be an injustice to the taxpayer to insist upon taxation. [37 F.2d at 34.]

In *Jones Lumber Co.*, 404 F.2d 764 (6th Cir. 1968), the court required an accrual-method taxpayer to recognize interest income because the taxpayer failed to provide evidence demonstrating “reasonable doubt as to the collectibility of the notes” due to the financial condition or insolvency of the debtor (doubtful collectibility). Even though the loans had no ascertainable fair market value, the taxpayer was required to accrue interest because there must be “a definite showing that the insolvency of the debtor makes receipt improbable.” (See also *Georgia School-Book Depository, Inc.*, 1 T.C. 463 (1943)).

Such a “definite showing” must provide that doubt relates to a *permanent* uncollectibility, according to the U.S. Court of Claims in *Koehring Co.*, 421 F.2d 715 (Ct. Cl. 1970). The court held that a taxpayer must accrue income despite the payor’s financial problems that resulted in nonpayment when payments were due. The taxpayer regarded the

obligor’s financial problems as temporary, and such financial problems did not affect the taxpayer’s expectation that it would eventually receive payment. (See also *European Amer. Bank and Trust Co.*, 20 Cl. Ct. 594 (1990), *aff’d per curiam*, 940 F.2d 677 (Fed. Cir. 1991): “For accrual of income to be prevented, uncertainty as to collection must be substantial, and not simply technical in nature.”)

Establishing its position on the subject, the IRS issued Rev. Rul. 80-361, confirming that a taxpayer need not recognize interest in circumstances for which there is doubtful collectibility of such interest (the doubtful collectibility exception). In the ruling, a taxpayer may stop recognizing interest as it accrues when a borrower becomes insolvent. Most notable in the ruling, the Service differentiated between interest related to the period before the borrower became insolvent and interest related to the period after the borrower became insolvent. The IRS ruled that the lender must recognize interest prior to the borrower’s insolvency as it accrues, and such interest could be subject to Sec. 166 as a bad debt deduction in the event of uncollectibility. The IRS also ruled that the lender need not accrue interest related to the day of the borrower’s insolvency and thereafter.

Based on Rev. Rul. 80-361, is the IRS’s position for nonaccrual based solely on the insolvency of the borrower? More recently, the Service ruled in Rev. Rul. 2007-32 that an accrual-method lender must recognize as it accrues interest that relates to a loan in which the borrower has technically defaulted from late payments. Similar to *Koehring Co.*, the ruling provides that “late payment of interest by itself is not sufficient” to demonstrate no reasonable expectancy of payment. However, the Service also stated in Rev. Rul. 2007-32: “If there is some doubt regarding receipt of payment but a reasonable person would have an expectancy of payment, then an accrual method taxpayer is required to recognize the income,” which may suggest that the IRS’s position extends beyond the mere insolvency of the borrower.

While there is guidance for the nonrecognition of interest as it accrues due to the

doubtful collectibility exception, there is uncertainty whether the doubtful collectibility exception applies to the accrual of original issue discount (OID). In Technical Advice Memorandum (TAM) 9538007, the IRS concluded that a cash-basis lender was required to include OID that was doubtful to be collected due to the borrower's financial condition. The Service's position primarily relies on the argument that OID is separately accounted for under the tax law despite being treated similar to the accrual method. The IRS also notes in the TAM that the legislative history of Sec. 1232 (the predecessor of Sec. 1272) states that Congress provided for interest inclusion by the holder to eliminate a mismatch between the lender's income and the borrower's deduction. It is the IRS's position that applying the doubtful collectibility exception for OID could potentially create such a mismatch. The IRS relaxed its position on borrowers in bankruptcy proceedings in IRS Litigation Guideline Memorandum TL-103 (5/6/96) by providing that the holder "may not include interest, including original issue discount, in income after the issuer has filed a petition for bankruptcy."

Recent events in the credit markets have reopened debate as to whether TAM 9538007 is correct in distinguishing OID from interest. If the doubtful collectibility exception is available for the recognition of interest as it accrues, why should such an exception be restricted to non-OID interest? The New York City Bar Committee on Taxation of Business Entities recently published a report arguing that the doubtful collectibility exception should be available for holders with respect to OID (New York City Bar, Committee on Taxation of Business Entities, "Report Regarding Proposals for Accounting Treatment of Interest on Non-Performing Loans," 2008 TNT 145-59 (July 28, 2008)). It argues that the legislative history to Secs. 1271-1275 (which provide for the recognition of OID as it accrues) indicates that Congress was concerned with the mismatch between cash-method lenders and accrual-method borrowers rather than a mismatch due to nonrecognition of interest income by a lender via the doubtful collectibility exception. Accordingly, there

is an inconsistency in allowing the doubtful collectibility exception to apply for interest accrual but not OID.

As in *Corn Exchange*, "it would be an injustice" to require a taxpayer to recognize income that it will never receive. Such an injustice occurs regardless of whether or not such uncollectible interest constitutes OID.

From Jeff Borghino, CPA, and Andrew Cordonnier, CPA, Washington, DC

PROCEDURE & ADMINISTRATION

New Regs. Govern Overseas Disclosure and Use of Taxpayer Information

Sec. 7216 and the regulations thereunder were promulgated to set guidelines and impose restrictions on the use and disclosure of taxpayer information by tax return preparers. The rules were designed to protect taxpayers from having tax return information that is furnished to preparers disclosed and used in a manner that the taxpayer would not ordinarily authorize or contemplate. Sec. 7216(a) imposes significant penalties, including fines and/or imprisonment, for situations in which such information is disclosed knowingly or recklessly (subject to the many exceptions contained in the regulations) or is used for an improper purpose by return preparers. A civil penalty for improper disclosure of tax return information is contained in Sec. 6713.

The IRS issued final regulations under Sec. 7216 that were effective on January 1, 2009 (T.D. 9375). The purpose of these regulations is to update the existing rules to address current tax industry practices, such as electronic preparation and filing, expanded tax and nontax service offerings, and resource sharing across national borders.

Tax preparers who offer international tax services may be part of a multinational firm or a U.S. firm with overseas affiliates; they may provide services to expatriates or clients with international operations; or they may outsource tax return preparation services performed for U.S. clients to take advantage of cost savings. Regardless of how the preparer's firm is structured or how work is divided among jurisdictions, the new Sec. 7216 regulations are likely to

affect preparers who operate internationally because they contain new requirements related to cross-border information sharing. Such preparers will have to reevaluate firm procedures and protocols in light of the new regulations.

Consent to Disclose Information Outside the United States

Regs. Sec. 301.7216-2(c)(2) requires a preparer to obtain taxpayer consent before disclosing any of the taxpayer's tax return information to another preparer located outside the United States, regardless of whether the preparers are related parties. In all cases, the consent must be knowing and voluntary, obtained prior to any disclosure, and signed and dated by the taxpayer. The term "tax return information" is defined in Regs. Sec. 301.7216-1(b)(3) and has been expanded to include items such as statistical compilations, IRS communications, and amounts generated (e.g., credits or deductions) based on information provided by the taxpayer. The consent requirements applicable to all tax return filers are described in Regs. Sec. 301.7216-3. Additional consent requirements that apply to taxpayers filing individual returns are specified in Rev. Proc. 2008-35.

Regs. Sec. 301.7216-3(a)(3)(i) requires taxpayer consent to contain the following items:

- The name of the tax return preparer and the name of the taxpayer;
- The intended purpose of the disclosure and, generally, the specific recipient(s) of the tax return information; and
- A specific description of the tax return information to be disclosed or used by the preparer.

Rev. Proc. 2008-35 requires preparers to adhere to additional requirements when obtaining consent from taxpayers who file returns in the Form 1040 series. Examples of specific rules include determining when separate consent forms must be used and when multiple disclosures within a single consent form are permitted; the language to be used in mandatory statements based on the intended use of the information; and even the size of the paper and font to be used when producing the consent form. Return preparers who collaborate with

foreign tax experts in providing services to clients who are natural persons (i.e., individuals) must understand and carefully follow Rev. Proc. 2008-35 to ensure that taxpayer consent to share information is properly obtained prior to disclosure.

Regs. Sec. 301.7216-2(c)(3) provides an exception to the consent requirement where the taxpayer initially furnishes tax return information to a tax return preparer located outside the United States. In such instances, the foreign preparer who received the information may use or disclose such tax return information to another officer, employee, or member that assists in the preparation of the taxpayer's tax return regardless of the respective preparers' geographical locations. This exception provision appears to provide an opportunity to mitigate some of the administrative burden relating to the consent process for firms that utilize tax return preparers employed by member firms outside the United States.

Disclosure of Taxpayer Social Security Numbers

The initial release of the final Sec. 7216 regulations (in January 2008) did not allow disclosure of a taxpayer's Social Security number (SSN) to a return preparer located outside the United States. The rule was reportedly designed to protect against identity theft and the heightened risk of misuse of confidential information readily associated with the taxpayer's SSN. The provision required the taxpayer's SSN to be redacted from any tax return information prior to being distributed overseas. This provision was viewed as a practical and administrative burden by U.S. preparers and clients who collaborate with foreign affiliates of the U.S. preparer in the preparation of tax returns. One of the concerns raised was that it would be difficult and time consuming for expatriate U.S. taxpayers to obtain tax treaty benefits from foreign jurisdictions.

In order to address practitioner and taxpayer concerns while maintaining the policy of closely safeguarding taxpayer SSNs, the IRS released rules allowing disclosure of a taxpayer SSN when there are sufficient data and security programs and procedures in place that meet IRS standards (T.D. 9409). The exception allows a U.S.-based return

preparer to obtain consent to disclose a taxpayer's SSN to a foreign return preparer if the SSN is disclosed through an "adequate data protection safeguard" where the U.S. preparer verifies maintenance of the safeguard in the consent form provided to the taxpayer. Further, the U.S. preparer may only disclose the SSN to a preparer located outside the United States who also employs an adequate data protection safeguard. Several examples of adequate safeguards are listed in Rev. Proc. 2008-35.

This exception will primarily benefit preparers who have a large network of foreign affiliates or who outsource tax compliance work to low-cost jurisdictions. Tax return preparers who do not have adequate safeguards in place, or who wish to disclose to foreign preparers who lack adequate safeguards, are still subject to the rule requiring SSNs to be masked or redacted prior to disclosure regardless of any taxpayer consent.

Conclusion

The new regulations under Sec. 7216 update the tax return information disclosure rules to address the increasingly global nature of the modern return preparation marketplace, including changes that affect multinational arrangements between preparers, collaboration between unrelated U.S. and foreign preparers, and the expansion of accounting and law firms overseas. Practitioners with international operations or overseas clients should carefully evaluate the impact of the updated consent requirements, particularly when dealing with clients who are natural persons. The technical nature of certain required procedures (e.g., Rev. Proc. 2008-35) may cause practitioners to reevaluate and amend their current policies and procedures to mitigate the financial and reputational risks associated with improper disclosures and uses of tax return information.

From Greg Jamouneau, J.D., Chicago, IL

New Transaction of Interest Identified

In Notice 2008-99, the IRS identified a new transaction of interest (TOI) for purposes of the reportable transaction disclosure and list maintenance rules under

Secs. 6011, 6111, and 6112. A transaction of interest is defined in Regs. Sec. 1.6011-4(b)(6) as "a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has identified by notice, regulation, or other form of published guidance as a transaction of interest."

Although TOIs are a category of reportable transaction under Sec. 6011, they are not necessarily considered abusive by the IRS. Unlike a listed transaction, which is a category of reportable transaction also specifically identified in published guidance, a TOI is not determined to be a "tax avoidance transaction." The IRS added the TOI category in order to gather information about transactions that it believes have the *potential* for tax avoidance but for which it lacks sufficient information to determine if the transaction should be identified as a tax avoidance transaction (i.e., a listed transaction). The transaction described in Notice 2008-99 is the third transaction identified by the IRS as a TOI. (The others were identified in Notices 2007-72 and 2007-73; see Emilian and Jamouneau, "IRS Issues Reporting Requirement for Transactions of Interest," *Tax Clinic*, 39 *The Tax Adviser* 81 (February 2008).)

Notice 2008-99 identifies certain transactions involving the use of charitable remainder trusts and substantially similar transactions as TOIs. A charitable remainder trust (CRT) is a vehicle through which a donor (grantor) contributes property that provides income to the grantor (or his or her designated beneficiaries) but provides that the remainder interest (or principal) is received by a designated charity. CRTs provide tax benefits in the form of capital gains savings (on the donated property), an income tax deduction (based on the value of the remainder interest), and estate planning (i.e., the donated property is removed from the estate).

The use of CRTs is quite common and does not by itself invite IRS scrutiny. The type of CRT transaction identified in Notice 2008-99, however, involves a tax benefit that the IRS believes has the potential for tax avoidance or evasion. Specifically, the IRS is concerned that the Notice 2008-99 transaction allows

the CRT grantor to permanently avoid recognition of gain on the sale or other disposition of appreciated assets.

Transaction Steps and Results

The transactions described in Notice 2008-99 generally involve four entities: a grantor or donor (Grantor) who seeks tax benefits by donating appreciated property to a CRT, the CRT itself, a charity or other tax-exempt entity (Charity) that holds the remainder interest in the CRT, and an unrelated third party (*X*) to whom Grantor and Charity sell their respective interests in the CRT.

Notice 2008-99 outlines the basic framework and tax results of the TOI as follows:

1. Grantor creates the CRT and contributes appreciated assets to the CRT. Grantor retains a term interest in the CRT and designates Charity as the CRT's remainder beneficiary. Upon contributing appreciated assets to the CRT, Grantor claims a charitable contribution deduction for the present value of the charitable remainder interest, which is based on the fair market value of the assets attributable to the remainder interest.
2. The CRT sells the appreciated assets and reinvests the proceeds from the sale in other assets (e.g., a diversified portfolio consisting of money-market funds and marketable securities). The CRT is not taxed on the proceeds of the sale of the appreciated assets because of its tax-exempt status (see Sec. 664) and will have a basis in the newly purchased assets equal to the purchase price.
3. Grantor and Charity sell their entire respective interests in the CRT to *X* for the fair market value of all the CRT's assets, including the newly purchased assets. The CRT terminates immediately following the sale. On the sale of all the CRT interests to *X*, Grantor and Charity take the position that they have sold their entire interest in the trust for purposes of Sec. 1001(e)(3) and that Sec. 1001(e)(1), which would operate to disregard basis in the sale of a term interest in the CRT, does not apply. Grantor asserts

that, for purposes of computing gain on the sale of interests in the CRT, the relevant basis is the portion of the cost basis of the new assets allocable to the interests in the CRT (see Regs. Secs. 1.1014-5 and 1.1015-1(b)), rather than the basis of the appreciated assets originally contributed to the CRT.

Therefore, Grantor has received a charitable contribution deduction and the gain on the sale of appreciated assets contributed to the CRT is not taxed, even though Grantor received its share of the appreciated fair market value of the assets.

The notice indicates that the IRS is not concerned with the creation and funding of a CRT, with or without appreciated assets, or the CRT's reinvestment of any contributed appreciated property. Instead, the focus of concern is on the Grantor's claim to an increased basis in its CRT interest together with the termination of the CRT in a coordinated transaction designed to avoid tax on gain from the sale of the appreciated assets. Other trust arrangements with details that vary from the situation described above also will be considered TOIs if they fit the general pattern in substance, if not the exact form or order. Such variations include the use of trust vehicles similar to a CRT or the use of CRTs that have been in existence prior to the sale of trust interests, situations in which appreciated assets are already in the trust prior to the commencement of the transaction, and the contribution of appreciated assets to a passthrough entity, which in turn contributes the assets to a trust.

Effective Date and Participation

A transaction that is the same as, or substantially similar to, the transaction described in Notice 2008-99 is a TOI as of October 31, 2008 (the release date of the notice). Notice 2008-99 states that the tax-exempt entity taking a remainder interest in the CRT assets is not a participant if it sold or disposed of its interest in the trust at issue on or before October 31, 2008. However, other participants who entered into this TOI on or after November 2, 2006, must disclose participation in the transaction in the manner prescribed in Sec. 6011 and the regulations thereunder. States may also require disclosure.

Disclosure Requirements

Although Notice 2008-99 is effective as of October 31, 2008, a transaction that is the same as, or substantially similar to, the identified transaction must be disclosed if it was entered into after November 2, 2006. Generally, a taxpayer who participates in such a transaction after November 2, 2006, must disclose its participation in the transaction with its tax return reflecting the tax consequences or tax strategy of the transaction.

The disclosure regulations have special rules when a transaction is identified as a TOI after the filing of the taxpayer's return reflecting the tax consequences or tax strategy of the TOI. In such situations, if the statute of limitation on assessment for the prior return is still open, the general rule is that the taxpayer is required to file Form 8886, Reportable Transaction Disclosure Statement, with the Office of Tax Shelter Analysis (OTSA) within 90 days after the date on which the transaction is identified as a TOI. However, if the transaction at issue was entered into prior to August 3, 2007, the taxpayer must provide disclosure with its tax return next filed after the date the transaction is identified as a TOI (i.e., October 31, 2008) regardless of whether the taxpayer participated in the transaction during 2007.

The following examples illustrate the application of the disclosure rules described above:

- If a taxpayer participated in the TOI after November 2, 2006, and has not yet filed a tax return claiming tax benefits from the TOI, it must include the Form 8886 disclosure when it files that tax return.
- If the taxpayer has already filed a tax return without the Form 8886 disclosure and the TOI was entered into after November 2, 2006, but prior to August 3, 2007, the taxpayer is required to file Form 8886 with its next tax return filed after October 31, 2008.
- If the taxpayer already filed a tax return without the Form 8886 disclosure and the CRT transaction was entered into on or after August 3, 2007, the taxpayer is required to file Form 8886 with OTSA within 90 days of October 31, 2008 (i.e., by January 29, 2009).

Conclusion

It is critical for practitioners and taxpayers to understand and meet their respective obligations with regard to TOIs. As with any type of reportable transaction, there are substantial penalties applicable to taxpayers and material advisers (who must disclose this transaction on Form 8918, Material Advisor Disclosure Statement, on or before January 31, 2009) who do not comply in a timely manner, and such penalties cannot be waived. Therefore, practitioners should work with both colleagues and clients to evaluate transactions that could be considered the same or substantially similar to the TOI described in Notice 2008-99 and, if it is determined that the notice applies, take timely appropriate action.

From Greg Jamouneau, J.D., Chicago, IL

The Tax Return Preparer Standard: Policy Developments

The tax return preparer standard set forth in Sec. 6694 has been subject to a series of revisions and refinements. Legislation enacted in May 2007 established a new more-likely-than-not (MLTN) return preparer standard, which required preparers to have a greater-than-50% level of confidence in undisclosed positions. Treasury and the IRS have issued guidance to address many practical concerns about the effects of the MLTN standard, including:

- The difference between the standards that apply to preparers and to taxpayers;
- Application of the standard to nonsigning preparers who provide post-transaction advice; and
- Which positions, with adequate disclosure, should be eligible for a standard that is less than MLTN.

In October 2008, Congress again changed the tax return preparer standard, retroactively lowering it to substantial authority (no disclosure required) for most tax positions. Under the new legislation, certain positions will still require a minimum MLTN confidence level to avoid imposition of a return preparer penalty (and effectively enable tax return preparers to sign a return). As the return preparer standard evolves,

there is increasing uncertainty among tax professionals about how to provide traditional tax services to clients without being exposed to the Sec. 6694 penalty regime.

Prior Standard

Under prior law enacted in 1989, tax return preparers could prepare tax returns without making any specific disclosures as to positions reported on tax returns as long as a tax position had at least a “realistic possibility” (approximately a one in three chance) of being sustained on its merits. As a practical matter, under the realistic possibility of success standard it was not difficult for return preparers appropriately evaluating relevant authority to conclude that a tax position had a 33% chance of being sustained on its merits.

A key policy behind the increased MLTN standard seems to have been the desire to hold tax return preparers to a greater gatekeeping role in the tax system. It appears that Congress wanted tax return preparers to take on a greater responsibility for ensuring that tax returns reflect sustainable positions at a level of confidence much greater than one in three without issue disclosure and create more confidence and transparency for the IRS. This resulted in the increased MLTN standard and the required disclosure of positions not meeting the MLTN standard. Moreover, Congress apparently believed that, over time, implementation of the MLTN standard would raise the overall accuracy of tax returns being filed.

Implementation of the MLTN Standard

The implementation of the MLTN standard created many obstacles for tax return preparers. The difference between the standards applied to return preparers (MLTN) and taxpayers (substantial authority) placed stress on preparer-client relationships and created a conflict between the parties when clients elected not to disclose against the advice of the preparer. The standard applied to nonsigning preparers was the same as that applied to signing preparers even where the nonsigner did not have the same level of information or involvement in the position

at issue, leading to tension between these preparers. Many tax positions, including several related to accounting methods, amended returns, and passthrough entities, could not ordinarily (if ever) meet the MLTN standard because of their nature or complexity.

Guidance issued shortly after the original MLTN legislation (Notices 2007-54 and 2008-13) showed an attempt to balance the increased burden on tax return preparers by permitting reliance on others in certain instances. The guidance clarified that return preparers may continue to rely on taxpayer representations in preparing returns as long as the preparer does not have reason to know (or should know) that the representations are false. Further, preparers may rely in good faith on the advice of an unaffiliated third party who the preparer had reason to believe was competent to render the advice.

This provision, in some instances, actually reduced the due diligence standard for reliance on third-party advice. Many preparers, however, were not comfortable with such reliance and continued to perform levels of investigation they believed to be appropriate in their role as return preparers. Overall, it was clear that the heightened standard had created a difficult environment for preparers and taxpayers and that additional legislation was necessary to resolve the tension between Congress’s policy goals and the practical impediments to implementing the new standard.

Current Status and Challenges

Congress recently enacted legislation that attempted to address concerns with the return preparer standard more broadly by relaxing the MLTN requirement for many tax positions. The Emergency Economic Stabilization Act of 2008, P.L. 110-343, amended Sec. 6694(a)(2) to lower the return preparer standard for nondisclosed tax positions other than those that have a significant purpose of tax avoidance or evasion (or are certain types of reportable transactions) from MLTN to substantial authority. Under the new rules, a tax position that does not meet the substantial authority level of confidence may nonetheless be taken on a return if there is at

least a reasonable basis for the position, provided there is adequate disclosure. Tax positions that have a significant purpose of tax avoidance or evasion or are reportable avoidance transactions must continue to meet the MLTN standard; furthermore, the statutory change (Sec. 6694(a)(2)(C)) does not contain a provision allowing a preparer to sign a return containing such transactions at a lower confidence threshold (i.e., there is no adequate disclosure provision for such transactions).

Reducing the standard for many tax positions to a substantial authority level of confidence (or reasonable basis with adequate disclosure), which is the same standard that taxpayers must meet to avoid an accuracy penalty under Sec. 6662, has been received as a welcome change by most preparers. However, tax positions with a significant purpose of tax avoidance or evasion and reportable avoidance transactions remain at the MLTN standard. The absence of an adequate disclosure provision to address such positions remains a significant issue, and return preparers must understand the issue.

A prominent concern is that “significant purpose of tax avoidance or evasion” is a phrase that could be construed generally to include all transactions that provide a significant tax benefit to the taxpayer. “Significant” is an undefined term, so unless some form of test, safe harbor, or other helpful parameters are established to clarify what constitutes a significant purpose, preparers will be challenged to apply the provision.

Another difficult question is how preparers should view their responsibility to communicate to a taxpayer that they have not reached an MLTN level of confidence on a significant purpose or reportable avoidance transaction. It is not difficult to imagine instances in which relationships among preparers, clients, and third-party advisers could be strained due to the new legislation. For instance, when a signing preparer wishes to rely on advice provided by a nonsigning preparer, additional investigation will be required when there is a disagreement about whether a given tax position involves a significant purpose or constitutes a reportable avoidance transaction, where the signing preparer does

not have an MLTN level of confidence that such a position would be sustained on its merits. Furthermore, client representations may increasingly be challenged by both signing and nonsigning preparers as a result of the uncertainty surrounding significant purpose transactions.

Responding to concerns about the most recent return preparer legislation, the IRS has released final regulations and guidance. (For more information, see News Notes, p. 68, and Tax Trends, p. 128.)

Conclusion

The increased return preparer standard enacted in 2007 was originally intended to reduce the increasing number of what were perceived to be aggressive positions being taken on a tax return by requiring tax return preparers to serve in a greater gatekeeping role. The implementation of the MLTN standard forced preparers to heighten their scrutiny of client tax positions but also resulted in significant confusion and uncertainty, which has yet to be resolved. Additional legislation and explanatory guidance clarified certain matters, but many important areas have not been addressed.

The recent amendments to Sec. 6694 included in the Emergency Economic Stabilization Act relaxed the return preparer standard for a large number of tax return positions, but they created a new set of issues that require additional guidance. It appears that the tax return preparer standard will continue to be a work in progress as Congress, the IRS, Treasury, and tax professionals work to establish policy and rules that balance the need for increased scrutiny of transactions at the preparer level with the need for a practical tax administration framework that allows preparers to provide tax services to clients where the rules and penalties are clearly understood.

From Greg Jamouneau, J.D., Chicago, IL

STATE & LOCAL TAXES

Maryland Tax Court Adopts Economic Substance Doctrine

Two recent decisions highlight the Maryland Tax Court’s creation and use of the economic substance doctrine in cases involving the use of intangible holding

companies (IHCs). The Tax Court ruled in *The Classics Chicago, Inc. v. Comptroller* and *The Talbots, Inc. v. Comptroller*, Nos. 06-IN-OO-0226 and 06-IN-OO-0227 (Md. Tax Ct. 4/11/08), that deductions relating to transactions between a parent company with Maryland nexus and a subsidiary can be revoked if the subsidiary does not have sufficient “economic substance.”

Further, the court held that the subsidiary, which had not previously filed corporation income taxes in Maryland, had constitutional nexus with Maryland and was subject to a Maryland filing requirement. The Tax Court reached a similar result in *Nordstrom, Inc. v. Comptroller*, Nos. 07-IN-OO-0317, 07-IN-OO-0318, and 07-IN-OO-0319 (Md. Tax Ct. 10/24/08), where two IHCs belonging to a parent company that did business in Maryland both had nexus with the state because they lacked real economic substance as separate business entities.

Talbots

In *Talbots*, the Maryland comptroller’s assessments stemmed from the effect of several intercompany transactions. In 1988, Talbots, Inc. (Talbots), a national retailer with locations in Maryland, transferred its intellectual property (including the Talbots trademarks) to Jusco BV, a related foreign holding company. Talbots and Jusco BV then entered into a licensing arrangement whereby in exchange for the right to use the Talbots trademarks, Talbots paid Jusco BV a royalty fee based on a percentage of Talbots’ net sales. In 1993, Jusco BV sold the intangible assets to The Classics Chicago (Classics), a new Talbots subsidiary. Classics and Talbots entered into a new licensing agreement under which Classics held the Talbots trademarks and licensed them to Talbots in exchange for royalty payments representing a percentage of Talbots’ sales.

Talbots filed Maryland corporation income tax returns and deducted the royalty payments from its Maryland taxable income. Classics did not file Maryland corporation income tax returns because it had no property, bank accounts, or employees in Maryland. Maryland imposed an assessment on Talbots for tax

years 2001 and 2002 and on Classics for tax years 1993–2003. The assessments resulted from the comptroller’s disallowance of Talbots’ royalty and interest deductions because such payments were not considered “ordinary and necessary” business expenses and because the comptroller claimed that Classics had nexus with Maryland and was subject to tax on the receipt of royalty income from the Talbots agreement.

The Sham Doctrine

Talbots relied on *Comptroller v. SYL, Inc.*, 825 A.2d 399 (Md. 2003), to argue that the related-party transactions with Classics should be reviewed under the “sham doctrine,” which analyzes the challenged transactions under the framework of whether they were designed solely to avoid taxation. Talbots argued that the deductions arose from a legitimate business expense because the company did not enter into the royalty agreement to avoid state tax liability. The company claimed that there were reasons to engage in such transactions that were not related to state taxation, such as maximizing the value of Talbots stock for an initial public offering, creating a valuable income stream to collateralize, and other legitimate business purposes. Talbots claimed that the facts of *SYL* differed from its own situation because *SYL* involved a scheme that was clearly used to avoid the reach of Maryland taxation. In fact, the company asserted that there were some negative implications, from a state tax perspective, resulting from its transactions with Classics, in that Classics became subject to state tax liability in unitary reporting jurisdictions.

The Tax Court found that *SYL* did not establish the sham doctrine as the standard to be applied when determining the nexus of affiliated entities. The court instead used the economic substance test, which states that an out-of-state affiliate must have real economic substance as a separate business entity. The Talbots and Classics facts did not meet this test. Classics had no other income except for the royalty income from Talbots, had minimal operating expenses, and had only about \$2,000 of expenses for office space

and bookkeeping services. Talbots loaned Classics nearly all the funds needed to purchase all the intangible assets from Jusco BV. The Tax Court held that these facts showed that Classics completely “relied on the parent for performance of ordinary business operations,” proving that Classics lacked economic substance. The court thus elected to view Classics through the lens of Talbots, its parent, which had nexus with Maryland.

As a result, the Tax Court held that Classics had constitutional nexus with Maryland, subjecting Classics to assessment for tax based on the receipt of royalty income from 1993 to 2003. In addition, the court disallowed Talbots’ royalty and interest payment deductions for 2001 and 2002 for the related-party transaction. While the Tax Court upheld the assessments that related to Maryland corporation income tax and interest, it reduced the comptroller’s penalty assessment from 25% to 10% of the taxes owed.

Nordstrom

In *Nordstrom*, the taxpayers consisted of a national retailer that operated stores in Maryland and two of its subsidiaries (NIHC and N2HC) that did not conduct business or own tangible personal property in the state. Nordstrom entered into a licensing agreement with NIHC in which Nordstrom authorized NIHC to license the use of Nordstrom’s trademarks in exchange for the entire stock of NIHC. Nordstrom later transferred its trademarks to NTN, a wholly owned subsidiary of Nordstrom that like NIHC and N2HC did not conduct business or own tangible personal property in Maryland. Nordstrom then transferred the stock it owned in NTN and NIHC to N2HC for cash. NIHC then transferred the licensing agreement to N2HC as a dividend. N2HC then entered into an agreement with Nordstrom to license Nordstrom’s trademarks in exchange for royalty payments.

Nordstrom paid royalties to N2HC of approximately \$200 million during tax years 2002–2004.

Nordstrom, NIHC, and N2HC contended that NIHC and N2HC were not subject to Maryland tax because they had sufficient economic substance to differentiate themselves from the IHCs in prior Maryland cases in this area, such as *SYL*. In addition, NIHC and N2HC had offices that were staffed by a full-time



employee who would bring actions to enforce and protect the trademarks, which in Nordstrom’s view was enough substance to pass the sham entity test.

The comptroller argued that the deductions for the royalty payments were not proper because Nordstrom, NIHC, and N2HC should be treated as one company for nexus purposes. The comptroller claimed that NIHC and N2HC had no economic substance because the activities of the subsidiaries were the activities of the parent.

As in *Talbots*, the Tax Court found that the sham doctrine was not the standard to be applied when determining nexus of affiliated entities. The court applied the economic substance test created in *Talbots* that required it to examine the economic substance of NIHC and N2HC as well as the legitimate business activities of NIHC, N2HC, and Nordstrom. The application of this test required a transparent consideration of the business activity of Nordstrom, NIHC, and N2HC and a review of the royalties paid by Nordstrom and the financial statements of NIHC and N2HC.

The Tax Court found that the transactions between Nordstrom and its subsidiaries were not at arm’s length, considering that one of the subsidiaries loaned

most of the royalty payments back to Nordstrom. Note that the Tax Court's conclusion that the transactions were not at arm's length does not appear to follow the analytical construct of examining the business activities and the financial statements of the IHCs. According to the Tax Court, the subsidiaries were similar to those in previous Maryland cases (*SYL, Inc.*; *Ward Europa, Inc. v. Comptroller*, 503 A.2d 1371 (Md. Ct. Spec. App. 1986); and *Comptroller v. Armco Export Corp.*, 572 A.2d 562 (Md. Ct. Spec. App. 1990)) that lacked economic substance. The Tax Court found that "the subsidiaries did not act independently, although the financial structure creates an illusion of substance."

However, there appears to be an inconsistency in this analysis because the requirement of acting independently differs from the requirement of adhering to corporate formalities, substance, purposeful activity, and a profit motive characteristic of economic substance. The Tax Court treated NIHC and N2HC as part of the parent, Nordstrom, which had nexus in Maryland. Because NIHC and N2HC had nexus with Maryland, the Tax Court affirmed assessments against NIHC and N2HC.

The Tax Court rescinded an alternative assessment that the comptroller imposed on Nordstrom itself on the premise that if NIHC and N2HC did not have nexus with Maryland, then Nordstrom should not be able to deduct the payments it received from these entities. The comptroller had proceeded on this alternative basis by arguing that the expenses incurred by Nordstrom were not ordinary and necessary expenses deductible under Sec. 162 and as such could not be deducted for Maryland corporation income tax purposes.

Conclusion

The *Talbots* and *Nordstrom* decisions make clear that the economic substance doctrine is now a part of Maryland tax jurisprudence, at least in the area of related-party transactions, and potentially in other areas of Maryland tax law. These cases provide the comptroller flexibility to challenge either the deduction taken by the entity incurring the related-party expense or the nexus status of the entity

earning income on the transaction, to the extent such entity claims it is not subject to the state's corporation income tax.

The Maryland Tax Court has placed an additional burden on the taxpayer to prove not only that the transaction is not a sham but that the entities involved in the transaction also have economic substance as stand-alone entities. Thus, a subsidiary must have some independence and operate as a separate business entity. Unfortunately, to date neither the Tax Court nor the comptroller has offered specific guidance on what facts and circumstances would satisfy the economic substance standard.

Items that a taxpayer will need to consider are whether one entity receives revenue from sources other than royalty payments from the related party, whether the entities in the transaction have officers and/or employees, whether the entities have ordinary and considerable business expenses, and whether the entities were created for purposes other than to avoid state tax liability. The taxpayer will need to show that one entity is not excessively relying on a related-party entity in order for their separate existence to be respected. The taxpayer must ensure that its IHCs have a significant level of substance and that the transactions between the taxpayer and its related IHCs, such as loans and royalty payments, are at arm's length. It remains to be seen whether upper-level Maryland courts will agree with the Tax Court's conception of the economic substance test and, if so, whether the Tax Court or the comptroller will provide guidance on what specific type of fact pattern will satisfy the economic substance standard.

From Jamie C. Yesnowitz, J.D., LL.M., Washington, DC, Chuck Jones, J.D., CPA, Chicago, IL, Duane Dobson, CPA, CMI, McLean, VA, Lori Magee, J.D., LL.M., McLean, VA, Tom Morgan, J.D., McLean, VA, and Giles Sutton, J.D., LL.M., Charlotte, NC

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EditorNotes

Greg Fairbanks is a tax manager with Grant Thornton LLP in Washington, DC.