

# TaxClinic

## PRACTICAL ADVICE ON CURRENT ISSUES

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#### CORPORATIONS & SHAREHOLDERS

### Stock Basis Recovery in Outbound Sec. 304 Transfers

The IRS recently issued final and temporary regulations addressing recovery of basis in a stock sale subject to both Secs. 304(a)(1) and 367 (T.D. 9444—the 2009 regulations). In 2006, the IRS finalized regulations that exempted Sec. 304 transactions from the application of Secs. 367(a) and (b) (T.D. 9250—the 2006 regulations). However, the 2009 regulations in effect revoke the exemption provided in the 2006 regulations where the transferor in a Sec. 304 transaction claims to recover basis other than basis in the stock deemed issued under Sec. 304(a)(1) and thereby to avoid recognizing the entire gain built into the stock transferred.

#### Background

Sec. 304 is designed to prevent corporations from bailing out earnings and profits (E&P) through related-party stock purchases. Specifically, Sec. 304(a)(1) treats a brother-sister stock sale as a deemed exchange under Sec. 351 followed by a redemption of the stock of the acquiring corporation deemed issued.

This fictional Sec. 351 exchange may raise issues in the international context. For instance, Sec. 367(a) provides that an outbound transfer that otherwise qualifies under Sec. 351 does not qualify for nonrecognition treatment. Further, Sec. 367(b) generally provides that certain 351 exchanges can cause the transferor to receive a deemed dividend (Regs. Sec. 1.367(b)-4). Prior to the 2006 regulations,

taxpayers were concerned that a related-party stock sale would result in the application of both Sec. 304(a)(1) and, as a result of the deemed Sec. 351 contribution, Sec. 367.

The IRS mitigated the concern of Sec. 304/367 overlap transactions by providing in the 2006 regulations that Sec. 367 would not apply to Sec. 304 transactions because the income recognized in a Sec. 304 transaction should equal or exceed the transferor's inherent gain in the issuing corporation's stock transferred to the foreign acquiring corporation.

The IRS's view that all the inherent gain would be taxed under Sec. 304 was premised on the notion that the transferor could recover basis only in the shares deemed issued (an amount equal to the transferor's basis in the shares sold). However, the IRS's position that basis recovery in a Sec. 304 transaction is limited to the shares deemed issued in the Sec. 351 exchange is not free from doubt. Prior to a 1997 amendment to Sec. 304, courts looked to the transferor's basis in the shares deemed issued and the shares of the acquiring corporation (see *Cox*, 78 T.C. 1021 (1982)).

### **Basis Recovery Prior to the 2009 Regs.**

The following example illustrates how the reasoning underpinning the 2006 regulations falls short when the transferor looks to its basis in the shares of both the acquired and the acquiring companies.

*Example:* *USP*, a domestic corporation, is the sole shareholder of two foreign corporations, *FC1* and *FC2*. The *FC1* stock has a \$40 basis and \$100 fair market value. The *FC2* stock has a \$100 basis and \$100 fair market value. As of December 31, year 1, *FC1* has zero E&P and *FC2* has \$20x E&P. On December 31, year 1, in a transaction described in Sec. 304(a)(1), *USP* sells the *FC1* stock to *FC2* for \$100x cash (the *FC1* sale) (Temp. Regs. Sec. 1.367(a)-9T(e)).

Under the 2006 regulations, Sec. 367 would not apply to the *FC1* sale. Applying the principles of Sec. 304, the *FC1* sale is treated as a distribution under Sec. 301

because *USP* constructively owns 100% of the *FC1* shares (Regs. Sec. 1.304-2). The distribution is treated as a dividend to the extent of first *FC2*'s and then *FC1*'s E&P, resulting in a \$20 dividend in the example (Secs. 304(b)(2)(A) and 301(c)(1)).

Next, the transferor recovers its basis (Sec. 301(c)(2)). If the transferor looks only to the basis in the shares deemed issued and redeemed, *USP* recovers \$40 in basis (i.e., the amount equal to *USP*'s basis in *FC1*'s shares immediately before the deemed contribution). The remaining \$40 would be treated as gain from the sale or exchange of property (Sec. 301(c)(3)).

In the above example, the mechanics worked as the IRS had envisioned: *USP* recognized the \$60 of gain built into the shares of *FC1*. However, if *USP* took the position that it was entitled to recover basis in both the deemed issued *FC2* shares and its actual *FC2* shares, *USP* would receive a \$20 dividend, recover \$40 in basis in the deemed issued shares, and reduce its basis in the actual *FC2* shares by \$40. As a result, *USP*'s basis in the *FC2* shares would be reduced to \$60. Conceptually, the built-in gain would be preserved by the reduction of *USP*'s basis in *FC2*'s shares, but the transaction would no longer result in *USP*'s recognizing the built-in gain in *FC1*'s shares at the time of the outbound transfer of the *FC1* shares.

### **Application of the 2009 Regs. to Outbound Transfers**

Rather than wade into the debate over the proper method for recovering basis in a Sec. 304 transaction, the 2009 regulations provide that Sec. 367 will apply to a Sec. 304 transaction if a U.S. person claims to recover basis other than the basis in the shares deemed issued (Temp. Regs. Sec. 1.367(a)-9T(b)). The gain realized as a result of Sec. 367 equals the amount by which the gain realized exceeds the amount of the distribution received by a U.S. person that is treated as a dividend under Sec. 301(c)(1) and included in gross income. Furthermore, the 2009 regulations provide that the taxpayer may not enter into a gain recognition agreement (id.).

In the example above, if *USP* looked to its basis in the actual *FC2* shares to avoid recognizing the built-in gain in *FC1*'s shares, the 2009 regulations would apply. Under those regulations, the \$40 difference between *USP*'s \$60 amount realized and the \$20 dividend would be treated as gain from a sale or exchange. The gain recognized by *USP* would increase *FC2*'s basis in the *FC1* shares by \$40 (Temp. Regs. Sec. 1.367(a)-1T(b)(4)). In addition, *USP*'s basis in the actual shares of *FC2*'s shares would increase by \$40 immediately before the transaction. Thus, after the application of the 2009 regulations to the example, *USP* would be in the same position as if it had not attempted to recover basis in the *FC2* shares.

### **Observations**

The 2009 regulations approach the issue of basis recovery in outbound Sec. 304 transactions from the Sec. 367 perspective rather than attempting to impose a questionable view of basis recovery under Sec. 304. Interestingly, the IRS has reasserted its view of basis recovery in a Sec. 304 transaction as part of proposed regulations that impose a share-by-share method of recovering basis generally (see REG-143686-07). While the IRS has contended that the transferor in a Sec. 304 transaction may recover basis only in the deemed issued shares, the 2009 regulations illustrate that such an approach may not be as universal as the IRS initially believed.

From Arthur W. Sewall, J.D., LL.M., Washington, DC

## **EMPLOYMENT TAXES**

### **Correcting Employment Tax Errors**

Correcting an employment tax error that is discovered in the year in which the error occurs is generally a simple process. However, employers often discover such errors after the close of the calendar year in which they paid the wages to an employee. The adjustment process to correct those errors is confusing and often leads to further mistakes.

The mechanical process for making adjustments of wages and related taxes

varies depending on whether there is a correction to FICA taxes or to income tax withholding, whether the error is identified before or after the close of the calendar year of the wage payment, and whether there is an overpayment or underpayment of taxes. Many of these mechanical difficulties are products of the statute; unfortunately, even the most recent revised regulations have not resolved these problems (T.D. 9405, amending Regs. Sec. 31.6205-1).

Subtitle C of the Code imposes on an employer liability to withhold and pay over to the government an employee's income taxes and the employee's (one-half) share of FICA taxes on the employee's wages. The employer must also pay the other one-half share of FICA. An employer remains liable for the federal income and FICA tax withholding that it should have made, whether or not the taxes are in fact withheld (Regs. Secs. 31.3403-1 and 31.3102-1(d)).

### Adjusting FICA

**Underpayments:** If an employer fails to withhold and pay over to the government an employee's FICA taxes, in either a current or a subsequent year the employer can make an adjustment when the error is discovered to the quarter in which the underpayment occurred. Beginning January 1, 2009, Form 941-X, Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund, can be used to make the adjustment, generally on an interest-free basis under Sec. 6205. (The employer can make a similar correction for its share of FICA taxes.)

If the employer discovers the error after the calendar year of the wage payment closes, the employer provides the employee and the Social Security Administration (SSA) a corrected Form W-2 (Form W-2c, Corrected Wage and Tax Statement) reflecting additional FICA earnings for the prior year and FICA tax withholding as if the employer had made it correctly (Regs. Secs. 31.6051-2(c)(a)-(c) and 31.6051-1(c)(1)).

This change to FICA wages and FICA tax withholding generally does not affect the employee's prior year individual tax return. At this point the employer has

paid the employee's taxes. The regulations provide a specific remedy to allow an employer to recover from the employee's pay the FICA taxes that the employer paid on the employee's behalf (Regs. Sec. 31.6205-1(d)(1)). If the employer does not recover the amount from the employee, the payment of the employee share of FICA tax by the employer is current wage compensation, subject to FICA and income tax withholding, and reflected on the employee's year-end Form W-2.

**Overpayments:** With respect to an overpayment of FICA taxes, the Code provides that the employer may make an adjustment or seek a credit or refund of the employer's share of FICA. An employer generally cannot seek the employer's share of overpaid FICA taxes unless the employer, in its capacity as a fiduciary, also seeks the employee's share. This adds additional complications for the employer, including a requirement to gain consent from the employee to claim the credit or refund on the employee's behalf.

In some instances, the employer must solicit from the affected employee a certification that the employee has not sought and will not seek a refund for the same overpayment amount (Sec. 6413; Regs. Secs. 31.6413(a)-3 and 31.6402(a)-1(a)(2)). However, this requirement does not apply to the extent that the taxes were not withheld from the employee or, after the employer makes reasonable efforts to repay or reimburse the employee or secure the employee's consent, the employer cannot locate the employee or the employee will not provide consent (Regs. Sec. 31.6413(a)-3).

### Adjusting Income Tax Withholding

**Underwithholding:** The adjustment process differs if an employer fails to withhold and pay over to the government federal income taxes on the wages it paid to the employee in a prior year. In contrast to a FICA adjustment, the employer does not make an interest-free adjustment on Form 941-X. The employer must provide the employee and the SSA with a Form W-2c reflecting additional wages for the year in which the underwithholding occurred. However, because the employer

may not withhold income taxes from an employee after the calendar year in which the wages were paid, the federal income tax withholding amount does not change (Regs. Secs. 31.6051-2(c)(a)-(c) and 31.6051-1(c)(2)).

After receiving the Form W-2c with additional wages, the employee generally will file an amended personal income tax return and pay the additional income taxes, if any. At this point, the employee has extinguished his or her personal income tax liability for the prior year. However, as a technical matter, the employer remains liable for its failure to withhold income taxes in the prior year (Sec. 3403; Regs. Sec. 31.3403-1).

The employer can eliminate this liability if it secures a statement from the employee certifying that the employee included the wages on his or her personal income tax return and paid the related income taxes (Sec. 3402(d); Regs. Sec. 31.3402(d)-1). Form 4669, Statement of Payments Received, is used for this certification. While receipt of this form mitigates the employer's liability for the failed withholding amounts, the employer may still be subject to penalties for having failed to withhold as required (Sec. 3402(d)).

A significant issue arises because the employer remains liable for the taxes unless such certification is received. As a technical matter, the employer should pay the amount of federal income tax that was underwithheld. However, there is no guidance to an employer for making the payment and reporting it as an employer's payment. Because withholding was not made, the employee does not get credit for the withholding; as a result, the withholding reported on Form W-2 will not reconcile to the withholding taxes paid by the employer. Neither the regulations nor the instructions to Form 941-X address this matter.

**Overwithholding:** Similarly, in the case of overwithholding, an employer generally may not refund income tax withholding to employees after the calendar year closes (Sec. 6414; Regs. Sec. 31.6414-1). Instead, an employee must resolve the overpayment, if any, with the filing of a personal income tax return.

## Observation

Typically, employers make income and FICA tax withholding errors at the same time, and these adjustments are undertaken together. While the newly released Form 941-X has improved the adjustment process, employment tax adjustments often remain cumbersome.

From Kathleen Mort, CPA, Pittsburgh, PA, and Dan Boeskin, J.D., Washington, DC

## EXEMPT ORGANIZATIONS

### Sponsorships Offer Opportunities for Nonprofits, Corporations

As the economy struggles, tax-exempt organizations are facing financial challenges. With declining endowments and decreasing charitable contributions, many exempt organizations are considering creative ways to obtain funding. Corporate sponsorships remain one excellent opportunity. If structured correctly, corporate sponsorship arrangements can provide an organization with tax-free income that counts as public support to the organization while giving the corporate sponsor a tax-deductible expense and an opportunity to keep its name before the public.

### Qualified Sponsorship Payments

Sec. 513(i) provides that a tax-exempt organization's solicitation and receipt of "qualified sponsorship payments" does not constitute an unrelated trade or business and hence does not trigger unrelated business income tax. A qualified sponsorship payment is any payment made by a person engaged in a trade or business for which there is no arrangement or expectation that such person will receive any substantial return benefit other than the use or acknowledgment of the name, logo, or product lines of the person's trade or business in connection with the recipient organization's activities.

### Evaluating Return Benefits

Generally, when acknowledging a corporate sponsor, organizations may list the sponsor's location, telephone number, or internet address, and may provide a link

to the sponsor's website. Value-neutral descriptions, including displays or visual depictions, of the sponsor's product line or services are permitted. Distribution, whether free or for remuneration, of a sponsor's product at the sponsored activity also will not result in a substantial return benefit.

Organizations should avoid using any wording that could turn an intended acknowledgment into advertising. Advertising includes messages containing qualitative or comparative language, price information, or other indications of savings or value, endorsements, and inducements to purchase, sell, or use particular products or services.

Organizations should also carefully consider any exclusivity arrangements. If an organization allows a business to be the exclusive sponsor of an event, the mere acknowledgment as exclusive sponsor generally does not result in a substantial return benefit. However, allowing the corporation to be an exclusive provider generally would result in a substantial return benefit. Exclusive provider arrangements generally include those that limit the sale, distribution, availability, or use of competing products, services, or facilities in connection with an exempt organization's activity.

Corporate sponsorship arrangements structured with a contingent payment also fall outside the definition of qualified sponsorship payment. If a payment is contingent upon the level of attendance at one or more events, broadcast ratings, or other factors indicating the degree of public exposure to the sponsored activity, it will not satisfy that definition. Other substantial return benefits include exclusive or nonexclusive rights to use goods, facilities, services, intangible assets such as trademarks or logos, and other privileges.

In evaluating whether a tax-exempt organization has received a substantial return benefit, all benefits other than the sponsor acknowledgment must be taken into account. However, if the aggregate fair market value of all benefits provided to the sponsor is not more than 2% of the total amount of the payment, the benefits will be disregarded.

### What Happens If the Sec. 513(i) Exclusion Does Not Apply?

Tax-exempt organizations would prefer that the Sec. 513(i) exclusion from unrelated business taxable income apply to all revenue received from corporate sponsorship arrangements. However, if a substantial return benefit is deemed provided, all may not be lost.

- Regs. Sec. 1.513-4(d) provides for an allocation where a portion of a payment would, if made as a separate payment, constitute a qualified sponsorship payment and the other portion would not, thus allowing the organization to treat each such portion as a separate payment.
- If certain activities of the tax-exempt organization cannot be treated as permissible acknowledgments, the normal rules under Secs. 512–514 should be applied to determine whether such activities constitute an unrelated trade or business that is regularly carried on.
- If the tax-exempt organization recognizes unrelated business income as a result of certain corporate sponsor activities, the organization should identify and capture expenses that it can deduct from the revenue to arrive at net unrelated business taxable income. Only expenses that are directly connected with carrying on an unrelated trade or business are permissible deductions, but expenses can be allocated between exempt and nonexempt uses on a reasonable basis (Regs. Sec. 1.512(a)-1(c)).

### Tax Treatment to Sponsoring Corporation

By partnering with tax-exempt organizations, for-profit corporations may gain access to a valuable marketing opportunity, allowing them to reach target audiences while supporting the important efforts of tax-exempt entities. Depending on the particular facts, a corporate sponsorship payment may be deductible under Sec. 162 as an ordinary and necessary business expense or under Sec. 170 as a charitable contribution. According to Regs. Sec. 1.513-4(e)(3), the fact that a payment is a qualified sponsorship payment treated as a contribution to the

payee organization does not determine whether the payment is deductible by the payer under Sec. 162 or Sec. 170.

Deduction as a charitable contribution requires an intent to make a gift. A corporation's expectation of a return benefit may suggest a lack of gratuitous intent and could disqualify the deduction under Sec. 170. Deduction as a business expense requires that the payment must be an ordinary and necessary expense of carrying on the taxpayer's trade or business. Regs. Sec. 1.162-20(a)(2) provides that expenditures for institutional or goodwill advertising, which keep the taxpayer's name before the public, generally are deductible as ordinary and necessary business expenses if the expenditures are related to the patronage the taxpayer might reasonably expect in the future.

If a payment appears potentially eligible for deduction under either provision, the corporation may be able to evaluate which provision affords it the greatest tax savings. When making this determination, corporations should take into consideration the limits on charitable contributions. Corporate charitable contribution deductions are limited to 10% of taxable income (as computed under Sec. 170(b)(2)(C)).

### Observation

Each year businesses spend significant amounts for cause-related event sponsorships and similar expenses. These partnerships can be beneficial to both the sponsoring corporation and the tax-exempt organization. With the proper structuring, these arrangements can provide tax advantages to both parties.

When structuring corporate sponsorship arrangements, in order to avoid having the arrangement treated as an unrelated trade or business, tax-exempt organizations should be careful to limit any provision of goods or services in return for a sponsorship payment such that the return benefits do not exceed 2% of the total payment. To stay under this threshold, organizations must ensure that they are properly assessing all the return benefits provided.

For corporations, choosing the right organization with which to partner can

have a significant impact on marketing efforts. During a down economy, tax-exempt organizations and corporations can look for corporate sponsorship opportunities that can benefit both parties.

From Katrina D. Walker, J.D., Washington, DC

## FOREIGN INCOME & TAXPAYERS

### Adopting or Changing a Foreign Corporation's Accounting Method

Many companies are experiencing decreased cashflow during the present economic downturn and as a result are evaluating options to raise cash to fund ongoing business operations. One option that U.S. multinational corporations may consider is repatriation of earnings from related foreign corporations (FCs).

To the extent of the FC's positive current or accumulated earnings and profits (E&P), the repatriated amount is generally regarded as a dividend under Sec. 316. Dividend treatment may be beneficial, assuming foreign tax credits are triggered to offset the U.S. tax thereon (subject to certain limitations). Thus, the company must determine how to calculate the FC's E&P. Since E&P is a U.S. tax concept, determining E&P—including adoption or change of tax accounting methods—should be made in accordance with U.S. tax law.

### What Is an Accounting Method?

An accounting method affects when an item of income or deduction is recognized. That is, accounting methods generally result from temporary (not permanent) differences to lifetime income, and these differences reverse in the succeeding tax year or years. Nevertheless, companies should monitor these differences with respect to their FCs because they likely will affect the determination of actual or deemed dividends for repatriations in a particular tax year.

### How Does a CFC Adopt or Change a Method of Accounting?

The rules for determining how a controlled foreign corporation (CFC) adopts or changes a method of accounting are

provided under Regs. Sec. 1.964-1(c) and more specifically under Temp. Regs. Sec. 1.964-1T(c). It is important to note that the IRS did not finalize these temporary regulations, and they sunset in April 2009 under Sec. 7805. At the time of publication, however, these temporary regulations are expected to be finalized, possibly with only minor modifications. Moreover, much of the analysis presented in this item is also applicable to the rules promulgated in the final regulations under Sec. 964 prior to the publication of the temporary regulations. For these reasons, the item focuses on the temporary regulations even though they are no longer effective.

Temp. Regs. Sec. 1.964-1T(c)(2) provides that for a CFC, the controlling domestic shareholders—i.e., U.S. shareholders who own directly or indirectly, in the aggregate, more than 50% of the total combined voting power of all classes of CFC stock who are entitled to vote and undertake to act on its behalf—may make an election, or adopt or change an accounting method, on behalf of the CFC (without regard to any other different methods or elections previously used to prepare its books and financial statements). Any method adopted or election made must be used consistently for all tax years in the calculation of the CFC's E&P unless and until IRS consent to change the method is obtained.

To adopt or change a method on behalf of a CFC under the temporary regulations, a controlling domestic shareholder must comply with the applicable requirements in the Code or regulations, including Secs. 442 and 446 and the regulations thereunder. These requirements include filing forms, executing consents, securing IRS permission, and maintaining books and records in a particular manner. Thus, in general, once the accounting method is adopted, the controlling domestic shareholders must follow the method change procedures set forth in either Rev. Proc. 97-27 (nonautomatic method changes) or Rev. Proc. 2008-52 (automatic method changes), as applicable, to change that method.

**Note:** In general, the accounting method change procedures cited above provide favorable terms and conditions

applicable to most voluntary accounting method changes made by either a domestic or a foreign corporation, including a current year of change for adjustments to income (rather than amending returns), a four-year spread for positive changes (inclusions into income), one-time inclusion for negative changes in the year of change, and audit protection for positions taken in prior tax years. Depending on the item, the taxpayer may have to pay a user fee and obtain advance IRS consent in order to change its method of accounting.

### When Must Action Be Taken to Adopt a Method?

Under the temporary regulations (but not the final regulations), actions to adopt a method do not have to be taken until the due date (including extensions) of the U.S. controlling shareholder's return for the first tax year within which ends the CFC's first tax year in which the computation of its E&P is *significant* for U.S. tax purposes (Temp. Regs. Sec. 1.964-1T(c)(6)).

Events that cause an FC's E&P to have U.S. tax significance include, but are not limited to:

- A subpart F inclusion;
- An exclusion of an amount that would have been included in the U.S. shareholder's income as subpart F income but for the E&P limitations; and
- The use by the CFC's controlling domestic shareholders of the tax book value (or alternative tax book value) method of allocating interest expense.

If action by or on behalf of the CFC is not undertaken timely to adopt a method, a taxpayer, upon showing reasonable cause, may be granted an additional 30-day period from the demonstration to take the appropriate action. If the taxpayer cannot demonstrate reasonable cause for failure to satisfy the above requirements, the computation of E&P should be made as if no elections had been made and any otherwise permissible accounting methods not requiring an election had been adopted.

**Observation:** In conducting an E&P study in anticipation of repatriating earnings, a U.S. company may discover that it had unknowingly adopted a method of accounting affecting E&P. For example,

in computing E&P to determine a subpart F inclusion, the FC may have included all advance payments received during the tax year. On discovery of a method adoption for a particular item, if the company determines that a different permissible accounting method would be more desirable, the company should request a method change for that item from the IRS by filing a Form 3115, Application for Change in Accounting Method.

From Irene Pik-Wah Hui, CPA, San Jose, CA, and Sara Logan, J.D., Washington, DC

### Initial IRS Guidance Addressing EU Cap-and-Trade Systems, Subpart F Rules

In Letter Ruling 200825009, the IRS addressed for the first time the subpart F treatment of gains on sale of surplus carbon dioxide (CO<sub>2</sub>) emissions allowances.

The taxpayer took the position that such gain does not give rise to foreign personal holding company income (FPHCI) within the meaning of Sec. 954(c). The taxpayer argued that CO<sub>2</sub> emissions allowances should be viewed as commodities for purposes of the Sec. 954(c)(1)(C) exception from FPHCI or, alternatively, that such allowances should be treated as property that does not give rise to income within the meaning of Sec. 954(c)(1)(B)(iii). The IRS specifically did not address the taxpayer's argument that the allowances should be viewed as commodities, instead adopting the taxpayer's alternative argument in concluding that the gain from the sale of surplus CO<sub>2</sub> emissions allowances does not give rise to FPHCI.

The Service indicated that although it currently was studying whether CO<sub>2</sub> emissions allowances are commodities, "[n]o inference is intended as to whether CO<sub>2</sub> allowances are properly considered commodities for purposes of Code section 954 or any other section of the Code." Pending any further IRS guidance, the inclusion of this "no-inference" language may be significant to many taxpayers who may seek to treat CO<sub>2</sub> emissions allowances as commodities under various Code sections. Moreover, the "no-inference" language

suggests that the IRS may address in future guidance whether the definition of commodities under Sec. 954 (and other sections of the Code) includes CO<sub>2</sub> emissions allowances.

### Facts

The letter ruling involved a U.S. corporation that indirectly owned a controlled foreign corporation (CFC) and a membership interest in a controlled foreign partnership (CFP), each of which had manufacturing operations within European Union (EU) member states. Both the CFC and the CFP were granted allowances under the EU's Emissions Trading Scheme (ETS), the cap-and-trade system implemented by EU member states to regulate CO<sub>2</sub> emissions and other greenhouse gases within certain industries.

The EU ETS required the CFC and CFP to surrender their allocated allowances on a yearly basis in amounts equal to their CO<sub>2</sub> emissions. If the businesses had excess allowances in a given year, they could sell the surpluses to another person; however, if they exceeded their allowances, the EU imposed a fine. During the years at issue, both the CFC and the CFP had surplus allowances that they sold to unrelated parties.

### IRS Analysis

The IRS focused on the taxpayer's alternative argument that CO<sub>2</sub> emissions allowances are property that does not give rise to income within the meaning of Sec. 954(c)(1)(B)(iii), concluding that gain from the sale of surplus allowances could be excluded from FPHCI as Sec. 936(h)(3)(B) intangible property used in the CFC's active trade or business (see Regs. Sec. 1.954-2(e)(3)(iv)). The Service noted that possession of the CO<sub>2</sub> allowances was necessary for the taxpayers to operate in their industry. Thus, because the CO<sub>2</sub> emissions allowances permitted the CFC and the CFP to engage without penalty in business activity that otherwise would be unlawful and the values of the allowances are independent of the performance of any services by any individual, the allocation of CO<sub>2</sub> allowances represented the grant of intangible property rights.

## Significance of “No-Inference” Language

The importance of the no-inference language in the letter ruling is apparent in light of the ordering rule applicable to the categories of FPHCI (see Regs. Secs. 1.954-2(a)(1) and (2)). That rule determines into which category of FPHCI an item of income, gain, or loss falls when it is described in more than one category. Regs. Sec. 1.954-2(a)(2)(ii) specifies that gain or loss from a commodities transaction has a higher priority than gain or loss from certain property transactions, including property that does not give rise to income. Thus, gain that could be considered both gain from a commodities transaction and gain from property that does not give rise to income must be categorized as gain from a commodities transaction (i.e., the higher priority category of FPHCI).

Except for the no-inference language, the letter ruling might have been interpreted to mean that the IRS had analyzed the FPHCI priority rule and concluded that the CO<sub>2</sub> emissions allowances did not fall within the higher priority commodities category of FPHCI. By incorporating the no-inference language in the letter ruling, the Service has indicated that it is considering whether CO<sub>2</sub> emissions allowances may be considered commodities for purposes of Sec. 954 and other Code provisions.

### Relevance to Other Taxpayers

The no-inference language may be significant to many taxpayers because it leaves open the possibility that the IRS will address in future guidance whether the definition of commodities under Sec. 954 and other Code sections includes CO<sub>2</sub> emissions allowances. Depending on such guidance, for example, U.S. shareholders that own CFCs engaged in commodities hedging transactions might be able to exclude gains or losses from the sale of CO<sub>2</sub> emissions allowances under the Sec. 954(c)(1)(C) exception for active business gains or losses from the sale of commodities in hedging transactions.

Commodities dealers that trade emissions allowances might also be able to exclude such activities from subpart F

income under the dealer exception in Sec. 954(c)(2)(C) if CO<sub>2</sub> emissions allowances constitute commodities. In addition, dealers might benefit from treating CO<sub>2</sub> allowances as commodities to the extent they elect under Sec. 475(f) to mark to market their commodities positions so that they could treat all their commodities positions consistently. Nonresident taxpayers engaged in commodity trading activities in U.S. markets might also be able to qualify their trading activities in CO<sub>2</sub> emissions allowances for the commodities trading safe harbor under Sec. 864(b)(2)(B) so that their trading activities do not constitute a U.S. trade or business.

Without the no-inference language, the letter ruling could be interpreted as embodying the Service’s conclusion that CO<sub>2</sub> emissions allowances are not commodities under Sec. 954(c). By indicating in the letter ruling that it had not addressed the question of whether CO<sub>2</sub> emissions allowances constitute commodities under Sec. 954(c) or any other provision of the Code, the IRS has held open consideration of the issue for future guidance, which could benefit many taxpayers and promote the development of trading markets in emissions allowances.

From Lauren M. Janosy, J.D., LL.M., Washington, DC, and Alexandra K. Helou, J.D., Washington, DC

### Revised Form 1120-F: Practical Issues and Missed Opportunities

In early 2007, the IRS published a substantially revised Form 1120-F, U.S. Income Tax Return of a Foreign Corporation, to be used for tax years beginning in 2007. The revisions were intended to provide for increased disclosure of information regarding items such as allocable interest expense and home office expense allocations, as well as effectively and non-effectively connected income reported on Form 1120-F.

At that time, the IRS indicated that these changes—along with the new Schedule M-3, Net Income (Loss) Reconciliation for Foreign Corporations with Reportable Assets of \$10 Million or More—would enable the IRS to identify

high-risk returns requiring compliance action. To this end, the IRS issued the following new Form 1120-F schedules:

- Schedule H, Deductions Allocated to Effectively Connected Income Under Regulations Section 1.861-8;
- Schedule I, Interest Expense Allocation Under Regulations Section 1.882-5; and
- Schedule P, List of Foreign Partner Interests in Partnerships.

Based on taxpayer queries during the 2008 compliance season, significant confusion in completing the new form and schedules ironically arose among taxpayers with the least complex U.S. tax situations. Some of the issues and concerns expressed by those taxpayers about the revised form and schedules are briefly discussed below.

### Foreign Corporations Filing Certain Protective Returns

Prior to the revision of Form 1120-F, some foreign corporations filing protective returns under the procedures prescribed by Regs. Sec. 1.882-4(a)(3)(vi) did not answer the questions on page 1 of the form because they typically did not view these questions as relevant to a protective return. The instructions for the 2007 Form 1120-F now require taxpayers to answer page 1 questions, such as whether they had a U.S. agent or whether they were engaged in the conduct of a U.S. trade or business. In some cases the requirement has resulted in a fairly significant additional compliance burden, particularly when the questions did not seem relevant to many protective return filers.

A frequent complaint came from foreign corporations that felt strongly they had no permanent establishment (PE) in the United States under the provisions of a relevant income tax treaty and that properly disclosed that position on an attached Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b). Eligibility for an exemption under treaty permanent establishment provisions generally precludes the need to determine whether a foreign corporation is engaged in a U.S. trade or business under the rules of Sec. 864(b). Similar confusion arose about other page 1 questions, causing some foreign

corporations to ask whether the requirement to answer these questions could cause them to undertake otherwise unnecessary research.

## Complexity of Schedules H, I, and P

Many foreign corporations questioned the complexities associated with completing Schedules H, I, and P, especially if all the corporation's income and assets were effectively connected with a U.S. trade or business, either as a result of the direct conduct of a U.S. trade or business or the indirect conduct, through an investment in a partnership, of a U.S. trade or business. Although these schedules accurately reflect the rules in Regs. Secs. 1.861-8 and 1.882-5, the full complexities of those rules apparently had not been fully appreciated by many foreign corporations, especially those with seemingly simple tax situations. Even the use of phrases such as "home office" on those forms was confusing for some of these taxpayers, which did not recognize the general application of language normally applicable primarily to the banking industry. This confusion may be more indicative of the complexity of these regulations, which generally do not permit the use of simplified methodologies.

With respect to Schedule P, many foreign investors found themselves unable to complete much of the required information because partnerships do not normally provide the information on or attached to a Schedule K-1. Where foreign investors hold noncontrolling interests in partnerships, from a practical perspective it is often difficult to obtain the information requested by Schedule P. Even in those cases in which a U.S. partnership may wish to provide information to foreign investors, the partnership's computer systems and tax expertise may be inadequate for the task.

## Missed Opportunities

Although the IRS expended significant efforts in revising the Form 1120-F, it did not clarify some items that many foreign taxpayers have found unclear or confusing. For example, beginning with reporting for 2007, the instructions to Form

1042-S, Foreign Person's U.S. Source Income Subject to Withholding, were modified to indicate that a Form 1042-S is issued in the name and under the employer identification number (EIN) of a foreign disregarded entity (FDE) eligible to claim treaty benefits when the FDE is the beneficial owner of payments subject to reporting on Form 1042-S. However, so far there has been no coordination of 1042-S reporting for these FDEs with reporting on Form 1120-F where such reporting may be required.

In other words, is such an FDE eligible to file its own Form 1120-F even though it is not a corporation or a taxpayer for U.S. federal income tax purposes, or is the sole corporate owner of the FDE required to file the Form 1120-F when filing is required for overwithholding or underwithholding of tax on Forms 1042-S? If the latter, how does the IRS intend to match or reconcile the payments reported by a withholding agent under the FDE's EIN when there is as yet no place on the 1120-F to reflect an FDE's EIN?

Another area of confusion for many taxpayers has been the definition of U.S. net equity for branch profits tax purposes. Although this definition has been unchanged since it was introduced by the Tax Reform Act of 1986 and is described in the instructions to Form 1120-F, many foreign taxpayers continue to believe that U.S. net equity is based on book or financial statement equity rather than on a computed tax-based amount. This belief may be a function of the higher importance accorded to financial statement figures under the tax laws of many foreign countries. The expansion of the branch profits tax section of the Form 1120-F to clarify the required method of computing U.S. net equity would do much to dispel this incorrect belief.

From Susan J. Conklin, CPA, Washington, DC

## U.S. Tax Effects of a Foreign Jurisdiction Audit

A tax audit in a foreign jurisdiction may affect the amount of foreign tax credit that a taxpayer claimed on a U.S. return for a prior year. To obtain the benefit of

an increased foreign tax credit, the U.S. taxpayer's claim for credit or refund must be timely.

Generally, if the foreign audit results in higher foreign tax liability, U.S. taxpayers have a special 10-year statute of limitation for filing a claim for an increased foreign tax credit that starts with the year for which the additional foreign taxes were paid or accrued. This 10-year period starts on the due date of the tax return (excluding extensions) for the year for which the foreign tax was paid or accrued (Sec. 6511(d)(3)(A)). By contrast, if the foreign tax audit results in lower foreign tax liability, the IRS has an indefinite period of time to assess the additional U.S. tax liability created by the loss of foreign tax credit (see Secs. 6501(c)(5) and 905(c)(1) and Temp. Regs. Sec. 1.905-4T(b)).

When a foreign jurisdiction notifies a foreign affiliate of a U.S. corporation about a tax examination in that jurisdiction, the U.S. taxpayer should file a protective U.S. claim for credit or refund for the year or years that may be affected.

*Example:* Q, a calendar-year corporation, is under examination in a foreign jurisdiction for tax years 1997 and 1998. The foreign jurisdiction ultimately assesses an additional liability equivalent to \$2 million of tax for the 1997 year and authorizes a refund of \$1 million of tax for the 1998 year. The special 10-year statute for filing a claim for the 1997 year expired on March 15, 2008. Q is therefore time barred from obtaining a refund for the additional foreign taxes that otherwise would have been creditable. The IRS, however, may assess additional U.S. tax for the 1998 year at any time.

To avoid such an outcome, the taxpayer should have invoked U.S. competent authority as soon as the foreign jurisdiction notified the foreign affiliate that it was under examination.

## Tax Planning

While the IRS may appear to have the advantage, taxpayers may invoke a countervailing strategy if a tax treaty is

in place that allows the taxpayer to use the assistance of the U.S. competent authority as soon as the taxpayer learns a foreign affiliate is under examination. In fact, Treasury regulations require the taxpayer to inform the U.S. competent authority of the examination (see Regs. Sec. 1.901-2(e)(5)). The U.S. competent authority may allow a claim for credit or refund to be filed even if the regular 10-year statute under Sec. 6511(d)(3)(A) has closed.

Taxpayers should carefully follow the procedure set forth in Rev. Proc. 2006-54 for invoking U.S. competent authority. Protective claims for refund should be filed within the 10-year statute because taxpayers should not assume that the U.S. competent authority will always allow an untimely claim to be treated as timely. The taxpayer should file protective claims not only for the years the taxpayer knows are under examination in the foreign jurisdiction but also for all carryback and carryforward years to which additional foreign tax credits might be carried under U.S. tax rules.

Finally, taxpayers should be prepared to sign a Form 872, Consent to Extend the Time to Assess Tax, if requested by U.S. competent authority. Form 872 gives the IRS the right to raise offset to a claim that the taxpayer files for a year covered by the consent, but a taxpayer that refuses to sign the form may find that the U.S. competent authority is unwilling to accept a claim that otherwise is not timely.

From Bradley C. Thompson, CPA, MA, and Kevin M. Curran, J.D., LL.M., Washington, DC

## GAINS & LOSSES

### Effect of Debt Recharacterization on Worthless Securities Deductions

The Sec. 165(g) worthless securities deduction has attracted increased attention in light of the current bleak economic conditions. The IRS recently addressed concerns that the recharacterization of intercompany debt as common equity might prevent a worthless securities deduction (Field Attorney Advice (FAA)

20040301F; Chief Counsel Advice (CCA) 200706011).

This guidance concluded that debt treated as equity for tax purposes will be recharacterized as preferred, rather than common, equity. Consequently, equity owners who are also creditors may still access their common equity basis even if they continue to loan money as a lender of last resort, thereby subjecting their debt to potential recharacterization.

### Background

FAA 20040301F provided that recharacterized debt is treated as preferred equity, so a worthless securities deduction could be claimed on common equity. The taxpayer owned two controlled foreign corporations (CFCs) and began lending foreign currencies to them. When the CFCs failed to make timely payment, the loans were rolled into new loans issued by the taxpayer. An independent valuation determined that the CFCs' equity had no positive value. The taxpayer made check-the-box (CTB) elections to treat the CFCs as disregarded entities, triggering worthless securities and bad debt losses under Rev. Ruls. 70-489 and 2003-125.

Following a debt-equity analysis of the intercompany loans, an audit team reviewing the transaction determined that a significant portion of the loans should be reclassified as equity. As a result of the reclassification, the CFCs were solvent at the time of the deemed liquidation.

Where equity owners, owning at least 80% of the vote and value, receive property in exchange for all their interests in complete liquidation, Sec. 332 governs. *H. K. Porter Co.*, 87 T.C. 689 (1986), held that a liquidating corporation is deemed to distribute its property in the following order: (1) to creditors, (2) to preferred equity holders, and (3) to common equity holders. Therefore, if common equity holders receive no property in exchange for their interests upon liquidation, Sec. 332 will not apply. In FAA 20040301F, the IRS concluded that the terms of the notes should be respected for tax purposes. Because the notes provided for a preference to the companies' earnings in the form of interest payments, they were recharacterized as preferred equity.

In CCA 200706011, the Service determined that a foreign subsidiary had negative liquidation and going concern value due in part to debt guaranteed by the common parent of its consolidated group. The IRS concluded that because the debt had all the formal indicia of indebtedness and because the taxpayer made interest payments on the obligation, the debt, if recharacterized as equity, should be treated as preferred equity.

The following example illustrates the differences in the tax results between treating debt as debt, preferred equity, or common equity when converting a corporation to a disregarded entity.

**Example:** *P* owns all the equity interests of *S*, which have a basis of \$5 million. Both *P* and *S* are eligible entities within the meaning of Regs. Sec. 301.7701-3(a), and neither files consolidated returns. *S*'s balance sheet lists \$3 million of basis and fair market value in assets and \$4 million in liabilities from a revolving credit agreement with *P* that provides for a market interest rate. *S*'s gross receipts have all derived from its manufacturing operations. *P* makes a CTB election to classify *S* as a disregarded entity.

**Debt treated as debt:** Upon *S*'s conversion, *S* is deemed to transfer its \$3 million in assets in partial satisfaction of the \$4 million owed to *P*. *S* recognizes gain or loss on the disposition of its assets under Sec. 1001. *S* also will recognize ordinary cancellation of debt (COD) income of \$1 million under Sec. 61(a)(12). *S*, insolvent by \$1 million, may exclude the \$1 million COD income under Sec. 108(a) by reducing attributes under Sec. 108(b). Assuming the debt is excluded from Sec. 1271(a), *P* will receive an ordinary bad debt deduction of \$1 million under Sec. 166(a). *P* then is entitled to an ordinary worthless securities deduction of \$5 million under Sec. 165(g)(3).

**Debt recharacterized as preferred equity:** As discussed above, the terms of the recharacterized debt should be respected. The preference to the earnings in the form of interest payments, as well as its legally enforceable liquidation rights,

should ensure that as equity it would be treated as a preferred class of equity. Upon *S*'s conversion, *S* is deemed to transfer its \$3 million in assets to its preferred interest holder, *P*. *S* will recognize gain or loss under Sec. 336(a). *P* recognizes a capital loss of \$1 million on its preferred equity under Sec. 331(a), assuming the C reorganization requirements would not be satisfied. *P* will be entitled to an ordinary worthless securities deduction of \$5 million on its common equity, under Sec. 165(g)(3).

**Debt recharacterized as common equity:** Upon *S*'s conversion, *S* is deemed to transfer its \$3 million in assets to its common unit holder, *P*. *S* and *P* recognize no gain or loss under Secs. 332(a) and 337(a). *P*'s \$5 million basis in its original common equity and its \$4 million basis in its recharacterized common equity will simply disappear. *P* will have a carryover basis in the assets of \$3 million under Sec. 334(b).

## Observations

In the above example, the recharacterization of debt as common equity eliminates all losses otherwise resulting from the debt and equity; therefore, such a recharacterization should be avoided by ensuring that the debt provides for real and enforceable legal entitlements over the common equity. Debt recharacterized as preferred equity may result in a capital loss as opposed to an ordinary loss; by creating a second class of equity, however, this disadvantage may be greatly outweighed by the benefits of salvaging an otherwise lost worthless securities deduction. Treated as debt, the intercompany loans produce an ordinary bad debt deduction, assuming the debt is excluded from Sec. 1271(a), while maximizing the benefit of the basis through a worthless securities deduction, and produce the best results in the above example.

It is important to note that the relative values of the worthless securities and bad debt deductions and the likelihood of reclassification may create the need to reevaluate a CTB election. In order to predict the susceptibility of debt-to-equity reclassification, a debt equity analysis should be performed.

## Debt Equity Analysis

In determining the true substance of an intercompany advance, the legal rights and obligations of the parties should be considered. One threshold question, addressed in *Scriptomatic, Inc.*, 555 F.2d 364 (3d Cir. 1977), in determining if an equity holder is a lender of last resort is whether "an outside investor [would] have advanced funds on terms similar to those agreed by the shareholder." A thorough debt equity discussion is beyond the scope of this item. For further discussion of this topic, see Plumb, "The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal," 26 *Tax Law Rev.* 369, 526 (1971); Sec. 385; and Notice 94-47.

## Conclusion

While the reclassification of debt from its intended category may cause concern, FAA 20040301F and CCA 200706011 may help allay the concerns of equity-owning creditors seeking deductions for the growing number of worthless securities that the current turbulent economy has produced.

From Benjamin Willis, J.D., LL.M.,  
Washington, DC

## GROSS INCOME

### Should a Company Elect to Defer Cancellation of Debt?

The American Recovery and Reinvestment Act of 2009, P.L. 111-5, provides certain business debtors with a cancellation of debt (COD) income deferral election under new Sec. 108(i) for reacquisitions by the debtor or by certain related parties of applicable debt instruments after December 31, 2008, and before January 1, 2011. Electing debtors recognize deferred COD ratably over the five-tax-year period beginning in 2014. The debtor must also defer original issue discount (OID) deductions related to the COD deferral in certain actual and deemed debt modifications and exchanges, including using the proceeds of a new issuance to pay off an existing debt.

An electing debtor forgoes the potential benefits of the insolvency and bankruptcy exceptions under Sec. 108(a)(1)

for the deferred COD but also avoids the detriment of tax attribute reduction under Sec. 108(b). Companies realizing COD should analyze the costs and benefits of COD deferral.

## Overview of COD and Attribute Reduction

Generally, when a company purchases its own debt for less than the adjusted issue price (AIP) of the debt, it realizes COD under Sec. 61(a)(12) equal to the difference between the acquisition price and the AIP of the debt. For example, if a company purchases its own debt for \$30 million when the debt has an AIP of \$100 million, the company realizes \$70 million of COD. In addition, if a party related to the debtor (as defined in Sec. 108(e)(4)) acquires the debt, the debtor is deemed to have acquired the instrument (with potential COD) and reissued the instrument with an issue price equal to the amount the related party paid for the instrument.

Solvent debtors and debtors outside bankruptcy generally must recognize realized COD unless the debtor makes a deferral election or another relief provision applies. However, under Sec. 108(a), a bankrupt or insolvent debtor generally does not recognize COD income but is subject to a required reduction of tax attributes. Unless a debtor elects to first reduce the tax basis of depreciable property, the debtor first reduces net operating losses (NOLs) (after absorption against current-year income) and then reduces various other tax attributes. Of note, Sec. 382—limited NOLs are available in full for attribute reduction. Complex additional rules apply for partnerships and consolidated groups (see, e.g., Sec. 108(d)(6) and Regs. Sec. 1.1502-28, respectively).

In bankruptcy, Sec. 108 permanently excludes recognition of COD (even COD in excess of tax attribute reduction). However, Sec. 108(a)(2)(B) limits an insolvent company's COD exclusion to the extent of the company's insolvency.

Sec. 1017(b)(2) limits the reduction in the tax basis of property in an insolvency or bankruptcy case to the post-discharge excess of the aggregate tax basis of property less liabilities of the taxpayer. Only property held by the taxpayer at

the beginning of the tax year following discharge suffers basis reduction. Various planning opportunities, such as disposing of certain debtor property in the year of COD realization (via sales to creditors or third parties), may be available to debtors to utilize NOLs or avoid basis reduction.

**Example 1:** In 2009, Company Z, a calendar-year C corporation, is in bankruptcy and realizes \$100 million of COD upon repurchase of its debts for cash. Also in 2009, Z generates \$50 million of income (excluding COD) and has an NOL carryforward of \$60 million (limited only by Sec. 172). Z's tax basis in its assets immediately after discharge is \$60 million, and it has \$55 million of post-discharge liabilities. COD deferral is not elected. At the beginning of 2010, Z holds property with a tax basis of \$50 million.

Applying the tax attribute reduction provisions of Sec. 108(b), Z first reduces its remaining NOL (\$60 million – \$50 million) by \$10 million to \$0, and in the beginning of 2010 it reduces the tax basis of its property by \$5 million (see Secs. 1017(b)(2) and (a)(2)). The entire \$100 million of COD escapes recognition at the cost of \$15 million in tax attribute reduction.

### COD Deferral Election

A company makes the new irrevocable COD deferral election on an instrument-by-instrument basis and recognizes deferred COD ratably over the five-tax-year period beginning in 2014. The election can be applied to any COD realized on the reacquisition (as defined in Sec. 108(i)(4)) of an applicable debt instrument after December 31, 2008, and before January 1, 2011.

For example, if a solvent calendar-year C corporation that is not in bankruptcy purchases its debt for \$75 million in 2009 when the debt has an AIP of \$100 million, the corporation realizes \$25 million of COD. The corporation may elect to defer recognition of the \$25 million of COD and to recognize COD ratably (\$5 million per year) over the tax years 2014–2018 inclusive.

Certain events, such as the liquidation or sale of all the taxpayer's assets (including a sale in bankruptcy), terminate deferral. Additional rules apply to partnerships (see Sec. 108(i)(5)(D)).

### Debt for Debt

Under Sec. 108(e)(10), if a company retires a debt obligation with a new debt obligation or a company significantly modifies a debt instrument (see Regs. Sec. 1.1001-3), the company recognizes COD income equal to the difference between the AIP of the old debt and the issue price of the new debt. If either old or new debt qualifies as publicly traded, as defined in Regs. Sec. 1.1273-2(f), the issue price of the new debt is its fair market value. Otherwise, the issue price of the new debt generally is its face—i.e., the principal amount of the note provided that the note includes adequate stated interest (see Sec. 1274).

**Example 2:** Y, a calendar-year C corporation, realizes \$70 million of COD upon exchange of its publicly traded debt with an AIP of \$100 million and a value of \$30 million for its new debt with a face of \$100 million.

If Y elects to defer COD, it will recognize deferred COD into income ratably over the tax years 2014–2018 inclusive but must also defer the portion of the \$70 million of OID deductions accrued while the corresponding COD is deferred. Unfortunately, no OID income deferral is available for the creditor. A related relief provision suspends the applicable high-yield discount obligation interest deferral and disallowance rules (see Sec. 163(e)(5)) for certain debt exchanges between September 1, 2008, and December 31, 2009.

### Should a Company Elect COD Deferral?

A company in insolvency or bankruptcy or with NOL carryforwards (expiring or potentially limited) should weigh the costs and benefits of COD deferral versus current recognition or exclusion. For instance, it would not be beneficial for Z, in Example 1, to make the COD

deferral election because the bankruptcy exception provides Z with \$100 million of COD exclusion while the COD deferral election would only defer such income. Further, an insolvent or bankrupt corporation, with NOLs severely limited by Sec. 382, may forgo COD deferral to apply tax attribute reduction to otherwise unusable NOLs.

In addition, a partnership makes the COD deferral election at the partnership level, while the bankruptcy and insolvency exceptions are tested at the partner level. Partners with differing tax attributes or solvency status may disagree as to whether a partnership should make the election.

Various planning opportunities exist for debtor businesses realizing COD. A company should analyze the benefits and costs of COD deferral as part of its overall COD planning.

From Gabriel Cohen, CPA, Los Angeles, CA

## PROCEDURE & ADMINISTRATION

### Protecting Refunds of Certain Overpaid Deficiency Interest

Disputes regarding interest issues are not uncommon. Taxpayers frequently file refund claims for overpaid underpayment (deficiency) interest or requests for additional overpayment interest. Such a submission generally results from an analysis of the taxpayer's federal tax accounts and related IRS interest computations that a service provider specializing in interest and other IRS account-related issues performs. Issuance by the Service of a statutory notice of deficiency (90-day letter) to the taxpayer may affect the taxpayer's ability to file a later refund claim for overpaid interest for the same tax period.

A taxpayer may make a request for additional interest on a tax overpayment within six years from the refund date (see ILM 200532001 and Rev. Ruls. 56-506 and 57-242). A claim for overpaid underpayment interest is subject to the limitation period applicable to refund claims in Sec. 6511. Because in many cases the taxpayer and the IRS would have entered into an agreement (Form 872, Consent to

Extend the Time to Assess Tax, or 872-A, Special Consent to Extend the Time to Assess Tax) extending the assessment limitation period prior to issuance of the notice of deficiency, the impact of the deficiency notice on Sec. 6511(c) must be explored.

### Limitation Period

Sec. 6511(c) gives a taxpayer six months from the expiration of an agreement extending the assessment period to file a claim for credit or refund. Under Sec. 6503(a), the issuance of a notice of deficiency suspends the running of the assessment limitation period. Accordingly, it appears that once the suspension ends, the unexpired portion of the limitation period—as extended by the Form 872 or 872-A—resumes, and, once it ends, the six-month period for filing refund claims provided in Sec. 6511(c) begins to run (see FSA 200221004). In addition, purely from a statute of limitation standpoint, payment of a deficiency determined by the Tax Court would trigger a two-year period under Sec. 6511(a) during which the taxpayer could file a refund claim for overpaid underpayment interest, up to the amount of the payment.

However, where for the same tax year(s) a statutory notice of deficiency has been issued and a Tax Court petition filed, a more fundamental consideration than the deadline for filing a refund claim for overpaid underpayment interest is whether such a claim can be filed at all, or if the taxpayer must instead raise the interest issues in the Tax Court, even if such interest is not related to the issues involved in the Tax Court case.

### Tax Court Jurisdiction

Under Sec. 6512(a), if a taxpayer that receives a statutory notice of deficiency files a petition with the Tax Court, the court acquires exclusive jurisdiction to determine the existence of a deficiency or an overpayment in tax for the tax years covered by the statutory notice. Accordingly, no credit or refund of tax (income, gift, estate, and certain excise taxes) for the same tax year will be allowed or made, and no refund suit in any other court may be brought, except for:

- Overpayments determined by a Tax Court decision that has become final;
- Any amount the IRS collects that is in excess of the tax computed in accordance with the Tax Court's final decision;
- Any amount collected after the collection limitation period has expired;
- Overpayments attributable to partnership items that are determined at the partnership level in a separate proceeding, according to the TEFRA (Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248) partnership rules of Secs. 6221–6233;
- Any amount that was collected within the period during which the Service is prohibited from collecting by levy or through a court proceeding under Sec. 6213(a); or
- Any claim for credit or refund of an overpayment that is not contested on appeal and that the IRS is authorized to refund under Sec. 6512(b)(1).

In *Barton*, 97 T.C. 548 (1991) (reviewed by the full court), the Tax Court determined that it had jurisdiction over previously assessed and paid underpayment interest—not related to the determinations set forth in the statutory notice of deficiency—insofar as such interest could be considered in determining whether there was an overpayment for the years before the court. The Tax Court also pointed out that underpayment interest is treated as tax for purposes of Sec. 6512, i.e., that the exception in Sec. 6601(e) to the general rule that interest is treated like tax relates only to the definition of a deficiency and not to Sec. 6512.

Therefore, although it does not appear that either the IRS or the Department of Justice has ever raised the issue, if the term “interest” is read into Sec. 6512(a), that Code section arguably could preclude a taxpayer that has received a statutory notice of deficiency and has filed a petition with the Tax Court from later filing a separate claim or suit for a refund of overpaid underpayment interest that is not related to the Tax Court case.

### Observations

If a refund opportunity based on overpaid deficiency interest is identified while

a Tax Court case is pending, the taxpayer may want to discuss with its counsel whether the Tax Court petition can or should be amended to raise the interest issues. Simply deferring the interest issues until after the Tax Court decision has become final would appear to entail some risk. Sec. 6512 would not, however, preclude a claim or suit for additional overpayment interest because that would not involve a refund or credit of monies previously paid to the IRS by the taxpayer.

If a dispute arises over the Service's computation of interest due on a tax deficiency determined by the Tax Court, under Sec. 7481(c) the taxpayer may, within one year from the date the Tax Court decision becomes final, move to reopen the case for the sole purpose of having the court determine whether:

- The taxpayer has made an overpayment of interest (i.e., paid the IRS too much deficiency interest); or
- The IRS has made an underpayment of interest (i.e., failed to pay the taxpayer enough overpayment interest).

Because Sec. 7481(c)(1) speaks in terms of “a redetermination (by the Tax Court) of the amount of interest involved,” a motion filed under that section might be limited to interest directly related to the deficiency or overpayment determined by the court, thereby precluding a motion involving previous instances in the same tax year(s) where the taxpayer may have paid too much underpayment interest or received too little overpayment interest.

From Michael A. Urban, J.D., M.L.T., Washington, DC

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### EditorNotes

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