

# TaxClinic

## PRACTICAL ADVICE ON CURRENT ISSUES

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#### CORPORATIONS & SHAREHOLDERS

### Transaction Analysis: Sponsored Spin

Arguably one of the most restrictive and limiting rules imposed on a corporation by the federal income tax system is the corporate-level tax on the sale of business assets or subsidiaries that hold business assets. This inability to sell business assets without a corporate-level tax severely impedes a corporation from monetizing appreciated assets and reinvesting the sale proceeds to expand its retained businesses. Not surprisingly, with limitation comes the inevitable challenge to find a solution. Unfortunately, in this case businesses and their tax advisers often find themselves with an empty toolbox and are unable to overcome the challenge. Nonetheless, the search for tax-efficient exit structures often leads to creative planning and use of the current tax rules to produce economic results otherwise reserved for a tax-free sale of assets.

Sec. 355 allows a corporation (Distributing) to distribute to its shareholders or its security holders the stock or securities of one or more corporations that it controls (Controlled) without triggering income or gain to itself or its shareholders. Following the repeal of the *General Utilities* doctrine (see *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935)), Sec. 355 remains the only reliable way to distribute appreciated assets from a corporation to its noncorporate shareholders without paying a corporate-level tax on the distributed assets.

## Sponsored Spin

It should be no surprise that Sec. 355 is a useful tool for mitigating the corporate-level tax on the disposition of business assets. However, in order for a transaction to be governed by Sec. 355, a long list of requirements must be met, some of which specifically target a sale of either Distributing or Controlled (e.g., the device prohibition, continuity of interest, continuity of business enterprise, Sec. 355(d), and Sec. 355(e)). The latter two requirements are generally the most restrictive and require careful planning to produce tax-free results. One transaction that can successfully navigate all the requirements of Sec. 355, yet economically results in a tax-free monetization of appreciated business assets, is known as the “sponsored spin.”

Sec. 355(d) causes a spin-off to be taxable at the corporate level if the distribution of a controlled corporation is to any person holding “disqualified stock” constituting a 50% or greater interest (by vote or value) of either Distributing or Controlled. Generally, disqualified stock is any stock of the distributing or controlled corporation acquired by purchase within the five-year period ending on the date of the distribution. Under Sec. 355(e), a spin-off is taxable at the corporate level if it is “part of a plan or a series of related transactions” involving an acquisition of 50% or more of the stock of either Distributing or Controlled. Accordingly, a sponsored spin transaction generally limits the acquisition of either Distributing or Controlled to less than a 50% interest.

The best way to illustrate the mechanics and benefits of a sponsored spin is by walking through a very basic example.

**Example:** Corporation X is a publicly held corporation engaged in two separate lines of businesses. The first business, A, is X’s primary business and accounts for two-thirds of its revenue, cashflow, and fair market value (FMV). Business B accounts for the remaining one-third of X’s revenue, cashflow, and FMV. X conducts each business through a separate LLC subsidiary treated as a disregarded entity for U.S. income tax purposes (collectively, the LLCs). A has an FMV of \$800 and B has an FMV of

\$400. X has a zero basis in its A and B assets. X has \$400 of outstanding third-party debt and has no assets other than its interests in the LLCs.

Despite the smaller size of B relative to A, X’s management devotes the majority of its time to running B and believes that the lack of resources devoted to A is severely limiting A’s growth. Further, a disposition of B would result in cash proceeds available either to satisfy a portion of X’s outstanding debt or to fund the growth and expansion of A. Clearly, the most straightforward method to dispose of B is a cash sale of either the B assets or the LLC interest that holds the assets. However, both of these sales would result in a significant tax bill to X.

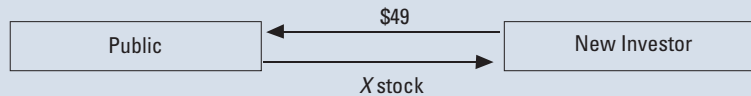
First, consider the economics and taxation of a straight sale of B to a third party. If X sells B for its FMV, X will recognize a \$400 gain on the sale (\$400 FMV less \$0 basis). Assuming that a combined federal and state tax rate of

40% is applied to this gain, X will pay \$160 of tax on the sale and realize after-tax cash proceeds of \$240. Following the sale, X will have an FMV of \$640 (assuming that X uses the cash proceeds either to pay down existing debt or to invest in capital assets).

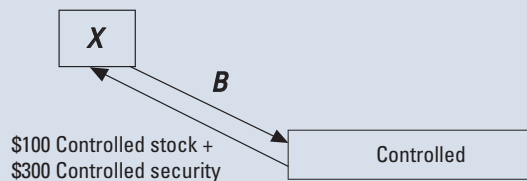
Next, contrast the alternative transaction, which uses Sec. 355 to provide a greater economic benefit to X and its shareholders. (See Exhibit 1.) First, a third-party investor (New Investor) purchases \$49 of X stock on the open market. (New Investor is the “sponsor” in the sponsored spin.) Next, X forms a new controlled corporation (Controlled) and contributes B in exchange for Controlled stock and a \$300 debt instrument from Controlled that qualifies as a security for U.S. tax purposes. As part of a reorganization plan, X then distributes the Controlled security to its third-party debt holders in exchange for a portion of X’s outstanding debt, and it distributes the Controlled stock to its shareholders in a transaction intended to

### Exhibit 1: Steps in sponsored spin transaction

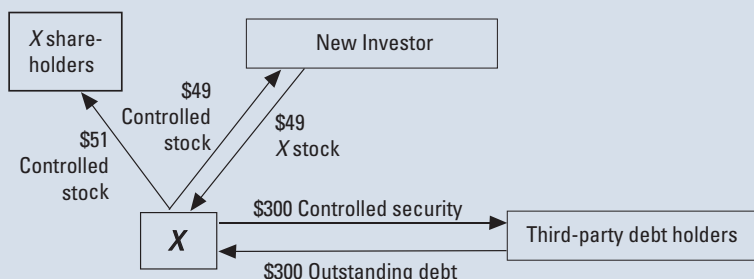
Step 1: New Investor purchases X stock on the open market



Step 2: X forms Controlled



Step 3: Spin-off



**Exhibit 2: Straight sale vs. sponsored spin**

	Straight sale of Business B (\$)	Sponsored spin of Business B (\$)
Value to X		
Cash sales proceeds	400	—
Debt repayment	—	300
Tax due (40%)	(160)	—
<b>Net value to X</b>	<b>240</b>	<b>300</b>
Value to X's shareholders	—	51
<b>Total value</b>	<b>240</b>	<b>351</b>

meet all the requirements of Sec. 355. In the stock distribution, X will transfer a portion of the Controlled stock (having an FMV of \$49) to New Investor in redemption of the X stock held by New Investor, and it will distribute the remainder of Controlled stock pro rata to its public shareholders.

The result of this sponsored spin is that X receives \$300 of value from Controlled free from tax because Controlled has effectively assumed \$300 of X's third-party debt. In addition, X's public shareholders receive \$51 of value in the form of Controlled stock. Following the transaction, X will have an FMV of \$700, and Controlled will have an FMV of \$100. Exhibit 2 compares each alternative.

Practitioners should note that the rules applicable to sponsored spin transactions are very specific and require careful planning and that there are numerous variations on the sponsored spin transaction described above (see, e.g., Letter Ruling 200708016, which involves a "sponsored reverse spin"). As with all transactions, the precise form of transaction the taxpayer uses must be determined based on all the facts and circumstances as well as the taxpayer's short- and long-term goals.

### Sec. 355 and IRS Private Letter Rulings

As a result of the complexities of Sec. 355, the often-ambiguous application of the statutory and nonstatutory requirements for tax-free treatment, and the

potential tax cost involved in running afoul of these requirements, taxpayers often wish to confirm the tax treatment of a Sec. 355 distribution before its execution. The highest level of confirmation comes in the form of a private letter ruling from the IRS and provides the taxpayer with assurance that the Service will uphold any ruled-upon positions taken on its tax return. In addition, an IRS ruling can reduce the chance that the Service will challenge or analyze aspects of a transaction in future audits. Generally, a taxpayer may file a request for a ruling before executing a transaction or, for a completed transaction, any time before filing its tax return for the year of the transaction. A taxpayer may also submit a request after the return is filed, provided that the relevant IRS field office waives jurisdiction over the transaction (see generally Rev. Proc. 2008-1).

From Stephen P. Musante, CPA, New York, NY, and Stephen R. Wegener, J.D., Washington, DC

### Update on Determinations of Target Stock Basis in B Reorgs.

In Notice 2009-4, the IRS has proposed to amplify the methods available to an acquiring corporation (Acquiring) to estimate basis in the stock of a target corporation (Target) received in tax-free reorganizations under Sec. 368(a)(1)(B) (a B reorganization), as well as to expand the use of such methods to certain other tax-free transactions. Those methods currently are set forth in Rev. Proc. 81-70.

In the interim period, the notice provides safe harbors upon which taxpayers may currently rely.

### Background

In a typical B reorganization, all the stock of Target is acquired from the Target shareholders solely in exchange for shares of Acquiring's voting stock (or for the voting stock of a corporation that controls Acquiring). Under Sec. 362(b), Acquiring's basis in the acquired Target stock is equal to the former Target shareholders' bases in such stock. While a determination of former Target shareholder basis would seem readily available where Target was closely held, this is not the case where the Target stock was publicly traded and widely held. In those instances, to avoid a zero basis in the acquired Target stock, Acquiring must inquire of the former Target shareholders regarding their bases in the Target shares. In order to provide taxpayers with some relief from this burdensome process, as well as in recognition of the reality of nonresponsive former Target shareholders, the IRS issued Rev. Proc. 81-70, which permits taxpayers to rely on certain statistical methodologies under which aggregate Target stock basis is extrapolated from a sampling of the former Target shareholders.

Since the issuance of Rev. Proc. 81-70, however, the trend in the public markets has shifted sharply toward the holding of stock in "street name"—i.e., by brokers who hold the stock as nominee on behalf of their clients, who are the true economic owners of such stock. In light of this market development, the IRS issued Notice 2004-44, in which it identified potential concerns with the impact of subsequent market developments on the application of Rev. Proc. 81-70. The IRS requested comments regarding how it might modify or amplify Rev. Proc. 81-70 to accommodate this market trend. Based upon the comments received, the IRS determined that Rev. Proc. 81-70 must be expanded to address issues raised by nominee stock holdings.

### Notice 2009-4

Notice 2009-4 reaffirms the general approaches of Rev. Proc. 81-70 but indicates that future guidance will expand

the revenue procedure to adjust for current market realities (this future guidance is referred to in the notice as Expanded Rev. Proc. 81-70). The notice states that surveying the surrendering Target shareholders and using sampling and estimation techniques is a proper method for Acquiring to determine its basis in Target stock following a B reorganization but that a modeling methodology may be appropriate in the case of stock held in street name. Thus, the notice envisions that Expanded Rev. Proc. 81-70 will preserve certain provisions of Rev. Proc. 81-70 without material modification but will include certain safe-harbor provisions.

In the interim, Notice 2009-4 sets forth three separate safe harbors, each of which is described in more detail below. These safe harbors are tailored specifically to different types of shareholders (i.e., one for reporting shareholders, one for registered but nonreporting shareholders, and one for shares held in street name). Subject to certain conditions, including actual knowledge of the former Target shareholders' bases, taxpayers may currently rely on these safe harbors until additional guidance is issued.

### **Safe Harbor 1: Reporting Shareholders**

Under Safe Harbor 1, Acquiring's basis in Target stock surrendered by "reporting shareholders" must be determined under the survey guidelines prescribed in Rev. Proc. 81-70. Thus, Acquiring's basis in shares acquired from the surveyed shareholders is the basis reported by such shareholders. If Acquiring does not receive a response from a surveyed shareholder, Acquiring may use estimation techniques to determine the basis of Target shares surrendered by the nonresponding shareholder. If Acquiring does not survey a reporting shareholder, estimation may not be used, and the basis of the shares acquired from that shareholder is deemed to be zero.

For purposes of Expanded Rev. Proc. 81-70, a reporting shareholder is any surrendering Target shareholder that was a "significant transferor," a "significant holder," an officer or director of Target,

or a plan that acquired Target stock for or on behalf of Target employees, such as an employee stock option or pension plan, immediately before the date of the transaction. The term "significant transferor" has the same meaning as in Regs. Sec. 1.351-3, and the term "significant holder" has the same meaning as in Regs. Sec. 1.368-3 (i.e., in both cases, a person owning 5% of the voting power or value of a publicly traded Target or 1% of the voting power or value of a nonpublic Target). To identify reporting shareholders, Target's books and records, the master security holder files maintained by the stock transfer agent, and SEC filings, including Schedule 13 series data, may be used.

### **Safe Harbor 2: Registered Nonreporting Shareholders**

Under Safe Harbor 2, Acquiring's basis in Target stock surrendered by registered, nonreporting shareholders must be determined by the certificate method, which requires that Acquiring examine Target's books and records to determine the date each stock certificate was issued. Using both public and private stock exchange trading data, Acquiring must then determine the average trading price of the Target shares on the date each certificate was issued. Subject to adjustments for extraordinary issuances and events, Acquiring may treat the basis of each such share as equal to the average trading price on its issuance date.

For purposes of Expanded Rev. Proc. 81-70, a registered, nonreporting shareholder is a shareholder that held Target stock in certificated form but that is not a reporting or nominee shareholder.

### **Safe Harbor 3: Nominees for Nonreporting Shareholders**

Under Safe Harbor 3, Acquiring's basis in Target stock surrendered by nominees on behalf of nonreporting shareholders must be determined under a four-step basis modeling method:

- First, Acquiring must establish measuring dates for purposes of the model. Generally, the dates selected should be representative of Target stock trading activity, including dates surround-

ing periods of significant volatility in share price or trading activity of Target stock.

- Second, Acquiring must determine each nominee's starting basis in Target stock using the guidelines set forth in the notice.
- Third, Acquiring must compare nominee holdings between measuring dates. Any increase or decrease in the holdings of a previously identified nominee is treated as a purchase or sale of that number of shares on each subsequent measuring date. Deemed purchases are treated as made at the volume-weighted average of the trading prices for the period between the measuring dates. Deemed sales are treated as being made on the first-in, first-out (FIFO) method; the last-in, first-out (LIFO) method; or the average cost (ACO) method. Acquiring must identify and adopt the single method that best predicts estimated basis across all investors, which will generally be the lowest of the LIFO, FIFO, and ACO basis.
- Finally, Acquiring's basis in Target shares acquired from nominees on behalf of nonreporting shareholders is deemed to be the basis allocated to such shares under the safe-harbor model, determined as of the date of the transferred basis transaction.

### **Safe-Harbor Reliance Conditioned upon Timely and Diligent Completion**

In order to rely on any of the safe harbors, the notice requires that Acquiring timely and diligently complete a basis determination. A timely determination generally is one that is completed within two years after the date of the transaction or the date that Expanded Rev. Proc. 81-70 becomes effective, whichever is later. In order to complete the basis determination diligently,

- Acquiring must make every reasonable effort to obtain best evidence; or
- To the extent it was unable to obtain such evidence, Acquiring must demonstrate that it could not have reasonably obtained the evidence or basis information.

In addition, Acquirer must make every reasonable effort to identify surrendered Target shares having low bases (relative to Target's average historical trading price) and surrendered shares with bases lower than the bases of shares bought and sold under normal market conditions. The notice also provides taxpayers with a two-year extension of time for reporting Target stock basis under Regs. Secs. 1.351-3 and 1.368-3, provided that they include a statement in the relevant tax returns that a basis study with respect to acquired Target stock is pending.

### New Guidance Expanded to Certain Other Transferred Basis Transactions

Finally, the notice expands the scope of transactions currently covered by Rev. Proc. 81-70, recognizing that the difficulties in establishing basis in Target stock may be present in certain transferred basis transactions other than B reorganizations. Such transactions may include Sec. 351 exchanges, certain reverse triangular mergers, and certain triangular reorganizations involving foreign corporations. Thus, any further guidance in this area may apply not only to B reorganizations but also to all transferred basis transactions in which Target stock is so acquired.

For the interim period, the IRS continues to invite comments on whether it should adopt the approaches described in the notice and to what extent, if any, it should combine or modify the approaches to produce a set of administrable rules.

From Blagovest L. Petkov, CPA, Matthew E. Gareau, CPA, and Mark A. Schneider, J.D., Washington, DC

## DEPRECIATION

### Sec. 168(k)(4) Credit in Lieu of Bonus Depreciation

Last year's efforts to stimulate the economy included the reenactment of 50% "bonus depreciation" under Sec. 168(k), generally for property placed in service during 2008. It did not take long, however, for companies representing a range of industries to lobby Congress for an alternative tax incentive because

these cash-strapped businesses could not currently use the net operating losses (NOLs) generated by additional depreciation deductions.

In response, as part of the Housing and Economic Recovery Act of 2008, P.L. 110-289 (signed by the president on July 30, 2008), Congress enacted a special tax benefit under Sec. 168(k)(4) that allows corporations to claim a refundable tax credit in lieu of 50% bonus depreciation for certain capital investments made during the period April 1–December 31, 2008 (or during 2009 for certain long-lived and transportation property). As explained below, the method for calculating the new refundable credit under Sec. 168(k)(4) is complicated, and the procedural rules for electing the credit vary for taxpayers in different situations.

In essence, Sec. 168(k)(4) permits corporations in a loss position to capture the intended economic benefits of bonus depreciation by converting into cash a portion of their carryforward research credits and/or alternative minimum tax (AMT) credits. The "price" of electing this new refundable credit, however, is that the corporation must use straight-line depreciation for property that otherwise would be eligible for bonus and modified accelerated cost recovery system (MACRS) depreciation. Taxpayers and practitioners should also keep in mind that election of the refundable credit by one member of a controlled group could have significant tax consequences for other members of the same controlled group.

The new credit is provided indirectly through an increase in the credit utilization limitations described in Sec. 38(c) (relating to the general business credit) and Sec. 53(c) (relating to the AMT credit), with such increases treated as refundable overpayments of tax. (See Sec. 168(k)(4)(F) and Rev. Proc. 2008-65, §2.04.) The credit amount computed under Sec. 168(k)(4) is the lowest of the following three amounts:

- The bonus depreciation amount, meaning 20% of the additional depreciation that the taxpayer would have been entitled to claim for the tax year as a result of applying Sec. 168(k)(1)

to eligible qualified property placed in service between April 1 and December 31, 2008 (or in 2009 for certain property);

- 6% of the taxpayer's accumulated research credit carryforward amounts and AMT credits generated from tax years beginning before 2006; or
- \$30 million.

### Computation of the Credit

The credit amount is a function of several factors—that is, the credit is computed by reference to both the bonus depreciation amount for certain property placed in service by the taxpayer after March 31, 2008, and the taxpayer's aggregate carryforward research and AMT credit amounts from tax years beginning before 2006. In addition, in no event may the Sec. 168(k)(4) credit amount exceed \$30 million. Consequently, to reach this \$30 million cap, a taxpayer is required to place in service eligible qualified property for which Sec. 168(k)(1) otherwise would yield additional first-year depreciation totaling \$150 million (20% of \$150 million = \$30 million). The taxpayer must also have aggregate carryforward research and/or AMT credits totaling \$500 million from tax years beginning before 2006 (6% of \$500 million = \$30 million).

The following example further illustrates the operation of this statutory formula. Suppose that during May 2008, a calendar-year taxpayer placed in service eligible qualified property costing \$10 million with a five-year depreciable life (and the taxpayer made no additional investment in eligible qualified property). First-year depreciation generally allowed by applying Sec. 168(k)(1) to such property would equal \$6 million (i.e., \$5 million of bonus depreciation plus \$1 million of MACRS depreciation on the remaining basis, using the 200% declining balance method). In contrast, MACRS depreciation allowed for such property for the first year (without regard to Sec. 168(k)(1) bonus depreciation) would equal \$2 million (again using the 200% declining balance method). Under this fact pattern, the bonus depreciation amount for purposes of Sec. 168(k)(4)

would equal \$800,000 [20% × (\$6 million – \$2 million)]. The rationale underlying this calculation is that it is roughly equivalent to the net economic benefit provided by the reenactment of Sec. 168(k)(1) to a profitable company making the same investment, which could result in additional first-year depreciation of \$4 million and thus \$800,000 of tax savings if the company were subject to the AMT.

The \$30 million cap for taxpayers electing the new refundable credit obviously serves to limit the overall revenue loss to Treasury, as does the rule in Sec. 168(k)(4)(C) that the credit amount cannot exceed 6% of the taxpayer's aggregate research and AMT carryforward credits from tax years beginning before 2006. This limitation based on carryforward research and AMT credits may have served the additional purpose of enabling legislative sponsors to characterize the new refundable credit as a partial acceleration or monetization of deferred tax assets already earned by the electing corporations, rather than as some new form of corporate relief.

To assist taxpayers with their Sec. 168(k)(4) computations, the IRS recently added to its website "Worksheet for Calculating the Refundable Minimum Tax Credit and Research Credit Amounts" ([www.irs.gov/pub/irs-utl/amtresearchworksheet.pdf](http://www.irs.gov/pub/irs-utl/amtresearchworksheet.pdf)).

### Eligible Qualified Property

A comprehensive discussion of the rules for determining whether property is eligible qualified property for purposes of Sec. 168(k)(4) is beyond the scope of this item. Eligible qualified property generally has the same meaning as "qualified property" for bonus depreciation purposes (see Secs. 168(k)(2) and 168(k)(4)(D)), except that the modified placed-in-service period generally covers April 1–December 31, 2008 (or through December 31, 2009, for certain long-lived and transportation property). Section 3 of Rev. Proc. 2008-65 contains a detailed discussion of several placed-in-service issues, and §4.04 explains the option available to taxpayers to make elections under both Secs. 168(k)(2)(D)(iii)

and 168(k)(4) so that the refundable credit (and thus straight-line depreciation) applies to some classes of eligible qualified property, yet the taxpayer is allowed to claim MACRS (but not 50% bonus) depreciation for other classes of eligible qualified property.

### Procedural Rules

The IRS recently issued Rev. Proc. 2009-16, which provides detailed guidance regarding the time and manner for making the Sec. 168(k)(4) election. As a general rule, the election must be made on a corporation's original return (Form 1120, U.S. Corporation Income Tax Return) for its first tax year ending after March 31, 2008, regardless of whether any eligible qualified property is placed in service by the taxpayer during that year or the taxpayer wishes to apply the election to property placed in service during the following tax year. (See Rev. Proc. 2009-16, §§3.01 and 3.04, for general filing instructions.)

Fiscal-year taxpayers whose first tax year ending after March 31, 2008, ended before December 31, 2008, should not make a Sec. 168(k)(4) election on their original return but should file an amended return (Form 1120X, Amended U.S. Corporation Income Tax Return) for such year. A special rule applies, however, if the taxpayer did not place in service any eligible qualified property during the election year. (See Rev. Proc. 2009-16, §§3.02 and 3.03, for the deadline for making elections on an amended return and other special rules.)

Although 9100 relief may be available in some situations (see Rev. Proc. 2009-16, §3.06), the IRS warned in §3.01 of Rev. Proc. 2009-16 that a taxpayer's attempted Sec. 168(k)(4) election will be nullified if the taxpayer fails to comply with any of the reporting requirements to the IRS or other notification requirements that apply when an electing corporation is a member of a controlled group or is a partner in a partnership.

Once a valid election is made, the Service allows taxpayers considerable flexibility when allocating the bonus depreciation amount between their research credit carryforward amounts (which

eventually could expire) and their AMT credits (which can be carried forward indefinitely). See Rev. Proc. 2009-16, §4.01, and the example in Rev. Proc. 2008-65, §6.

### Controlled Groups

Additional complexity results from Sec. 168(k)(4)(C)(iv), which requires that all corporate members of a controlled group (generally determined by using a more-than-50% ownership test) be treated as one taxpayer, such that an election to relinquish bonus depreciation made by one member of a controlled group is treated as binding on the other members. This rule applies even if the controlled group members do not file a single consolidated return. Accordingly, Rev. Proc. 2009-16, §3.05, provides rules for identifying the members of a controlled group (some of which could join or depart the controlled group as time passes) and also requires that a member of a controlled group notify all other members when the Sec. 168(k)(4) election has been made.

Moreover, §4.02 of Rev. Proc. 2009-16 provides detailed rules for computing and allocating the bonus depreciation amount when a controlled group consists of members that file separate (nonconsolidated) returns. Each member must be allocated its proportionate share of the group's bonus depreciation amount, unless all members of the group agree to an alternative allocation formula. Several examples in §4.04 illustrate the adjustments required when members of a controlled group have different tax years, or when one member places in service the eligible qualified property within the scope of Sec. 168(k)(4) while a different member of the group has the unused research or AMT credits. The revenue procedure also clarifies that a taxpayer's Sec. 168(k)(4) election does not allow it to use research or AMT credit carryforwards that otherwise are limited by Sec. 383 (Rev. Proc. 2009-16, §2.09).

### Passthrough Entities

Only corporations are allowed to make the Sec. 168(k)(4) election, but Rev. Proc. 2009-16 clarifies the application of that section when an electing corporation

is a partner in a partnership. In such cases, the electing corporate partner is required to notify the partnership that the partner is making the Sec. 168(k)(4) election, and the partnership is then required to provide the partner with sufficient information so that its distributive share of depreciation on eligible qualified property placed in service by the partnership can be computed on a straight-line basis (see Sec. 168(k)(4)(G)(ii) and Rev. Proc. 2009-16, §5). As previously clarified by the IRS, however, straight-line depreciation must be used to determine the corporate partner's distributive share of depreciation attributable to eligible qualified property placed in service by the partnership, even though property placed in service by the partnership itself cannot be taken into account to compute the corporate partner's maximum Sec. 168(k)(4) credit (see Rev. Proc. 2008-65, §5.02(2)).

With respect to passthrough entities, §6 of Rev. Proc. 2009-16 explains the rare situation in which an S corporation can obtain a benefit under Sec. 168(k)(4) because it is subject to tax on certain recognized built-in gains and is also allowed a credit for research or AMT credit carryforwards that arose in a prior period when the entity was a C corporation. Rev. Proc. 2009-16, §7, elaborates on the application of a special "rifle-shot" provision (Housing and Economic Recovery Act §3081) enacted by Congress along with Sec. 168(k)(4) to provide similar cash benefits to a U.S. partnership that produces automobiles.

### Future Legislation

Finally, practitioners should keep an eye out not only for future IRS guidance but also for possible congressional action during 2009 related to Sec. 168(k)(4). Members of the new Congress have already expressed an interest in extending 50% bonus depreciation for another year or two (as one component of a massive economic stimulus package), and it can be expected that the same companies that lobbied in favor of the refundable credit option in lieu of bonus depreciation will again return to Capitol Hill.

From Steven Arkin, J.D., Washington, DC

### Sec. 409A Proposed Regs. Address Income Inclusion

On December 5, 2008, Treasury and the IRS issued proposed regulations addressing the calculation of amounts includible in income and additional taxes imposed under Sec. 409A(a) (REG-148326-05). The regulations are proposed to be generally applicable for tax years beginning on or after the issuance of the final regulations. Taxpayers may rely on these proposed regulations only to the extent provided in Notice 2008-115. That notice indicates that, until Treasury and the IRS issue further guidance, compliance with the provisions of the proposed regulations with respect to the calculation of the amount includible in income under Sec. 409A(a) and the calculation of the additional taxes under Sec. 409A will be treated as compliance with the requirements of the notice.

These proposed regulations do not address the calculation of income inclusion for violations of requirements of Sec. 409A(b), the rules relating to funding. Treasury and the IRS anticipate issuing interim guidance for tax years beginning after January 1, 2007, to address the calculation of income inclusion under Sec. 409A(b) and the application of federal income tax withholding requirements to such amounts.

### Year-by-Year Approach

Sec. 409A generally provides that amounts deferred under a nonqualified deferred compensation plan are includible in income unless certain requirements are satisfied. The proposed regulations interpret this rule to provide that failures to comply with Sec. 409A(a) apply to amounts deferred under a plan in the year in which the failure occurs and all previous tax years, to the extent such amounts are not subject to a substantial risk of forfeiture and have not previously been included in income.

As a result, each tax year is analyzed independently as to whether there is a failure. Amounts associated with a failure are required to be included in income for that year, with applicable tax paid.

A failure in one year does not, however, continue to taint amounts deferred under the plan in a subsequent year in which there is no failure. A further consequence is that amounts are includible in income in the year of failure. The proposed regulations do not provide taxpayers with a mechanism for current inclusion of income related to a failure from a prior year.

### Determination of Amount Deferred

Under the proposed regulations, the amount of income includible for failure to satisfy Sec. 409A(a) is based upon the total amount deferred under the plan for the service provider's tax year and all preceding tax years, less the portion of the total amount deferred for the tax year that either is unvested or has been previously included in income. In calculating these amounts, the plan aggregation rules apply.

*Calculating total amount deferred as of the last day of the tax year:* The total amount deferred is determined as of the last day of the service provider's tax year and is equal to the present value of future payments to which the service provider has a legally binding right under the plan as of that date. In addition, any payments of deferred amounts to, or on behalf of, the service provider during that tax year are added back to the total amount deferred. Notional earnings or losses and additional amounts deferred during the year are simply netted against one another in determining the value as of the last day of the tax year.

Because the determination is as of the last day of the year, the timing of actions during the year does not make a difference under the proposed regulations. For example, it is not relevant whether a distribution is made prior to the occurrence of the operational failure; because it occurred during the tax year of the failure, it is added into the total amount deferred as of the end of the year. Similarly, it is not relevant that an amount was deferred under the plan after the occurrence of an operational failure; it is also taken into account as part of the total amount deferred as of the end of the year.

**Calculating total amount deferred—general principles:** Generally, the total amount deferred is the present value as of the last day of the tax year, determined using reasonable actuarial assumptions and methods. If the assumption or method used is not reasonable, as determined by the Service, the total amount deferred is determined using the applicable federal rate (based on annual compounding for the last month of the tax year for which the income inclusion amount is being determined) and, if applicable, the appropriate Sec. 417(e) mortality table.

The regulations also provide general rules for determining the present value of payments for the following:

- Payment triggers based on events;
- Alternative times and forms of payment;
- Formula amounts; and
- Payment restrictions.

**Calculating total amount deferred—specific rules:** The regulations also provide rules for determining the amount deferred under specific arrangements. The general rules described above apply in conjunction with the following rules for specific arrangements:

- Account balance plans;
- Nonaccount balance plans;
- Stock rights;
- Separation pay arrangements;
- Reimbursement and in-kind benefit arrangements;
- Split-dollar life insurance arrangements;
- Foreign arrangements; and
- Other plans.

**Calculating unvested amounts and amounts previously included in income:**

The unvested portion of the total amount deferred for a tax year is determined as of the last day of the tax year, and such amounts are not taken into account in the calculation of the total amount deferred. Amounts that vest during the year in which the failure occurred are treated as vested for purposes of Sec. 409A(a), regardless of whether vesting occurs before or after the failure, and thus are taken into account in the calculation.

In addition, amounts that have previously been included in income are excluded from the total amount deferred.

Consistent with the overall approach of analyzing each year independently, the proposed regulations provide that amounts are considered previously included in income only if the service provider included the amount in income under an applicable provision of the Code for a previous tax year, including on an original or amended return, as a result of IRS examination or a final decision of a court of competent jurisdiction. The amount previously included in income is reduced to reflect any payments made during the tax year because these amounts also reduce the total amount deferred after the year of distribution. Other adjustments are also provided.

For failures that occur in multiple years, each year is analyzed independently to determine if amounts were includible in income. As a result, amounts must be included in income for each year in which a failure occurs. A failure that occurs in multiple years is not corrected if amounts are included in income only for the last year in which the failure occurred.

### **Determination of Additional 20% and Premium Interest Taxes**

The amount includible in income is the difference between the total amount deferred less the sum of the unvested amounts and amounts previously included in income. In addition, this amount is subject to the additional 20% and premium interest taxes. The additional 20% and premium interest taxes are additional income taxes, subject to the rules governing assessment, collection, and payment of income tax. They are not excise taxes, and the premium interest tax is not interest.

The proposed regulations provide guidance on how to calculate the premium interest tax. That tax is applied to the amounts required to be included in income under Sec. 409A(a) for the tax year that were not first subject to a substantial risk of forfeiture in a previous year. The premium interest tax is determined as the amount of interest at the underpayment rate (established under Sec. 6621) plus 1% on the underpayment

that would have occurred had the deferred compensation been includible in gross income for the tax year in which the amounts were first deferred or vested. The proposed regulations provide step-by-step calculations to determine premium interest, which tends to reduce the amount subject to the premium interest tax.

Treasury and the IRS have indicated they understand that the premium interest tax calculation provided in the regulations may be cumbersome. As a result, they are considering safe-harbor calculation methods for that tax.

### **Treatment of Payments and Forfeitures After Amounts Are Included in Income**

The proposed regulations state that if a service provider includes an amount in income under Sec. 409A, the service provider will have a deemed basis in that amount, so the amount is not later subject to tax. As a result, if an amount under a plan would be includible in income under a Code section other than Sec. 409A, the amount previously included in income would be immediately applied to the amount paid under the plan. The service provider cannot elect the extent to which amounts previously included in income will be applied. Earnings on amounts included in income and previously included amounts may continue to be subject to Sec. 409A. The Sec. 409A plan aggregation rules apply.

In addition, if a service provider has included deferred amounts in income under Sec. 409A but actually receives less than the amount included in income, the service provider may take a deduction equal to the amount included in income, less amounts allocated to previously included amounts. This deduction is a miscellaneous itemized deduction subject to the 2% floor and is not deductible for AMT. For these purposes, a deferred amount is treated as permanently lost if the service provider's right to payment becomes wholly worthless during the tax year. A mere diminution in the deferred amount due to deemed investment loss, actuarial reduction, or other decreases in the deferred amount is not treated

as a permanent forfeiture or loss if the service provider retains the right to the amount deferred under the plan. The plan aggregation rules apply. If a service provider is entitled to a deduction, to the extent the service recipient has benefited from a deduction or the inclusion in the service provider's income, the service recipient may be required to recognize income under the tax benefit rule and Sec. 111 or make other appropriate adjustments.

### Reporting and Wage Withholding Under Sec. 409A

On December 10, 2008, the Service released Notice 2008-115, interim guidance concerning the reporting and wage withholding requirements for nonqualified deferred compensation under Sec. 409A. The notice is effective for calendar year 2008 and will remain in effect for subsequent calendar years until Treasury and the IRS issue further guidance.

### Employer Reporting and Withholding Provisions

For employers, code Y reporting in box 12 of Form W-2 is not required for 2008 or any future year until further notice. Likewise, a payor is not required to report deferred amounts in box 15a of Form 1099-MISC.

In general, the amount includible in gross income under Sec. 409A(a) and required to be reported by the employer on Form W-2 in box 1 and in box 12 using code Z, or by the payor on Form 1099-MISC in boxes 7 and 15b, equals the portion of the total amount deferred under the plan that, as of December 31 of the applicable calendar year, is not subject to a substantial risk of forfeiture and has not been included in income in a previous year, plus any amounts of deferred compensation paid or made available to the service provider under the plan during the applicable calendar year.

The notice provides specific guidance for account balance plans, reasonable ascertainable amounts under nonaccount balance plans, and stock rights. For other deferred amounts, a reasonable, good-faith method must be applied in a reasonable, good-faith manner.

An employer that complies with this notice will not be liable for additional income tax withholding or penalties or be required to file a subsequent corrected information return or furnish a corrected payee statement as a result of future published guidance on the calculation of amounts includible in gross income under Sec. 409A.

### Service Provider Requirements for Amounts Includible in Gross Income

The same standards apply to a service provider as apply to an employer when calculating the amount required to be reported as income under Sec. 409A, except that an amount is treated as previously included in income only if the amount has been included in the service provider's income in a previous tax year (regardless of whether reported on a Form W-2 or Form 1099-MISC).

Whether a service provider has complied with the notice's requirements is determined independently of whether the employer has complied with the notice's requirements. Thus, the IRS may assert additional income taxes and penalties under Secs. 6651, 6654, and 6662 if it is determined that the amount of taxes reported and paid for calendar year 2008 was underreported or underpaid.

### IRS Provides Limited Relief for Certain Sec. 409A Operational Failures

On December 3, 2007, the IRS issued Notice 2007-100, providing relief for certain Sec. 409A operational failures and requesting comments on correction under Sec. 409A. On December 5, 2008, Notice 2008-113 was issued, updating and, for periods beginning on or after January 1, 2009, replacing Notice 2007-100.

Notice 2008-113 addresses the eligibility and types of failures for which correction may be made, during either the same, subsequent, or second tax year after the year in which the failure occurred. The relief is in addition to any other action that would otherwise be permissible under generally applicable tax principles and any adjustments or

corrections that may be available under Sec. 409A transition relief, which for the most part expired on December 31, 2008.

### Basic Requirements for Notice 2008-113 Reliance

Notice 2008-113 applies only to inadvertent and unintentional failures in the operation of a plan that otherwise complies with Sec. 409A. In addition, the service recipient must take commercially reasonable steps to avoid recurrence of the failure. In particular, if the same or a substantially similar failure has happened before, relief is available for tax years beginning after December 31, 2009, only if the service recipient can demonstrate that it had taken steps to ensure that the failure would not recur and that the failure occurred despite such efforts.

In addition, in order to correct a failure in a year after the year in which the failure occurred, the service provider must not be under examination with respect to the plan. Certain corrections are not available during years in which the service recipient experiences a substantial financial downturn or there is other indication of a significant risk that the service recipient would not be able to pay the amount deferred when due.

In some cases, the ability to correct depends on whether the service provider is an "insider," which is defined as a director, officer, or 10% owner of a corporation, or analogous persons for non-corporate service recipients.

Notice 2008-113 generally requires service recipients who rely on it to attach a statement to their tax return explaining their reliance and to provide information to affected service providers (other than for correcting discounted options and stock appreciation rights). Service providers are required to attach this information to their federal income tax returns.

The amount of time between failure and correction, the status of the service provider as an insider, and the amount involved will determine:

- The extent to which correction is available;

- Whether income inclusion, withholding, and reporting are required (they are generally required only in circumstances where the failure is not corrected before the end of the year in which it occurred); and
- Whether attributable interest, gains, and losses will be required, permitted, or prohibited.

### Available Correction Methods

If all of the foregoing eligibility requirements are met, the following corrections are available for the specified operational failure:

**Early payments and failed deferrals:** Early payments are defined as amounts deferred in a prior year that should be paid in a future year but are mistakenly paid or made available during the current year. Early payments do not include payments that fail to comply with the six-month delay rule for specified employees or current-year amounts that should have been deferred but were paid currently.

For early payments that are identified in the year paid, Notice 2008-113 allows early payments to be repaid by the end of the service provider's tax year for distribution as otherwise provided by the deferred compensation arrangement. This can be done through actual repayment, through the service recipient's retention of other amounts payable, or over a 24-month period, assuming financial need.

In the case of a noninsider, correction may also be made in the year immediately following the year in which the failure occurred.

**Failure to delay distribution of deferred compensation:** A failure to delay a distribution is defined as a payment made more than 30 days prior to the distribution date as otherwise defined under the plan or payment of an amount to a specified employee within six months after separation from service.

The service provider is required to repay the early distribution, subject to an agreement that the service recipient will make the distribution as provided. If repayment is made prior to the date on which payment should have been made, the service provider must wait

additional time after the correct payment date equal to the number of days it held the erroneous payment. If repayment is made subsequent to the date on which payment should have been made, the service provider must wait additional time after the original payment date equal to the number of days it held the erroneous payment plus the original waiting period under the plan or applicable guidance.

If a failure to delay relates to a payment to a noninsider, it may be corrected by repaying the entire amount by the end of the year immediately following the year in which the failure occurred. After the repayment, the service provider must have a legally binding right to receive such amount on a date after the date of the repayment equal to the amount of days between the date the erroneous payment was made and the date it should have been made.

**Excess deferrals:** Excess deferrals are deferrals in excess of the amount provided for under the plan or election. The excess amount deferred must be distributed by the end of the service provider's current tax year, with an adjustment made to the amount to which the service provider has a legally binding right at the end of the year (e.g., a reduction in the account balance).

Excess deferrals by a noninsider are also permitted to be corrected through a distribution of the excess deferral by the end of the year immediately following the year in which the failure occurred. There must be a related adjustment to the amount to which the service provider has a legally binding right at the end of the year (e.g., a reduction in the account balance).

**Discounted stock options and stock appreciation rights:** A stock option or stock appreciation right (stock right) that constitutes nonqualified deferred compensation solely because the exercise price was erroneously set at an amount less than the fair market value of the underlying stock on the date of grant is a discounted stock right eligible for correction.

During the year of grant, the exercise price may be reset to an amount not less than the fair market value on the date of

grant prior to the date of exercise or the last day of the service provider's tax year in which the grant was made. Correction can be made to outstanding stock rights even if other rights in the same grant were already exercised and are therefore ineligible for correction. Notice 2008-113 provides no correction method for discounted options after exercise.

For grants made to noninsiders, the exercise price of a discounted stock right may also be reset prior to the earlier of the exercise date or the end of the service provider's year immediately following the year in which the stock right was granted.

### Relief for Failures Involving Limited Amounts

In addition to the correction methods discussed above, Notice 2008-113 provides relief from the taxes that would be incurred for failures involving limited amounts. This relief is available only to the extent that all steps are taken by the end of the second tax year after the service provider's tax year in which the failure occurred, but it is available only for early payment, failed deferrals, failure to delay distributions, and excess deferrals.

### Relief for Certain Other Operational Failures

Notice 2008-113 provides further relief in some circumstances in which correction is made by the end of the second tax year after the tax year in which the failure occurs by limiting the extent to which the premium interest tax is applicable. This relief is restricted to correction of early payments and failed deferrals, failure to delay distributions, and excess deferrals.

### Special Transition Relief for Noninsiders

In general, operational failures that occurred prior to December 31, 2007, if otherwise eligible for correction under the methodologies discussed above for correction in the year after the year in which the failure occurred (other than discounted stock rights), are eligible for correction notwithstanding the fact that

the time limit for correction has passed. For this purpose, the service provider's tax year ending in 2009 is deemed to be the year following the year in which the failure occurred.

### **A Modification to the IRS's No-Rule Policy on Sec. 409A Issues**

In January 2007, the IRS issued its annual revenue procedure on rulings and determinations, indicating that it would not rule on the tax consequences of arrangements described in Sec. 409A. This blanket no-rule policy was modified by Rev. Proc. 2008-61, which indicates that the IRS will continue not to consider the tax consequences of the establishment, operation, or participation in a plan described in Sec. 409A, but will rule on other very specific tax law provisions, such as estate and gift taxes and FICA. *From Deborah Walker, CPA, and Mark Neilio, J.D., Washington, DC*

## **GAINS & LOSSES**

### **The Importance of Proper and Timely Hedge Identification**

Many Fortune 1000 companies, as well as many private enterprises, engage in hedging activities to manage the risk of price, currency, or interest rate fluctuations. Many companies enter into interest rate swaps to hedge the interest rate risk on debt they have issued. With the current economic turmoil in the financial services industry, companies may be holding an instrument where the counterparty has sought bankruptcy protection or changed ownership, triggering or permitting the early termination of a hedge. Further, many taxpayers issued floating-rate debt and entered into an interest rate swap to effectively convert the floating-rate debt into fixed-rate debt. With the recent drop in interest rates, taxpayers may choose to terminate these swaps to prevent further losses.

In general, failure to properly identify a hedge for tax purposes may expose a taxpayer to ordinary treatment of gains and capital treatment of losses (i.e., character whipsaw). An early termination, where termination payments could

result in significant and unexpected capital loss, typically increases the magnitude of this general exposure. In an environment in which early terminations may have unexpectedly been triggered, taxpayers that have not properly identified their hedges for tax purposes should evaluate remediation strategies as soon as possible. The timing effects of hedging transactions, even with improper identification procedures, should also be considered.

### **Treatment of Hedging Transactions**

Sec. 1221(a)(7) and Regs. Sec. 1.1221-2 present the character rules for tax hedges. These rules provide ordinary treatment for any income, deduction, gain, or loss from a qualified hedging transaction provided the hedge is timely and properly identified. If a hedge is not properly identified as a qualified tax hedge, under an anti-abuse rule (Regs. Sec. 1.1221-2(g)(2)(iii)), the IRS can treat any gains from the unidentified hedge as ordinary. The character of the loss is what it would have been under general tax principles. Therefore, to the extent the losses on an unidentified hedge are treated as capital under general tax principles, the taxpayer could have capital loss and ordinary gains, potentially resulting in a character whipsaw. Consequently, failure to identify a hedge for tax purposes may change the character of the gain or loss when the hedge is terminated early.

Proper tax identification requires the taxpayer to identify:

- The transaction as a hedge on the day the hedge is acquired, originated, or entered into; and
- The item or risk being hedged within 35 days after entering into the hedging transaction (Regs. Sec. 1.1221-2(f)).

The regulations provide detailed rules for identification of the hedge and the hedged item. In addition, the taxpayer must also describe the method of tax accounting chosen to properly match the timing of income, deduction, gain, or loss from the hedge with the timing of income, deduction, gain, or loss from the item being hedged.

**Caution:** Identification for financial accounting purposes alone is not sufficient for tax purposes.

Taxpayers must also comply with the timing rules for hedges under Regs. Sec. 1.446-4. Generally income, deduction, gain, or loss from the hedge must match the timing of the income, deduction, gain, or loss from the item being hedged. Thus, early termination of the hedge when the debt is still in place may result in spreading the gain or loss over a longer period rather than recognizing the entire gain or loss in the year of termination (Rev. Rul. 2002-71).

### **Early Termination of Hedges**

In the case of an early termination, evaluating the transaction under general tax principles could result in capital loss treatment, which may need to be spread over some period of time. For example, many interest rate swaps that taxpayers do not identify as hedges qualify as notional principal contracts (NPCs) (see Regs. Sec. 1.446-3(c)(1)). Payments under an NPC that are not termination payments are ordinary in character whether or not the swap has been identified as a tax hedge (Prop. Regs. Secs. 1.162-30 and 1.1234A-1; Letter Rulings 9824026 and 9730007). Conversely, gain or loss from the termination of an NPC is capital under Sec. 1234A and Prop. Regs. Sec. 1.1234A-1, provided the NPC is a capital asset in the taxpayer's hands. Thus, if the taxpayer had not terminated the NPC early, it would not have recognized a capital gain or loss.

### **Potential Remediation**

Taxpayers who have failed to make a proper tax identification may obtain relief for character issues under the inadvertent error exception. Relief may apply if:

1. The transaction qualifies as a tax hedge;
2. Failure to identify was caused by inadvertent error; and
3. Gain or loss from all the taxpayer's hedging transactions has been or will be treated as ordinary on its tax returns (including on amended returns if necessary) for all open years.

The remediation of timing issues may involve filing a Form 3115, Application for Change in Accounting Method, to correct improper tax accounting methods for future years.

### Reportable Transactions

The tax shelter regulations require corporations to disclose any loss transaction that generates at least \$10 million in any single tax year or \$20 million in any combination of tax years. (The thresholds are lower for S corporations, partnerships without corporate partners, and individuals.) Rev. Proc. 2004-66 provides an exception from the disclosure rules for loss transactions that are properly identified as hedging transactions (Rev. Proc. 2004-66, §4.03(5)). A hedging transaction that a taxpayer does not identify may trigger the disclosure requirements if it generates large enough losses (and does not otherwise fit within another exception from the loss disclosure rule).

From Jeff Callender, CPA, New York, NY, Jo Lynn Ricks, J.D., LL.M., Washington, DC, and Samantha Chan, J.D., Washington, DC

#### PROCEDURE & ADMINISTRATION

### New Information Reporting Requirements for Payment Card and Third-Party Network Transactions

Convincing taxpayers to notice newly enacted tax legislation that does not affect the current year is difficult. Getting them to address ministerial requirements that will not be effective for two to three years is next to impossible. One piece of legislation passed in mid-2008 that has not received a lot of attention could end up biting some that have placed it at the bottom of their to-do list or, worse, failed to notice it altogether.

A provision in the Housing and Economic Recovery Act of 2008, P.L. 110-289, which was signed by President Bush on July 30, 2008, contains new information return reporting requirements related to the settlement of reportable transactions involving payment card (e.g., credit and debit cards) and

third-party network transactions, including the settlement of any credit or debit card sales and internet transactions through a third-party network (Sec. 6050W).

The provision is part of Congress's latest attempts to close the tax gap. The new reporting requirements are expected to reduce noncompliance related to income underreporting by taxpayers with gross income from payment card and/or third-party network transactions. In practice, settlement of these transactions involves many steps that are performed by different participants. The new requirements target two of them:

- *Payment settlement entity (the payor):* The merchant acquiring entity or acquirer (for payment card transactions) or the third-party settlement organization (for third-party network transactions). A merchant acquiring entity is the bank or other organization that is contractually obligated to make payment in settlement of payment card transactions.
- *Participating payee:* The party that accepts a payment card as payment or establishes an account with a third-party settlement organization in order to settle transactions. In a payment card transaction, the payee may also be referred to as the merchant or seller.

Beginning with calendar year 2011, payment settlement entities for traditional and online merchants will be required to report to a payee, as well as to the IRS, the gross amount of the payee's reportable payment transactions within a calendar year. Failure-to-file penalties will apply. While a substantial majority of the new reporting burdens will fall on financial institutions and other large businesses that provide merchant acquiring bank services or offer online payment settlement, these services are not restricted to these types of companies. Entities that accept payment cards or payment from third-party network providers should also consider the impact of the new requirements. Starting in calendar year 2012, the backup withholding rules will apply to reportable payments when a participating payee fails to provide a taxpayer identification number in the manner prescribed (Sec. 3406(b)(3)(F)).

The statute provides some description of targeted transactions. The payment settlement entity must have a contractual obligation to make payment to the participating payee in order for the statute to apply, notwithstanding the type of transaction involved. The statutory language is also specific regarding what constitutes a payment card agreement or a third-party payment network agreement.

In general, both types of agreements should include standards and mechanisms for settling transactions between the payor and the participating payee. Each type also requires a material number of participants to meet the definition of an arrangement. Payment card agreements must provide for a "network of persons," while third-party payment network agreements are among a "substantial number of persons" (Sec. 6050W(d)). Though it is not defined in the statute, the Joint Committee on Taxation's technical explanation indicates that "substantial" means more than 50 (Joint Committee on Taxation, *Technical Explanation of Division C of H.R. 3221, The "Housing Assistance Tax Act of 2008,"* 61 (JCX-63-08) (July 23, 2008)).

Notwithstanding these similarities, relationships between the parties that appear to exclude certain arrangements from reporting requirements are not treated consistently between the transaction types. For a third-party payment network, the network of payees must be unrelated to the settlement entity, the central organization with which accounts are established (Sec. 6050W(d)(3)(A)). The same restriction does not exist for payment card agreements, but the payees must be unrelated to each other and to the card issuer(s) (Sec. 6050W(d)(2)(B)).

The application of the new rules may be unfavorable for some payees. The statute requires informational reporting of "the gross amount of the reportable payment transactions" for each participating payee (Sec. 6050W(a)(2); emphasis added). Neither the statute nor the technical explanation contemplates an adjusted amount that more properly reflects the taxpayer's (payee's) income. The Bush administration's revenue proposals previously included this type of

revenue offset provision, but they stated that “[reporting] would reflect appropriate adjustments for amounts that represent cash advances made by the merchant via the payment card or other amounts not included in the merchant’s gross income” (Department of the Treasury, *General Explanations of the Administration’s Fiscal Year 2009 Revenue Proposals* 65 (February 2008)).

Though a cash advance was the only example, it is reasonable to suggest that amounts debited from a merchant’s account, such as sales refunds or chargebacks due to improper acceptances, should be excluded from the reportable amount, or at least not subjected to 28% backup withholding (based on enacted rates). A settlement entity may process debits by netting them against the amount otherwise due to the payee. In these instances, the payee may be unable to verify the correctness of the reported amount without additional, and perhaps undue, burden.

It is unclear if all payments may be excluded from the rules if a contractual agreement is lacking. While the presumptive parties to such an agreement would be the payment settlement entity and the participating payee, the statute does not specify. Sec. 6050W(b)(4)(B) provides that in any case in which an electronic payment facilitator or other third party makes payment in settlement of reportable payment transactions on the settlement entity’s behalf, the third party will be required to make the return in lieu of the settlement entity.

One can infer from this language that a contractual obligation exists because, absent such an obligation, there would be no payment settlement entity as defined in the statute. Note here that the contractual obligation may not be between the party required to report and the payee. This would suggest that any contractual obligation to make payment in settlement of a transaction would suffice. However, the technical explanation would limit the scope to exclude mere processors of electronic payments (e.g., wire transfers, electronic checks, and direct deposit payments) where there are no contractual agreements with sellers

(*Technical Explanation of Division C of H.R. 3221*, p. 61). While this may suggest that the existence of a contractual agreement establishes the payor’s reporting obligation, the statute does not explicitly address this scenario.

Sec. 6050W(e) does provide a *de minimis* exception for third-party network transactions. Reporting is required only if the amount otherwise reportable to a participating payee exceeds \$20,000 and the aggregate number of transactions exceeds 200. No threshold exists for payment card transactions. The statutory language subjects a single payment card transaction to informational reporting.

Congress delegated the authority to prescribe regulations or other guidance to the IRS and explicitly included “rules to prevent the reporting of the same transaction more than once” (Sec. 6050W(g)). A single transaction can result in multiple reportable payments by more than one type of payment settlement entity. Similar to the rules for electronic facilitators, Sec. 6050W(b)(4) provides that when aggregated reportable payment transactions are settled through an intermediary, the intermediary shall be treated as the settlement entity with respect to the participating payees. In addition, the intermediary is treated as the participating payee with respect to the original payor. An example would include a franchise network that used an intermediary to process payment card transactions. In this situation, the settlement entity would report payments made to the intermediary, and the intermediary would be required to report the payments to each franchisee.

Taxpayers that may qualify as a payment settlement entity and/or participating payee under Sec. 6050W should take the opportunity to consider the adverse consequences and ambiguities that the IRS should address by future regulations or other guidance. Those businesses that may be subject to duplicate reporting under the current statutory language should be particularly sensitive and offer comments, if able, to ensure that further guidance is relevant and effective.

From D. Joe Gill, CPA, Washington, DC

## Notice 2008-111: Recent Guidance on Intermediary Transactions

On December 2, 2008, the IRS issued Notice 2008-111, which provides guidance on transactions it considers intermediary transaction tax shelters. The Service issued the notice to help clarify which transactions are considered intermediary transactions and who is considered a participant in an intermediary transaction. Notice 2008-111 clarifies Notice 2001-16 and supersedes Notice 2008-20.

### What Is an Intermediary Transaction?

A common intermediary transaction involves a seller (Seller) who wants to sell the stock of a corporation (Target) and a buyer (Buyer) who wants to purchase assets (and not the stock) of Target. Under a plan, Seller sells the Target stock to an intermediary corporation (Midco). Midco then sells some or all of Target’s assets to Buyer. Because of the asset sale, Buyer will have a basis in the assets equal to the fair market value of the assets. Typically, Midco either is an entity not subject to tax or has certain tax attributes that it believes would somehow offset any tax impact of the asset sale.

### Previous IRS Guidance

Initially, the IRS issued Notice 2001-16, which identified these intermediary transactions as tax shelters. The notice stated that any transaction that is the same or substantially similar to the intermediary transaction as described in the notice is considered a listed transaction and would be subject to the necessary reporting requirements. The notice also warns of potential penalties that may result from participating in these transactions or from either promoting or reporting these transactions as a tax return preparer or a representative of an intermediary transaction participant.

Because Notice 2001-16 applies to transactions that are “the same or substantially similar to” an intermediary transaction as described in the notice, many practitioners wanted more guidance on what constitutes an intermediary transaction. Accordingly, the Service

issued Notice 2008-20 on January 17, 2008. The notice identified four objective components of an intermediary transaction. All four components were necessary in order to meet the standard of “the same or substantially similar to” an intermediary transaction. As discussed below, these objective components identified by Notice 2008-20 have been superseded by four modified components in Notice 2008-111.

Notice 2008-20 also created a pair of safe harbors for potential participants in an intermediary transaction. Under Notice 2008-20, if a potential participant meets the requirements of either of these safe harbors, the potential participant would not be considered a party to the intermediary transaction identified in Notice 2001-16. Notice 2008-111 also supersedes and modifies these safe harbors, as described in detail below.

### Notice 2008-111

Under Notice 2008-111, a transaction constitutes an intermediary transaction with respect to a particular person if:

- The transaction occurs under a plan and the person engages in the transaction under that plan;
- The planned transaction meets four objective components indicative of an intermediary transaction; and
- No safe harbors apply to that person.

Under Notice 2008-111, a plan is described as a transaction, in connection with the disposition by Target shareholders of all or a controlling interest in Target’s stock, structured to cause the tax obligation for the taxable disposition of Target’s built-in gain assets to arise under circumstances in which the person or persons primarily liable for any income tax on the disposition will not pay that tax. A person engages in the transaction under a plan if the person knows, or has reason to know, that the transaction is structured to effectuate the plan. If the seller is at least a 5% shareholder of Target or is an officer or director of Target, then the seller will be deemed to have “reason to know” if any of the following situations exist:

1. An officer or director of Target knows (or has reason to know) about the plan

to effectuate the transaction. If there are more than five officers or directors of Target, the term “officer” will be limited to the CEO and the four highest compensated officers;

2. An adviser engaged by Target to advise Target or Seller on the transaction knows (or has reason to know) of the plan to effectuate the transaction; or
3. An adviser engaged by Seller to advise on the transaction knows (or has reason to know) of the plan to effectuate the transaction.

The notice warns that a person can “engage” in the transaction under a plan even if the person does not understand the mechanics of the transaction or the relationships of the parties or of Target after the disposition. A transaction could be an intermediary transaction for the seller and not the buyer, for the buyer and not the seller, or, if there is more than one seller or buyer, for some buyers or sellers and not other buyers or sellers, depending on whether the parties acted under a plan. A transaction can be under a plan regardless of the ordering of the asset sale and stock disposition.

Even if a taxpayer engages in a transaction under a plan, it is an intermediary transaction only if the transaction meets all four objective components set forth by Notice 2008-111:

- Target corporation directly or indirectly owns assets with a built-in gain (fair market value exceeds the tax basis of the assets) and, at the time of the transaction, Target (or the consolidated group of which Target is a member) has insufficient tax benefits to eliminate or offset the gain (or tax) on the sale of the assets in whole. The tax that would have resulted from an asset sale is referred to as Target’s built-in tax. However, for purposes of this component, Target will not be considered to have any built-in tax if the tax is less than 5% of the value of the Target stock disposed of in the transaction.
- Target shareholders dispose of at least 80% (by vote or value) of the Target stock, other than in a liquidation of Target, in one or more related transac-

tions within 12 months of the transaction. The first date on which at least 80% of the target stock has been disposed of by Seller is the “stock disposition date.”

- Either within 12 months before, simultaneously, or within 12 months after the stock disposition date, at least 65% (by value) of Target’s built-in gain assets are disposed of to one or more unrelated buyers in a transaction or transactions in which gain is recognized on the asset sale.
- At least half of Target’s built-in tax that would otherwise result from the disposition of the assets sold is purportedly offset, avoided, or not paid.

If the person engaged in the transaction under a plan and the four components of an intermediary transaction are met, the person will nonetheless not be considered to have a reporting obligation under Notice 2008-111 if the person falls under one of the following safe harbors:

- The person is a seller of Target stock that is traded on an established securities market and, prior to the disposition, the seller did not hold 5% or more by vote or value of any class of Target stock disposed of by the seller;
- The person is a seller, a target, or a midco if, after the acquisition of the target stock, the buyer of the Target stock is the issuer of stock or securities that are publicly traded on an established securities market in the United States or is consolidated for financial purposes with such an issuer; or
- The person is a buyer of Target assets, and the only Target assets it acquires are either securities that are traded on an established market and represent a less-than-5% interest in that class of security or assets that are not considered to be trade or business assets.

### Effective Date for Notice 2008-111

Because this notice is a clarification of intermediary transactions subject to Notice 2001-16, this notice is generally effective January 19, 2001, when Notice 2001-16 was initially effective.

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## Potential Consequences for Failure to Comply with Notice 2008-111

Persons who are required to disclose these transactions and fail to do so may be subject to a penalty up to \$200,000 (Sec. 6707A). A person required to disclose or register these transactions as a material adviser under Sec. 6111 who has failed to do so may be subject to penalties up to \$200,000 or 75% of the income derived from advising on the transaction, if greater (Sec. 6707(b)). In addition, in the case of an SEC registrant corporation, a person must disclose any payment of a penalty with respect to a listed transaction in his or her public filing for that period. A person required to maintain lists of investors as material advisers who fails to provide these lists within 20 days of an IRS request may be subject to penalties up to \$10,000 per day until the list is provided (Sec. 6708).

Other accuracy-related penalties may also be imposed on persons involved in these intermediary transactions or on persons who participate in the promotion or reporting of these transactions (including the return preparer penalty, the promoter penalty, and the aiding and abetting penalty). The potential accuracy-related penalties imposed on persons involved in these transactions can result in an additional 40% added to the amount of tax underpaid and/or an additional 30% on the amount of the understatement of income multiplied by the highest applicable tax rate. The adviser penalties can range anywhere from \$1,000 to up to 100% of the income derived from advising on these transactions. Further, the statute of limitation may be extended beyond the typical three-year period for persons who are required to disclose these transactions and fail to do so.

## Potential State Tax Consequences

Several states (e.g., California, Illinois, and New York) have implemented reporting and disclosure requirements similar to federal rules for certain transactions of interest, as well as list maintenance requirements. Failure to comply with the necessary state requirements may result in additional penalties.

From Susan F. Fiesta, CPA, and E. J. Forlini Jr., J.D., Washington, DC

### EditorNotes

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