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A Look Inside Worker Cooperatives

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Featured Articles

Dmitriy Kustov on Worker Cooperatives and Patronage Dividends

By Dmitriy Kustov*

§ 1.01 Introduction

"You could leave this Plane yourself, if you could but summon up the necessary volition. A slight upward or downward motion would enable you to see all that I can see." -- Flatland: *A Romance of Many Dimensions*, Edwin A. Abbott

Over the past few years I have become familiar with a novel and yet quite ancient entity structure that is being shaped in the foundries of community movements across the nation. It is "novel," because it is not ordinarily taught at the masters of tax programs, and many of its tax rules are sort of placed on the makeshift rafts and let down the stream. And it is "ancient," because its basic precepts were founded by our ancestors more than 50,000 years ago. This entity is the cooperative.

Cooperatives of various types (consumer, housing, marketing, purchasing, etc.) play an important role in American economy, especially in agriculture, by providing efficiency in allocation of monetary resources on behalf of their patrons. The focus of this article is the income tax treatment of worker cooperatives (WC, or worker coops). The purpose of worker coops is to maximize the ultimate payoff on the commitment of the patron-employees' personal efforts. Cooperatives are owned and governed by their members, operated to benefit those members; members participate economically in the enterprise. In a consumer cooperative (perhaps the best known type), the member-owners are the consumers, or patrons; their business with the cooperative is to buy its goods or services. In a worker cooperative, the member-owners are the workers, or employees of the cooperative; their business with the cooperative is to sell it their labor.

A resurgence of interest in worker-owned cooperatives in the United States took place during the Great Depression, when "capital" abandoned the workers to fend for themselves. An example of such organization was Construction Survey Cooperative organized in New York in 1933. Its chapter would state as one of the aims to "[a]bolish the barrier between capital, labor and management as employers and employees by placing them on par as co-investors, coworkers, co-partners, co-managers and co-owners."[1]

Construction Survey Cooperative was an unincorporated group of individuals varying in size from 5 to 25 over the years. It provided cost estimate services for the construction industry. In *Wirtz v. Construction Survey Cooperative*,[2] a district court addressed whether or not member-workers were subject to minimum wage and overtime regulations. The court decided that they were not, and called the organization "a partnership of intelligent technicians" who engaged at will, similar to self-employed individuals.

Worker coops have come a long way since then. They entered the Great Recession of 2008 with well-established organizational structures operating either as partnerships or cooperative corporations. As cooperative corporations, WCs operate under the same tax law framework as any other kind of

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[1] Wirtz v Construction Survey Coop, 235 F Supp 621 (D Conn 1964).

[2] 235 F Supp 621 (D Conn 1964).

cooperative. In the context of this article, I am only concerned with WCs that are organized as corporations.

[1] Emergence of Cooperativeness: the (Golden) "Principles"

While there must have been a few examples of cooperation in the stone, medieval, and other ages along the way, I'd like to skip to the dawn of industrial revolution, to one of the first well-documented organizations that played formative role in the modern cooperative economics: the Rochdale Society of Equitable Pioneers ("Rochdale" or the "Society") in Rochdale, England. Founded in 1844 in response to the hardening conditions of the skilled workers, as the industrial revolution was taking its course, the Society operated a store where its members could buy everyday necessities, not otherwise affordable. A consumer cooperative of 30 initial members, it started as an experiment but was wildly successful, and within ten years England saw nearly 1,000 cooperatives.[3]

Rochdale was the first known and recognized successful attempt at cooperation. Its success is commonly attributed in large part to the Rochdale Principles of Cooperation (the "Rochdale Principles") adopted by the Society. All the cooperatives afterwards modeled their bylaws on these principles. The courts in the U.S. today refer to Rochdale Principles while evaluating "cooperativeness" of business enterprises in order to establish their eligibility for special rules under the Internal Revenue Code.

The International Cooperative Alliance (ICA) (formed in 1895, the largest non-governmental organization in the world) officially adopted those principles in 1937 and revised them slightly over the years, most recently in 1995. Guidelines for cooperatives include the following basic principles:

- Open, voluntary membership;
- Democratic governance;
- Limited return on equity;
- Surplus belongs to members;
- Education of members and public in cooperative principles;
- Cooperation between cooperatives;
- Concern for community.[4]

A branch of ICA called CICOPA (International Organisation of Industrial, Artisanal and Service Producers' Co-operatives), that promotes worker cooperatives in the world, as part of its eight-page definition of what constitutes a WC, included the following specific characteristics of WCs during its general assembly in September 2005:

- Objective of creating and maintaining sustainable jobs and generating wealth;
- Free and voluntary membership of members;
- Work generally carried out by the members;
- Democratic process for creating cooperative's rules and regulations; and
- Autonomous and independent operation (separate from the governing state and third parties).[5]

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[3] More information about the Rochdale Society is available online, including their virtual museum site: http://www.rochdalepioneersmuseum.coop/.

[4] For a complete explanation of each listed cooperative principle, see the United Nations International Year of the Cooperatives website at http://2012.coop/en.

[5] The International Organisation of Industrial, Artisanal and Service Producers; Cooperatives (CICPOA) unanimously approved these principles as the World Declaration on Worker Cooperatives. See http://www.cicopa.coop/IMG/pdf/declaration_approved_by_ica_-_en.pdf.

The Mondragon Corporation of Spain has built its business culture, for example, on the basis of ten fundamental cooperative principles: Open Admission, Democratic Organization, the Sovereignty of Labor, Instrumental and Subordinate Nature of Capital, Participatory Management, Payment Solidarity, Inter-cooperation, Social Transformation, Universality, and Education.

These cooperative principles should be kept in mind. As discussed later, U.S. courts and Internal Revenue Service (IRS) have adopted some of the ICA's listed characteristics as "must haves" for a corporation to be considered a cooperative under the Internal Revenue Code. On the other hand, none of CICOPA specific principles are currently of significance to the worker coop requirements in the U.S. tax rules. Mondragon's list is the most comprehensive and pretty much encompasses the other two lists.

[2] Relevance of Worker Cooperatives Today

So, why worker coops, why now, what is the relevance of this worker oriented structure in our contemporary capital driven economic reality? This year in particular is special. The United Nations has declared 2012 as the International Year of Cooperatives (IYC):

> International years are declared by the United Nations to draw attention to and encourage action on major issues. The International Year of Cooperatives is intended to raise public awareness of the invaluable contributions of cooperative enterprises to poverty reduction, employment generation and social integration. The Year will also highlight the strengths of the cooperative business model as an alternative means of doing business and furthering socioeconomic development.[6]

Indeed, "the alternative means of doing business" is something to explore and pay attention to in view of today's economic uncertainty for many Americans and people worldwide.

A worker-owned cooperative provides a unique opportunity to address a key macroeconomic dilemma between the need to accumulate capital in order to finance technological progress, as well as economies of scale, and provide timely and adequate rewards to labor. If structured correctly, WCs have an ability to allocate earnings in and out of the corporation depending on the short and long-term goals, and in accordance with the membership consensus. Such flexibility is truly unique. In a partnership or S Corporation, the earnings are taxed to the partners - thus, there is a strong incentive to distribute the earnings sooner rather than later. In a C corporation, only a small fraction of earnings is paid out as dividends because it is often not prudent to subject earnings to double taxation. Thus, many large successful corporations chose to keep money in low tax jurisdictions and wait for investment opportunities in order to keep growing and accumulating earnings in perpetuity. The shareholders get rewarded mostly with capital gains on appreciated stock. WCs provide a balanced flexibility allowing the members to make decisions in accordance with their preferences and the dictates of an economic situation, without being swayed by tax incentives in the long run.

On the other side of the coin, it has become apparent to many that the healthy "cut throat" competition, "the winner takes all" approach, in the contemporary capitalist society has its limits: some private companies can't be allowed to fail, which distorts the fairness graphs drawn by the 18th century economists. There is a point at which competitors should perhaps take another look at themselves and see instead cooperators managing shared pools of limited resources and opportunities, within the norms and rules benefiting all the stakeholders. Cooperation today is the economic safety net for countries, large businesses, producers, consumers, and increasingly so for individual workers.

[6] Statement of the United Nations, see http://social.un.org/coopsyear.

A classic proof of concept where consistent application of the cooperative principles and wise management created a successful business enterprise is the Mondragon federation of cooperatives in Spain Basque region. Mondragon is a major force in the Spain's economy employing close to 100,000 workers and generating on the order of 15 billion Euros annually. It is the country's fourth largest industrial and seventh largest financial group. The wage disparity between the highest and lowest paid employee at Mondragon is on average 5:1, with lower wage workers receiving 13 percent higher wages than the country's average.[7]

The U.S. now has great examples, such as the Evergreen Cooperative in Cleveland, Ohio, partially sponsored by the government via "patient money" loans. It is a growing federation of WCs, currently including three companies: industrial grade laundry facility, solar panel installation company, and an urban hydroponic greenhouse.[8]

The urban worker coops are also being recognized in U.S. political circles. A bipartisan bill has been introduced in the House,[9] which will authorize the Secretary of Housing and Urban Development to establish a national program to create jobs and increase economic development in underserved areas by promoting cooperative development.[10] This emphasis on urban cooperatives is significant and historically recent; the bulk of cooperative growth happened in other cooperative sectors (agricultural producer cooperatives, rural electric cooperatives) early in the 20th century and almost exclusively in rural areas. Thus federal understanding of and support for the cooperative form has been primarily rural, through the USDA.

The 5th National Worker Cooperative conference took place in Boston in June of 2012, organized by the US Federation of Worker Cooperatives (USFWC).[11] It's a biennial forum of national leaders of WCs in the U.S. This year saw a record attendance of 400 participants, including Congressman Chaka Fattah who sponsored the aforementioned legislation.[12]

Finally, two contemporary documentary feature films address worker cooperatives and the movements in the U.S. and around the world.[13]

§ 1.02 Worker Cooperative Tax Roots

[1] The Seed

It has taken some time for the tax rules to mold into the coop laws we know today. The Internal Revenue Code and IRS regulations are rather economical in explaining and clarifying various provisions. Coop businesses have in large part been relying on revenue rulings, court cases, and private letter rulings. PLRs can't ordinarily be cited as precedents but due to the conspicuous paucity of the

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[7] Figures drawn from Wikipedia.com and the Evergreen Cooperative's own website at http://evergreencooperatives.com/.

[8] The largest worker cooperative in the country is Cooperative Home Care Services of the Bronx with around 1200 worker-owners (annual revenues unknown). Other large and well-known worker cooperatives are:

Associations:

- WAGES (2009): $2.8M revenue, 90 worker-owners (4 cooperative businesses)
- Arizmendi Association (2011) : $13.7M revenue, 150 worker-owners (6 cooperative businesses)

Individual Cooperatives:

- Alvarado St. Bakery (2011): $25M revenue, 118 worker-owners
- Rainbow Grocery (2011): $51.9M revenue, 236 worker-owners
- Equal Exchange (2011): $43M revenue, 113 workers

[9] HR 3677, 2011 HR 3677.

[10] See more at http://www.campaign.coop.

[11] http://www.usworker.coop.

[12] http://www.usworker.coop/events/2012-national-worker-cooperative-conference. The USFWC estimates that there are 300-400 worker cooperatives in the country, employing around 3,500 people, with total annual revenues of $250-300 million.

[13] The film "Fixing the Future" premiered in 60 communities around the country in July 2012 (http://fixingthefuture.org/). The production of "Shift Change: Putting Democracies to Work" is still in progress as of this writing (http://shiftchange.org/).

primary authorities on many subtle issues and often contradictory holdings by the courts and IRS, PLRs have become an important tool for gleaning into possible Service positions.

The very first set of the tax rules in the "permanent" era of taxation, the Revenue Act of 1913,[14] did not have a word "cooperative" included, but exempted from taxation practically any mutual benefit company in its "Section G." (What a simple rule that was!)

The Omnibus Revenue Act of 1916 added more specifics by exempting "cooperative banks," "cooperative telephone companies," and farmers fruit growers ("organized and operated as a sales agent for the purpose of marketing products of its members" - essentially, a classic case of a cooperative). Nothing was included in the act about worker coops.

Fast forward to the Revenue Act of 1951[15] containing some concepts used in Sections 521 and 522 under the Internal Revenue Code of 1954 ("1954 Code"). The first exempted farmers' cooperatives from tax, in general, and the second provided the rules under which the exempt farmers' cooperatives can be taxed. The concept of patronage dividend deduction was codified as well as some timing of payment rules.

Worker coops were not directly referred to in the 1954 Code, nor was there a set of rules that could vaguely map out tax treatment for a WC (the new IRC Sections 521 and 522 related specifically to "farmer's coops"). The IRS had not been of much help either. It narrowly interpreted the law, treating as cooperatives only those organizations that pay patronage dividends representing "either an additional consideration due to the patron for goods sold through the association or a reduction in the purchase price of supplies or equipment purchased by the patron through the association."[16] The IRS focused on "corrective and deferred" price adjustment to the cost of physical goods, supplies, and equipment. It did acknowledge that some state laws regarded as patronage work performed by the members of WCs. However, using the legal framework at the time, the taxing authorities would not allow patronage dividend deductions to worker cooperatives.

The year after Revenue Ruling 61-47 was issued, the Revenue Act of 1962[17] repealed IRC Section 522 and introduced new Subchapter T, "Cooperatives and their Patrons," in three parts. The move was, in part, politically motivated and came all the way "from the top":

> In 1962, President Kennedy brought to the attention of Congress that ... provisions of the 1951 Act had proved inadequate in several respects; and he recommended that supplemental provisions be enacted, *so that the purpose of Congress, which had been intended to be reflected in the 1951 Act, might be achieved*. This resulted in the enactment of subchapter T (secs. 1381-1388) of the 1954 Code; and in these new supplemental provisions, Congress again gave express recognition (in sec. 1381(a)) to the fact that the new and more comprehensive provisions would be applicable, not only to *exempt* cooperatives but also to "any corporation operating on a cooperative basis other than *** [one] which is exempt.[18]

The first part of Subchapter T covers the tax treatment of cooperatives and patronage dividends;[19] the second covers tax rules for patrons of patronage dividends and per unit retain allocations; [20] and the third provides definitions and special rules. [21] Note, that IRC Section 522 (rules

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[14] PL 63-16, 38 Stat 166 (1913).
[15] PL 82-183, 65 Stat 452 (1951).
[16] Rev Rul 61-47, 1961-1 CB 193 (1961).
[17] PL 87-834, 76 Stat 960 (1962).
[18] Puget Sound Plywood, Inc v Comm'r, 44 TC 305 (1965).
[19] IRC Sections 1381-1383.
[20] IRC Section 1385.

for taxing farmer's cooperatives) was repealed (the rules were moved to the new Subchapter T), while IRC Section 521 (exempting farmer's cooperatives from tax, in general) was left intact.

The cooperative rules had broadened but there still was no clear authority for deducting WCs' patronage dividends until two seminal cases a couple of years later: *Linnton Plywood Association v. United States*[22] and *Puget Sound Plywood, Inc. v. Commissioner*.[23] In each of these decisions, it was concluded that the amounts distributed by plywood producing nonexempt cooperative associations to the worker-members on the basis of the number of hours worked by them qualified as patronage dividends, and thus were deductible from the net taxable income.

The rationale for affording to worker cooperatives the benefits of Subchapter T was most precisely summarized in *Linnton* by Chief Judge Solomon:

> Workers' cooperatives are among the oldest forms of cooperatives and exist in many countries of the world. Many people regard a workers' cooperative as the basic type of cooperative. The Government concedes that if the members had individually created the plywood products and then brought them to the cooperative for marketing, the cooperative would be entitled to the exclusion, but claims that since the members collectively manufacture the products as well as market them, the cooperative is not entitled to the exclusion. I think that this is an illogical and absurd distinction. In my view, [nonexempt] workers' cooperatives are entitled to exclude retained patronage dividends from gross income to the same extent as purchasing or marketing cooperatives.[24]

In the *Puget Sound* case, the congressional intent was cited as follows:

> [I]n 1962, when the Congress had under consideration the matter of making more effective the cooperative provisions of the 1951 Act through enactment of the supplementary provisions which later became subchapter T of the 1954 Code, a question arose as to whether the phrase "business done with or for patrons," which was contained in these new provisions, was sufficiently broad to cover *services* done with or for patrons—so as to cover participating distributions of a cooperative association engaged in the manufacture of plywood. In this connection, the following colloquy was had in the Senate between Senator Kerr (floor manager of the bill), Senator Magnuson of Washington, and Senator McCarthy of Minnesota:
>
> Mr. MAGNUSON. Mr. President, I wish to ask the distinguished Senator from Oklahoma [Senator Kerr] a question.
>
> On pages 295 and 296 of the bill, in the definition of the term 'patronage dividend,' it is stated that a patronage dividend is a payment 'determined by reference to the net earnings of the organization from *business done with or for its patrons.* '
>
> In a case which has been called to my attention—*it involves the manufacture of plywood in the Pacific Northwest, and many of the companies are cooperative organizations*—the cooperative renders *services* for the patron. I wanted to be sure that in the opinion of the Senator from Oklahoma the phrase '*business* done with or for its patrons' *includes services* with or for patrons.

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[21] IRC Section 1388.
[22] 236 F Supp 227 (D Ore 1964).
[23] 44 TC 305 (1965).
[24] 236 F Supp at 227.

> Mr. KERR. I think it is clear, both *under the interpretation of a patronage dividend under present law* and also under the words 'business done with or for its patrons,' that *services* rendered with or for patrons are included. *Business done is not necessarily limited to products sold to or purchased for patrons.* Business done also includes services performed for patrons, as well.
>
> Mr. MAGNUSON. I thank the Senator from Oklahoma.
>
> Mr. McCARTHY. Mr. President, if the Senator will yield, let me say I think this is a *reasonable and desirable interpretation* of the language; and I believe that any other interpretation would create an impossible distinction.[25]

The court cases of the plywood cooperatives were practically discussed on the congressional floor, and it was firmly established that worker coops would receive the same treatment as any other. This is probably why the decision language of these cases continues to dominate the key concepts for doing business on cooperative basis.

The IRS acquiesced to both *Linnton* and *Puget Sound* in 1966[26] and five years later issued Revenue Ruling 71-439[27] holding that distributions of net earnings by a nonexempt cooperative association to its member-stockholders based on man-hours worked are patronage dividends. Prior Revenue Ruling 61-47 was thereby revoked.

Revenue Ruling 71-439 was an enormous development and cleared the way for many future worker cooperatives, and laid a tax law foundation for today's rising popularity of this entity structure. WCs were officially, taxwise, "admitted" into the larger pool of non-exempt coops, with no particular distinction or special treatment. The rules that ordinarily are applicable and adopted for other kinds of nonexempt cooperative organizations are applicable to WCs as well. Throughout this article, we'll refer to various examples and rulings pertaining to purchasing, producer, housing, agricultural, or consumer coops. Such rules in the relevant parts are also applicable to the WCs; the reverse is also true.

[2] Patron vs. Member

Before moving further, it would be timely to point out what is sometimes a confusing shuffle in terminology. For the purposes of this article, and as generally is the case, a "member" of a cooperative is a person who holds common shares entitled to vote. A "member" may or may not do business with the coop (most members do or have a requirement to).

The term "patron" is not defined in Treasury Regulation Section 1.1388-1(e)[28] however, the regulation does provide the following: "The term 'patron' includes any person with whom or for whom the cooperative association does business on a cooperative basis, whether a member or a non-member of the cooperative association, and whether an individual, a trust, estate, partnership, company, corporation, or cooperative association." Non-member patrons may either hold non-voting common shares or must have some other written evidence of the preexisting right to receive patronage dividends based on the amount of business done with the cooperative.

The early court cases and IRS rulings have confused this subject a bit by sometimes construing "member" to mean the voting members only, and other times as the entire pool of members and patrons. "It is not uncommon for all patrons of a cooperative to be stockholders and members. Thus, it is frequently unnecessary to distinguish between member patrons and nonmember patrons. In such cases

---

[25] 44 TC at 320-21.
[26] 1966-2 CB 4 (1966).
[27] 1971-2 CB 321 (1971).
[28] 26 CFR § 1.1388-1(e).

the terms 'member' and 'patron' are used interchangeably."[29] As I am trying to quote some of the authorities verbatim, please pay attention to the context in order to get the correct meaning.

§ 1.03 Principles of a Cooperative: Why General Motors Corp. is Not Considered a Cooperative for Tax Purposes

[1] What Distinguishes a Cooperative from a Regular Corporation?

Special cooperative taxation rules apply only to corporations operating on "cooperative basis,"[30] with the exceptions of organizations (other than exempt farmers' coops) exempt from income tax; mutual savings banks, cooperative banks and domestic savings associations; insurance companies; and organizations engaged in furnishing electric energy or telephone service to persons in rural areas.

Neither the Code nor regulations define "doing business on cooperative basis." The court had to turn to expert testimonies (of Dr. Edwin G. Nourse and Kelsey Gardner) and hit the history books in order to understand what Congress might have had in mind.

As a result, three pivotal cooperative principles, owing to the Rochdale Cooperative Society[31] discussed in Section 1.01, were adopted in *Puget Sound*: Subordination of Capital, Democratic Control, and Operation at Cost.[32] These principles continue to dominate the cooperative taxscape affecting all the exempt and non-exempt cooperative corporations. They have not significantly changed since 1965. Every court case and IRS ruling on the subject starts with citing the principles from *Puget Sound*.

[a] Subordination of Capital

A cooperative structure is primarily designed to be a mere conduit to the patrons of savings generated from discounted goods, services, or labor. The "capital" may take the back seat and enjoy the ride, provided that "subordination" is maintained.

What is "subordination?" According to *Puget Sound*, control of the cooperative and ownership of the pecuniary benefits arising from the cooperative's business must remain in the hands of the members/patrons of the cooperative rather than in non-patron equity investors in the cooperative.[33] In addition, "[i]mplementation of the subordination of capital as regards control over the management and direction of the cooperative, is achieved through by-law provisions which vest in the members themselves the right and power to elect the trustees and the officers of the cooperative...".[34] "The purpose of this limitation is to ensure that the gains that accrue to the cooperative from the business that it transacts with its patrons will <u>largely or completely</u> inure to the benefit of those patrons rather than to its stockholders. To be operating on a cooperative basis, a cooperative must <u>limit</u> the financial return with respect to its equity capital."[35]

The earnings of a WC must be distributed "largely or completely" to the patrons based on their participation. There was no quantification for this test in the opinion. "Completely" leaves no room for interpretation. "Largely," on the other hand, requires a trip to a dictionary: "for the most part, mainly..." but how much is "mainly"? Perhaps, it was meant to be "almost completely" or may be simply "more than half?" Probably not quite "almost completely" because the last sentence calls for "limiting," not eliminating of the financial return with respect to equity capital.

---

[29] PLR 8221111 (Feb 26, 1982).
[30] IRC § 1381(a).
[31] See Section 1.01[1], *supra*.
[32] 44 TC at 308.
[33] 44 TC at 308. See also PLR 201208008 (Nov. 29, 2011)(citing *Puget Sound*).
[34] *Id*.
[35] PLR 201208008 (Nov. 29, 2011) (citing *Puget Sound*) (emphasis added).

In GCM 38081 (September 6, 1979), IRS' General Counsel commented on a proposed revenue ruling that would create a bright line test for the subordination of capital principle. According to a possible ruling (that was never actually issued), the principle of subordination of capital is satisfied if more than 50 percent of each class of stock (e.g. voting common, non-voting preferred) of the coop is owned by patrons. The counsel asserted that such rule "...guarantees that in a year in which the earnings of a nonexempt cooperative are only sufficient to fund preferred stock dividends, a majority of those earnings will still be received by patrons rather than non-patron equity investors. Similarly, if the earnings of the cooperative are sufficient to pay preferred and common stock dividends, but not patronage dividends, this rule again guarantees that most of the earnings will be returned to patrons." According to this opinion, "largely" should not be interpreted as "almost all," but rather somewhere north of "more than half." [36]

Perhaps the ultimate protector and "capital subordinator" is in the other requirement of this principle giving members the decision making authority and control over any dividend payouts on the invested capital. This ensures that the members' interests are prioritized.

The IRS has issued a number of cautiously worded PLRs favorable to equity investments. Here are some examples.

- A corporation operating on cooperative basis requested a ruling on the merger with another two associations, an "Alignment Transaction." Taxpayer's articles of incorporation allowed for issuance of two types of stock: common and preferred. Only common are voting. Preferred would pay no dividends, and could be redeemed on dissolution at par value. The IRS states that "any Preferred Stock that may be issued in the future will provide fixed and limited rights to share in earnings. For this reason, and given the fact that the shares of Preferred Stock will not be entitled to vote, the tests for determining that "capital is subordinated" will be met."[37]

- In another ruling, the IRS allowed several series of preferred stock to be issued to members and "participating patrons." The ruling limited dividends to 8 percent of the issue price per annum. "Upon dissolution, holders of preferred shares will be entitled to receive an amount equal to the issue price of the preferred stock and cumulative, accrued unpaid or declared and unpaid dividends, if any, and no more. Thus, any preferred stock that may be issued will provide fixed and limited rights to share in earnings. For this reason, and given the fact that the shares of preferred stock will not be entitled to vote, the tests for determining that capital is 'subordinated' will be met with respect to the preferred stock. Thus, both the common stock and preferred stock will be subordinated to the interests of the Members and Participating Patrons."[38]

As can be seen from the two examples above, despite a stunning difference in the amount of a potential preferred reward (no dividends vs. annual cumulative at up to 8 percent), both were approved as "fixed and limited" rights to share in earnings.

Recent congressional developments in this area indicate a higher level of validation of the idea that cooperatives should be able to raise equity capital and pay dividends to the investors. Most notably, the American Jobs Creation Act of 2004,[39] clarified earnings allocation rules to encourage equity investments that could allow the nonexempt coops "raise needed equity capital by issuing capital stock without dividends paid on such stock causing the cooperative to be taxed on a portion of its patronage income, and without preventing the cooperative from being treated as operating on a cooperative basis."

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[36] GCM 38081 (Sept. 6, 1979) (emphasis added).
[37] PLR 201208008 (emphasis added). Note that it is not clear how preferred stock holders will achieve any return on their investment under these circumstances.
[38] PLR 201141007 (Oct 14, 2011) (emphasis added).
[39] PL 108-357, 118 Stat 1418 (Oct 22, 2004).

[b] Democratic Control

Democratic control: one member one vote. Each member must have a single vote regardless of the size of its investment or the amount of business it does with the corporation.

> Implementation of the second of the above principles, relating to democratic control, is effected by having the worker-members themselves periodically assemble in democratically conducted meetings at which each member has one vote and one vote only, and at which no proxy voting is permitted; and these workers there deal personally with all problems affecting the conduct of the cooperative.[40]

The phrase "no proxy voting is permitted" has been watered down somewhat over the years, for practical reasons. Sometimes, having an ability to vote by proxy allows members to have their say.

- In Revenue Ruling 75-97, the IRS stated that "[t]he exempt status of a farmers' cooperative will not be jeopardized if it permits proxy voting by shareholders."[41]

- The U.S. Tax Court ruled in *Thwaites Terrace House Owners Corp v. Commissioner*, [42] that "the fact that petitioner's shareholders may vote by proxy is akin to voting by absentee ballot" and was held to be not inconsistent with democratic control by those shareholders.

- The Fifth Circuit provided in *Etter Grain*[43] that the principle of democratic control "envisions [an organization] organized according to a model of a widely-based participatory democracy in which all of the members are able to exercise a franchise of equal strength."[44]

The organization must be careful in structuring its democratic processes to ensure the fair representation of every vote.

- According to PLR 200210033, "[e]ach member must have a single vote regardless of the size of its investment or the amount of business it does with the cooperative. Democratic control should depend on the control that the shareholders/members of a cooperative actually exercise."[45] In the ruling, because of the broad geographic area covered by the coop, many of the coop members found it difficult to be present at the general assemblies. In order to encourage wider participation in decision making by all the members, a board of directors was created responsible for most (but not all) of the decision making, and consisting of representatives from all geographical areas.

- In PLR 201141007, a cooperative corporation had two types of patrons (holding two types of stock): members, each having one vote, and "Participating Patrons," who had no vote but that was entitled to the annual patronage dividends as well as the share of the coop's assets based on the business done with the coop over the years. It is possible and simply reflects the fact that the cooperatives can have patrons who are members and non-members.[46]

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[40] *Puget Sound*, 44 TC at 308.
[41] Rev Rul 75-97, 1975-1 CB 167 (1975).
[42] TC Memo 1996-406 (1996).
[43] 462 F2d 259 (1972).
[44] 462 F2d at 263.
[45] PLR 200210033 (Dec 4, 2001).
[46] PLR 201141007 (Oct 14, 2011).

[c] Operation at Cost

Once capital is "subordinated" in a "democratically" controlled entity, the fair allocation of excess profit (earnings) must be ensured. The excess profit must be distributed to the cooperative members in proportion to the amount of business conducted with them.

> [T]he proportionate vesting in and allocation among the worker- members of all fruits and increases from their cooperative endeavor, is achieved through statutes, Bylaws, and contractual arrangements between the association and its members, whereby the elected officers of the association are required to make periodic allocations of the same among the members in proportion to their active participation as workers.[47]

> The requirement of operation at cost is met if the cooperative's net earnings or savings are distributed to the cooperative's patrons in proportion to the amount of business conducted with them. This requirement relates to 'the proportionate vesting in and allocation among the worker-members of all fruits and increases from their cooperative endeavor, is achieved through statutes, Bylaws, and contractual arrangements between the association and its members, whereby the elected officers of the associations are required to make periodic allocations of the same among the members in proportion to their active participation as workers.'[48]

In Revenue Ruling 70-481, the IRS determined that a corporation supplying services to its members at cost and making distributions to each member based on the value of business done with each member was "operating on a cooperative basis" within the meaning of Section 1381(a)(2) of the Code.[49]

There are two important aspects of this principle. The first is that every distinct business operation of a cooperative should be measured separately and the fruits of that particular business allocated to the participating patrons. Such allocation can be a matter of choice, but very often is necessary to preserve the fairness of cooperation. The second is that on liquidation, the assets are distributed to patrons in proportion to the business done with the coop.

Here are some authorities for both:

- If a cooperative operates two or more different businesses on a cooperative basis, a separate accounting pool for each business can be established in order to separately determine the net earnings of each pool and to distribute the net earnings of each pool solely to the patrons that utilized the service for which the pool was formed.[50]

- In accordance with fundamental cooperative and mutual principles, the rights and interests of the members in the savings of a cooperative should be determined in proportion to their business with the cooperative. With respect to liquidating distributions, the Service has stated that the cooperative principle of operation at cost requires that a cooperative's Articles of Incorporation or Bylaws obligate the cooperative to distribute its remaining assets upon liquidation to both its current and former members in proportion to the value or quantity of business that each did with the cooperative over some reasonable number of years.[51]

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[47] *Puget Sound*, 44 TC at 308.
[48] PLR 200224017 (June 14, 2002) (citing *Puget Sound*, 44 TC at 309).
[49] Rev Rul 70-481, 1970-2 CB 170 (1970).
[50] Rev Rul 74-567, 1974-2 CB 174 (1974). Section 1.04, *infra*, covers this rule in more detail.
[51] Rev Rul 72-36, 1972-1 CB 151 (1972).

Let's say that the patrons get their fair share of earnings but how much in non-patron business can a coop conduct? This question was not spared a dramatic turn of events. According to Revenue Ruling 72-602, cooperatives are required to conduct more than 50 percent in value of its business with its patrons, who may be members or nonmembers.[52] The Eight Circuit disagreed in *Conway County Farmers Association v. United States*,[53] and the IRS backed off only in 1993.[54] So, now it does not matter how much business is done with patrons vs. non-patrons.

[2] Corporate vs. Cooperative Statutes

Around the country, the states are racing towards adopting new worker coop friendly statutes. Many of them have not caught up yet. While a specialized WC statute could provide guidance with respect to legal and organizational points of view, it is not a requirement for application of the tax rules. According to PLR 8324108, a taxpayer operating under the general Corporation statute of a state would qualify as an organization subject to the provisions of subchapter T, if operated on the cooperative basis.[55] By the same token, an organization set up under a special cooperative statute, would be treated as a regular corporation for tax purposes, unless operating on a cooperative basis.

[3] Mutual Joinder of Interest

The IRS has stated that for an entity to be considered "operating on a cooperative basis" under IRC Section 1381(a)(2), the taxpayer must have "a sufficient membership to form a mutual joinder of interest in the risks and benefits of the organization . . ."[56]

In Revenue Ruling 72-602, it was determined that the existence of ten members constituted a sufficient membership to form the requisite mutual joinder of interests.[57] However, there is no language there that specifically ten or more members would be necessary. The case happened to have ten member and ninety non-member patrons.

In PLR 9219030, the taxpayer was found to have satisfied the "sufficient membership" requirement because "it currently has a member patrons and may enlist additional member patrons in the future."[58] No specific number of member patrons was provided as a guide.

Nothing could be found in various rulings to preclude a two-member cooperative.

Whereas General Motors Corp. may very well boast a "sufficient membership" in some form of a "mutual joinder of interest" (let's say at the dealership lots or occasional bankruptcy proceedings), it clearly does not possess the other necessary attributes for being a cooperative. "Cooperatives are distinguished from ordinary business corporations by how they allocate and distribute their earnings. In an ordinary business corporation, net earnings are shared by investors based upon the capital they invest in the business. In a cooperative, net earnings are shared by patrons on a patronage basis."[59]

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[52] Rev Rul 72-602, 1972-2 CB 510 (1972).
[53] 588 F2d 592 (8th Cir 1978).
[54] Rev Rul 93-21, 1993-1 CB 188 (1993).
[55] See also PLR 9227010.
[56] Rev Rul 93-21, 1993-1 CB 188 (1993); Rev Rul 72-602, 1972-2 CB 511 (1972).
[57] Rev Rul 72-602, 1972-2 CB 511 (1972).
[58] PLR 9219030 (Feb 7, 1992).
[59] PLR 9803019 (Jan 16, 1998).

§ 1.04 Growing a Worker Cooperative Fruit Tree: Deductibility and Timing of the Patronage Dividends

[1] Patronage Dividends Defined

The operation of a coop on cooperative basis with its patrons culminates in allocation of earnings back to the patrons based on the business conducted with the coop. This allocation is called patronage dividends. The net earnings of a WC are allocated between the patrons' accounts (eligible for patronage dividend deduction) and the "corporate" account (not eligible for patronage dividend deduction, taxed as earnings of a regular corporation).

The Code provides a definition of patronage dividends in Section 1388(a). "Patronage dividend" is defined as an amount paid to a patron:

(1) on the basis of quantity or value of business done with or for such patron,
(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and
(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Various rules for this allocation and timing are quite complex and are covered in this section.

[a] Quantity or Value of Business Done

As described above in Section 1.01[1], the "quantity or value of business done with or for such patron" in a WC setting is often based on man-hours worked.[60] The cooperative keeps track of the hours worked by patrons and non-patrons during the year. After the year end, the number of hours worked by each person is added up and we are ready for allocations.

If we take the net earnings and simply allocate them in accordance with the hours worked, then the allocation will be "on the basis of <u>quantity</u>." Some coops, though, may assign a higher weight to the member-worker hours than non-member-worker hours worked in calculating portion of the earnings to be paid out as patronage. Their proposition is that the members, as a rule, are more productive than non-members. This is in part due to better training and experience, and also because owners of a business care more about the outcome than non-members normally do. In a way, weighing hours is an attempt at an allocation based on "<u>value</u> of business done." However, such subjective weighting is met with some resistance by the IRS.

If clear factual determination can be made with regards to all workers (members and non-members) as to their respective productivity, then it is possible to weight number of hours worked by relevant factors. In *Olympia Veneer Company v. Commissioner*,[61] the question was whether employee-owners of a corporation were more productive than other workers for the purposes of reasonableness of compensation. The court decided that they were. Then, in another decision involving Linnton Plywood Association but with Multnomah Plywood Association joining as plaintiff, *Linnton Plywood Association & Multnomah Plywood Association v. United States* ("*Multnomah*"),[62] Judge Solomon wrote:

> Whether member hours are more valuable, and, if so, how much more valuable, are questions of fact. Workers and managers, based on personal experience and observation, and experts, based on elaborate studies, testified on the relative value of work performed by member and non-member workers. On the basis of this evidence, I am convinced that

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[60] *Puget Sound*, 44 TC 305 (1965); Rev Rul 71-439, 1971-2 CB 321.
[61] 22 BTA 892, 898 (1931).
[62] 410 F Supp 1100 (D Ore 1976).

> members are more valuable to the plaintiffs than non-member employees and that some weighting of member hours is appropriate. It is difficult to determine how much weighting is appropriate here.[63]
>
> …
>
> I believe that the determination of the boards here is entitled to some weight. Plaintiffs should be permitted to use the weighting factors adopted by their boards of directors, unless those weighting factors are unreasonable.[64]
>
> ...
>
> For the plaintiffs, Millard B. Hahn, a consultant to the plywood industry in the Pacific Northwest for 27 years, presented his detailed studies comparing the productivity of the plaintiffs' plywood mills with the productivity of comparable non-cooperative plywood mills. On the basis of these studies and his extensive experience as a consultant to both cooperative and non-cooperative plywood mills, Hahn concluded that member hours were at least 50% more valuable to each plaintiff than non-member employee hours. Katrina Berman, an economist who has studied workers' cooperatives, agreed with Hahn's appraisal.[65]
>
> ...
>
> Members usually can and do perform more than one job, thereby providing greater flexibility for job assignments. They have a lower turnover rate, require less supervision, and are more experienced than non-member employees. In addition to their production duties, they make many on-the-line management decisions, and they make broad management decisions about the direction of the company. Their conscientious performance influences the performance by non-member employees. In my view, these greater contributions to net earnings by members result from the members' incentive to make the cooperative more profitable because they, as owners, will be the direct beneficiaries of increased profitability. On the basis of these factors, I find that the plaintiffs' weighting factors are reasonable.[66]

The IRS has issued a number of rulings and there is a GCM calling such member hour increases arbitrary and disallowing them.[67] The *Multnomah* decision by Judge Solomon was issued after those rulings. However, the IRS has not changed its position on the issue and any cooperative attempting to assign weights to hours worked should be ready to defend its position before the IRS.

In order to be able to weigh member hours, a cooperative should secure industry studies or expert opinions. Moreover, in principle, it is also possible for a particular coop to have non-member employees who are better qualified or productive than some member employees and therefore would have to be given at least equal weights in the calculations.

In GCM 35238, the IRS proposed an alternative way of basing on “value” rather than “quantity” of the business done with the “patrons” (member-employees): to use “the number of member hours worked times the union scale at which those hours were worked divided by the total number of hours

[63] 410 F Supp at 1105.
[64] 410 F Supp at 1106 (emphasis added).
[65] 410 F Supp at 1106.
[66] 410 F Supp 1105-07
[67] Rev Rul 74-20, 1974-1 CB 242 (1974); GCM 35238 (Feb 9, 1973).

worked times the union scale at which those hours were worked." Moreover, the chief counsel Mr. Lee H. Henkel, Jr. (who wrote this opinion), considered this particular way of allocating patronage preferred where there was a substantial disparity in member and non-member workers' wages (average $6 vs. average $2 respectively).[68]

The "value" approach to the allocation of patronage either by weighing hours based on some subjective productivity measurement or hourly rates has not been used as much as the allocation based on straight hours. This is mostly due to some strategy and governance reasons. Perhaps, once US worker coops become larger, older, and more complex, the "value" approach should gain in popularity because of a more substantial disparity in value generated by the highest and lowest paid positions.

I should also mention that in some early cases, the IRS took a peculiar position. In *Multnomah*, the Service attacked an ability of a worker cooperative to deduct wages paid to member-workers under Section 162 as ordinary and necessary business expenses.[69] The argument was that such payments are advances against patronage dividends. The court, and even IRS's own counsel in GCM 37442, sided with the coops allowing the reasonable hourly compensation in accordance with the union scale. Again, an hourly compensation at the reasonable market rates (plus bonuses) would work just fine.

This leaves plenty of room to maneuver with wage determination and, probably, as confidence of worker coops increase, we could see some form of "value" allocation of patronage dividends gain popularity.

[b] Preexisting Written Obligation

It is not a patronage dividend if there was no preexisting (before the business/year began) obligation to pay it. That is why, in order to expand the population of patrons beyond the actual member-owners of a coop, a preexisting written obligation to pay patronage dividends to non-member patrons is necessary. This can be done by creating a special non-voting class of shares or by individual agreements.

The requirement that payments to patrons be made under a valid enforceable pre-existing written obligation is satisfied if the payments are required by state law or are paid under the co-op's bylaws, articles of incorporation, or other written contracts.[70]

The patronage allocations to patron members and non-members should be based on the same criteria. An exception to patronage dividends includes amount "to the extent [it] is paid out of earnings from business done with or for other patrons to whom <u>no amounts</u> are paid, or to whom <u>smaller amounts</u> are paid, with respect to substantially identical transactions. Thus, if a cooperative organization does not pay any patronage dividends to nonmembers, any portion of the amounts paid to members which is out of net earnings from patronage with nonmembers, and which would have been paid to the nonmembers if all patrons were treated alike, is not a patronage dividend."[71]

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[68] GCM 35238 (Feb 9, 1973). GCM 35238 was about a wood cutting enterprise for which union wage comparison could readily be obtained. In the absence of a union scale, and in the context of the economy today dominated by service oriented industries (where unions are not as strong), it is at least sensible to propose that IRS would not challenge an allocation of the patronage dividends based on some reasonable market derived hourly rates.
[69] 410 F Supp 110 (D Ore. 1976).
[70] Treas Reg § 1.1388-1(a)(1) (emphasis added).
[71] Treas Reg § 1.1388-1(a)(2)(II).

[c] Determined by Reference to Net Earnings

In the WC setting, earnings "determined by reference to the net earnings of the organization from business done with or for its patrons"[72] would be from selling a product or services of the organization.[73]

Section 1.1382-3(c)(2) of the Treasury Regulations defines the term "income derived from sources other than patronage" to mean incidental income derived from sources not directly related to the marketing, purchasing, or service activities of the cooperative association. For example, income derived from the lease of premises, from investment in securities, or from the sale or exchange of capital assets, constitutes income derived from sources other than patronage.

The classification of an item of income as from either patronage or nonpatronage sources is dependent on the relationship of the activity generating the income to the marketing, purchasing, or service activities of the cooperative. However, if the transaction producing the income does not actually facilitate the accomplishment of these activities but merely enhances the overall profitability of the cooperative, being merely incidental to the association's cooperative operation, the income is from nonpatronage sources.[74]

Interest income received by a nonexempt cooperative from loans made to its chief supplier to assure supplies, and an operating loss sustained in its operation of a veneer plant operated as a part of its business, are patronage sourced to the extent allocable to member workers. However, a payment it received as lessee from the cancellation of its lease on the veneer plant is nonpatronage sourced income. It construed the payment received for cancellation of the lease as an amount received for the sale of a capital asset which under Treasury Regulation Section 1.1382-3(c)(2), is considered income derived from sources other than patronage.[75]

In *Multnomah,* the taxpayer cooperative, together with another cooperative, organized a third corporation, in which the taxpayer owned a 50-percent interest, for the purpose of making glue which the two cooperatives used in their business of making plywood. The court held that the dividends received by taxpayer from the 50-percent-owned subsidiary were patronage-sourced income, since such income was directly related to the cooperative's business, in which glue was an essential element.[76]

However, let's say that a plywood coop hired a team to run a for-profit cafeteria for all the workers, members and non-members, their families, and maybe even general public attending a plywood museum. The net earnings from that operation would not qualify as the net earnings from the WC plywood business but such separate operation could be treated as a consumer coop rewarding all the patrons who used its services based on the amount of money spent. Or, maybe earnings from the cafeteria operations could be allocated among the worker-patrons who serviced it. Or, perhaps earnings could be allocated using a combination of the two. The plywood and cafeteria businesses would have to maintain separate books under the same corporate roof and measure separate types of patronages. The second business might have two buckets: worker and consumer for net earnings and patronage dividend allocations.

[2] Timing of Allocation, Payment, and Deductions: Opportunities Missed and Taken

The timing rules with regards to patronage are dry and technical. It is all in the Code and there is less controversy to discuss. Let's call them the "dry leaves" on our cooperative tax "fruit tree."

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[72] IRC § 1388(a)(3).
[73] The net earnings are not reduced by any taxes imposed by subtitle A of the Code. Treas Reg § 1-1388-1(a)(1).
[74] Rev Rul 69-576, 1969-2 CB 166 (1969).
[75] Rev Rul 74-160, 1974-1 CB 245 (1974).
[76] 410 F Supp 1100 (D Ore 1976).

In order to be eligible for deduction by the cooperative (and be subject to inclusion in income by the patrons), patronage dividends must be "allocated" by a "scrip" or "paid" during the "payment period." The "payment period" starts on the first day of the taxable year and ends on the 15th day of the ninth month following the year end (e.g. if coop year ends 12/31/X1, the payment period for this year is 1/1/X1–9/15/X2).[77]

The "scrip," also known as a "written notice of allocation," under Section 1382(b) means "any capital stock, revolving fund certificate, retain certificate, certificate of indebtedness, letter of advice, or other written notice, which discloses to the recipient the stated dollar amount allocated to him [or her] by the organization and the portion thereof, if any, which constitutes a patronage dividend." In other words, the patronage dividend allocation must be communicated to the recipient in some reasonably legible manner establishing recipient's right to receive this distribution at some future date. The "payment" can be made by a "qualified scrip" or "qualified check."

According to Section 1382(c)(1), the "qualified scrip," also known as a "qualified written notice of allocation," means a "scrip" that is redeemable in cash at its stated dollar amount for the period of at least 90 days from the day of issuance, whereas the distributee has consented to include the stated dollar amount into his/her taxable income in the year when such notice was issued, and only if it is accompanied by the payment in cash or "qualified check" of at least 20 percent of such stated amount. The "consent" can be obtained in a variety of ways described in Section 1382(c)(2) including in writing, by operation of the bylaws, or endorsement and cashing of a "qualified check" (e.g. a patron A was allocated $10,000 in patronage for year 12/31/X1; on July 1st of X2, he received a written notice with all the right language accompanied by a $2,000 qualified check. The coop takes a $10,000 deduction for year X1, the individual includes the same into his income for year X2).

A "qualified check" is defined under Section 1388(c)(4) as "a check (or other instrument which is redeemable in money) paid as a part of a patronage dividend...and on which is clearly imprinted a statement that the endorsement and cashing of the check (or other instrument) constitutes the consent of the payee to include in his gross income, as provided in the Federal income tax laws, the stated dollar amount of the written notice of allocation which is a part of the patronage dividend or payment of which such qualified check is also a part...". Caution must be paid as a "qualified check" transforms into a "non-qualified scrip" (the "scrip" which is not qualified) if not endorsed and cashed "on or before the 90th day after the close of the "payment period" for the taxable year for which the distribution of which it is a part is paid."[78]

You might have needed to read these rules a few times or even refer to a different source or simply call a colleague in order to fully understand them but as you can see these "dry leaves" may be covering some tasty fruits. If structured and timed correctly, patronage dividends may be partially or fully distributed in the same or following year and may be deducted in the current or future years. They could be deductible on the tax return of a coop for the prior year while included on the tax returns of the patrons in the current year.

[77] IRC § 1382(d).
[78] IRC § 1388(d).

Kimberly Stanley on *Mayo* and *Home Concrete:* Defining Treasury's Power as a Fourth Branch Player

by Kimberly Stanley*

§ 2.01 Introduction

Last year, in *Mayo Foundation for Medical Education and Research v. United States*,[1] the Supreme Court addressed a narrow tax issue – whether medical residents are required to pay Social Security taxes on wages – in the context of a much larger debate about the framework courts must use to determine the validity of federal regulations. The Court continued the debate this term in *United States v. Home Concrete & Supply, LLC,*[2] another esoteric tax case, and addressed the circumstances in which a federal agency may amend a regulation to support its litigation position that is contrary to prior court precedent. The opinions give practitioners important new guidance when seeking to invalidate a disadvantageous federal regulation.

§ 2.02 The *Mayo Foundation* Case

Most doctors who graduate from medical school in the United States obtain additional education in a specialty, and this specialized education generally is offered through a medical residency program.[3] The plaintiffs, the Mayo Foundation for Medical Education and Research, the Mayo Clinic, and the University of Minnesota (collectively Mayo), provide this type of instruction.[4] Mayo's residency programs usually last three to five years, and doctors are trained primarily through hands-on instruction by more senior residents and faculty members known as attending physicians.[5] Resident physicians carry a tremendous workload, often spending between 50 and 80 hours each week caring for patients.[6] They examine and diagnose patients, prescribe medication, recommend treatment plans, and perform medical procedures.[7] While medical residents take part in a formal and structured educational program that includes reading assignments, attending weekly lectures, taking written exams, and having their performance evaluated, the bulk of their time is spent caring for patients.[8] Residents at Mayo during the years in issue received annual "stipends" ranging between $41,000 and $56,000, and also were provided with health insurance, malpractice insurance, and paid vacation time.[9]

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[1] 131 S Ct 704 (2011).
[2] 132 S Ct 1836 (2012).
[3] *Mayo*, 131 S Ct at 708.
[4] *Id*.
[5] *Id*.
[6] *Id*.
[7] *Id*.
[8] *Id* at 708-709.
[9] *Id*.

Under Federal law, employees who work for wages generally must pay a tax under the Federal Insurance Contributions Act (FICA) to support the Social Security program.[10] The FICA tax has a broad sweep, defining "wages" as "all remuneration for employment,"[11] and "employment" as "any service, of whatever nature, performed . . . by an employee for the person employing him."[12] However, in IRC Section 3121 (b)(10) Congress excepted from this tax "service performed in the employ of . . . a school, college, or university . . . if such service is performed by a student who is enrolled and regularly attending classes at such school, college, or university." This is the so-called "student exception." The same exception for students applies for purposes of workers' eligibility for Social Security benefits.[13]

Treasury regulations, first adopted in 1951, provided that the student exception would apply to students who work for their schools "as an incident to and for the purpose of pursuing a course of study" there.[14] Under the regulation, whether a person's work is "incident to" his or her course of study was determined by the Internal Revenue Service (IRS) on a case-by-case basis, looking primarily at the number of hours the individual worked and the courses he or she took.[15]

While the same case-by-case approach applied to the corresponding student exception for purposes of Social Security benefits, resident physicians specifically were *not* considered students entitled to the exception for these benefits.[16] In 1998, the Eighth Circuit Court of Appeals overturned this position holding that the statute required a case-by-case approach.[17] Thereafter, thousands of claims for tax refunds were filed on the ground that medical residents qualified for the student exception to the FICA tax under IRC Section 3121(b)(10).[18] In response, the Treasury Department amended the student-exception regulation to clarify the rule for individuals who perform services in the nature of on-the-job training. The amended regulation provides that an employee's service is "incident" to his studies only when "[t]he educational aspect of the relationship between the employer and the employee, as compared to the service aspect of the relationship, [is] predominant."[19] In addition, the amended regulation sets forth a categorical rule that the service of a full-time employee (specifically defined to include any employee normally scheduled to work 40 hours or more per week) is not "incident to and for the purpose of pursuing a course of study."[20] This new "full-time employee rule" applies regardless

[10] IRC § 3101(a) (tax on employees); IRC § 3111(a) (tax on employers); Fed Ins Contributions Act, Aug 16, 1954, ch 736, 68A Stat 415.
[11] IRC § 3121(a).
[12] IRC § 3121(b).
[13] 42 USC § 410(a)(10); Social Security Act of 1935, Aug 14 1935, Ch 531, Title II, § 210, as added Aug 10, 1946, Ch 951, Title II, § 201, 60 Stat 979.
[14] Treas Reg § 31.3121(b)(10)-2(d); see *Mayo*, 131 S Ct at 709, citing 16 Fed Reg 12474 (adopting Treas Reg 127, § 408.219(c)).
[15] *E.g.*, Rev Rul 78-17, 1978-1 CB 307 (a part-time course load of a full-time employee was not incident to or for the purpose of pursuing a course of study).
[16] 20 CFR § 404.1028(c) (1998); SSR 78-3, 1978 CB 55-56.
[17] Minn v Apfel, 151 F3d 742, 747-748 (8th Cir 1998).
[18] Mayo Found for Medical Educ and Research v US, 568 F3d 675, 677 (8th Cir 2009).
[19] 69 Fed Reg 8605, 76408 (2004); Treas Reg § 31.3121(b)(10)-2(d)(3)(i).
[20] 69 Fed Reg 76408; Treas Reg § 31.3121(b)(1)-2(d)(3)(iii).

whether there is an educational, instructional, or training aspect to the employment, and provides, as a specific example, that a medical resident is not exempt as a student under IRC Section 3121(b)(10).[21]

Mayo thereafter filed suit in federal District court for a refund of FICA taxes paid for its medical residents, arguing that the new regulation's full-time employee rule was invalid.[22] The District court agreed, holding that the statutory language unambiguously requires that the student exception apply "so long as the educational aspect of [the student's] service predominates over the service aspect of the relationship with his employer."[23] In determining that the regulation was invalid, the District court applied a multi-factor test set forth in *National Muffler Dealers Assn., Inc. v. United States*.[24] The Eighth Circuit reversed,[25] holding that the proper framework for analyzing the validity of the regulation was set forth by the Supreme Court in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*[26] Applying *Chevron*, the Eighth Circuit held that IRC Section 3121(b)(10) was silent or ambiguous on the precise question whether a medical resident working full time is a "student," and that, given the ambiguity, the Treasury's full-time employee regulation was a permissible interpretation of the statute.[27] The Supreme Court took the case to clarify whether *National Muffler* or *Chevron* provided the proper framework for evaluating the validity of an administrative regulation.

§ 2.03 The *Home Concrete* Case

The central issue in *Home Concrete* concerned the statute of limitations on the assessment of an income tax deficiency under IRC Section 6501 (e)(1)(A).[28] Generally, the government must assess a tax deficiency within three years after the taxpayer files his or her return.[29] This three-year period is extended, however, if the taxpayer "omits" from reported gross income more than 25 percent of his income, in which case the limitations period for assessment goes from three to six years.[30] In *Home Concrete*, the issue was whether the three- or six-year statute of limitations applies when the taxpayer overstates his basis when reporting his gain on the sale of property. By overstating basis, the taxpayer understates the gain he receives on the sale, and, according to the Government, this constitutes an omission of income warranting application of the six-year statute of limitations.[31]

This issue already had been decided by the Supreme Court back in 1958 in *Colony, Inc. v. Commissioner*,[32] applying a prior but "identical" version of IRC Section 6501 (e)(1)(A).[33] The *Colony*

[21] Treas Reg § 31.3121(b)(10)-2(e) (Ex 4) ("Employee E" who is employed as a medical resident at "University V" is not entitled to the student exception because E's "normal work schedule calls for [him] to perform services 40 or more hours per week"); 69 Fed Reg 76409.
[22] Regents of Univ of Minn v US, 503 F Supp 2d 1164, 1166-67 (D Minn 2008).
[23] *Id*, 503 F Supp 2d at 1175.
[24] 440 US 472 (1979).
[25] Mayo, 568 F3d 675 (8th Cir 2009).
[26] 467 US 837 (1984).
[27] Mayo, 568 F3d at 679-680, 683.
[28] 132 S Ct 1836, 1839-1840 (2012).
[29] IRC § 6501(a).
[30] IRC § 6501(e)(1)(A).
[31] 132 S Ct at 1839-1840.
[32] 357 US 28 (1958).

Court reasoned that the statute's use of the word "omit" limits its scope to situations in which specific receipts or accruals of income are *left out* of the computation of gross income, and held that inflating one's basis in property does not result in the omission of a specific item of income.[34] However, in 2010, during the lower court proceedings, the Treasury Department promulgated a new regulation that supported its litigation position.[35] The new regulation provided that "an understated amount of gross income resulting from an overstatement of unrecovered cost or other basis constitutes an omission from gross income."[36] By interpreting the operative language of IRC Section 6501 (e)(1)(A) this way, the Treasury effectively sought to overturn C*olony* by administrative rule. At issue in *Home Concrete*: can the Government do this?

§ 2.04 Judicial Deference to Federal Administrative Regulations

A federal regulation constitutes "an agency's construction of a statute which it administers,"[37] and Treasury Regulations in particular are accorded substantial deference.[38] In 1979, the Supreme Court set forth a multi-factor test to determine the validity of a tax regulation in *National Muffler Dealers Association, Inc. v. United States*, as follows:

> A regulation may have particular force if it is a substantially contemporaneous construction of the statute by those presumed to have been aware of congressional intent. If the regulation dates from a later period, the manner in which it evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute.[39]

Five years later, in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*,[40] the Court enunciated a different, two-part framework for testing the validity of a regulation. Under *Chevron*, the court first must determine whether Congress has "directly addressed the precise question at issue."[41] If the statute unambiguously addresses the question, the statute prevails.[42] If not, the court moves on to the second prong of the *Chevron* test, asking whether the agency rule is a "permissible construction of the statute." [43]

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[33] 132 S Ct at 1839.
[34] 132 S Ct at 1840 (emphasis in the original); see *Colony*, 357 US at 32-33.
[35] Treas Reg § 301.6501(e)-1.
[36] Treas Reg § 301-6501(e)-1(a)(1)(iii).
[37] *Home Concrete*, 132 S Ct at 1842, quoting *Chevron*, 467 US at 842.
[38] Boeing Co v US, 537 US 437, 448 (2003).
[39] 440 US 472, 477 (1979).
[40] 467 US 837 (1984).
[41] Chevron, 467 US at 842-43.
[42] *Id* at 842.
[43] *Id* at 843. The *Chevron* Court stated the test as follows (467 US at 842-43):

> First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter, for the court, as well as the agency, must give effect to the

Since 1984, courts sometimes have applied the earlier, tax specific multi-factor test in *National Muffler* and at other times have applied the two-prong test in *Chevron*.[44] Under the *National Muffler* test, courts may look at such things as whether the regulation was issued contemporaneously with the statute, the length of time it had been in effect, the reliance placed on it, and the consistency of the agency's interpretation.[45] Because there were several bases for questioning a regulation, the *National Muffler* test was widely regarded as being less deferential to agency action than the two-prong test in *Chevron*.[46]

§ 2.05 *Mayo* Clarifies the Standards for Review of Administrative Regulations

In *Mayo*, the Supreme Court resolved this debate, opting for the more deferential *Chevron* test and essentially putting to rest the multi-factor test applied in *National Muffler*. After some discussion, the Court agreed with the Government that IRC Section 3121(b)(10) did not define "student" and therefore, under *Chevron's* first prong, the statute was silent or ambiguous on the specific question whether a medical resident working for a school full-time is a "student who is enrolled and regularly attending classes." [47] This opened the door to *Chevron's* prong two, upholding Treasury's wide latitude to promulgate a rule to address the statutory ambiguity so long as the rule is not "arbitrary or capricious in substance, or manifestly contrary to the statute."[48] Although the Mayo plaintiffs argued that the student exception regulation ticked off several of the *National Muffler* factors, *e.g.*, it was not adopted contemporaneously with the statute, it had not been consistent over time, and it was promulgated in the midst of litigation that had turned out badly for the agency,[49] the Court agreed with the Government that such factors need not be considered post-*Chevron*, and that the full-time employee regulation was "a permissible construction of the statute."[50]

> unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.

[44] *Mayo*, 568 F3d at 712; *e.g.*, US v Cleveland Indians Baseball Co, 532 US 200, 219 (2001) (citing *National Muffler*); Cottage Savings Assn v Commr, 499 US 554, 560-561 (1991) (same); Atlantic Mutual Ins Co v Commr, 523 US 382, 387 (1998) (citing *Chevron*); US v Boyle, 469 US 241, 246 n.4 (1985) (same); Lederman, *The Fight Over "Fighting Regs" and Judicial Deference in Tax Litigation*, 92 BU Law Review 643, 646 (2012); Johnson, "*Mayo* and the Future of Tax Regulations," Tax Notes, 2011 TNT 60-5 (March 28, 2011) 1547 at 1549.
[45] *National Muffler*, 440 US at 477.
[46] *National Muffler* generally was regarded as a pro-taxpayer rule, allowing a court to give less deference to a Treasury regulation if any one of the multiple factors were present, *e.g.*, the regulation was entitled to less deference if it had been changed following an adverse judicial decision. Johnson, *supra*, note 44 at 1553.
[47] *Mayo*, 568 F3d at 711.
[48] *Mayo*, 568 F3d at 711-712 (citing Household Credit Services, Inc v Pfennig, 541 US 232, 242 (2004) and quoting US v Mead Corp, 533 US 218, 227 (2001)).
[49] *Mayo*, 503 F Supp 2d at 1176.
[50] *Mayo*, 568 F3d at 712 (citing *Chevron*, 467 US at 843); *e.g.* Smiley v Citibank (SD), N.A., 517 US 735, 740 (1996); United Dominion Indus, Inc v US, 532 US 822, 838 (2001).

Chevron requires only that the court inquire whether the agency's rule is a "reasonable interpretation" of the statutory language.[51] *Mayo's* discussion of this point is instructive. The Court held that the full-time employee rule rather easily met the reasonableness standard because it was a "perfectly sensible" way to distinguish between "workers who study and students who work."[52] Treasury reasonably could conclude that the full-time employee rule would "improve administrability" and end the "continuing uncertainty that would inevitably accompany a purely case-by-case approach" like the one that was the basis for the initial regulation.[53] On a more substantive level, the Court found the agency rule reasonable because it followed the long-standing principle that exemptions from taxation must be construed narrowly,[54] and it upheld an important social policy goal to provide medical residents and their families with the vital disability and survivorship benefits that Social Security provides.[55]

[1] Are Tax Regulations Special?

In rejecting the *National Muffler* multi-factor test, the Court in *Mayo* clarified that there is no justification for applying a different or more deferential standard of review for tax regulations than it applies to the rules of any other federal agency.[56] Although noting that *National Muffler* involved the validity of a Treasury regulation, the Court reiterated the importance of maintaining a uniform approach to judicial review of administrative action, and held that *Chevron* applied with "full force" in the tax context.[57]

[2] No Distinction Between "Legislative" and "Interpretive" Regulations

Furthermore, the Court in *Mayo* eliminated the distinction courts had made between "interpretive" and "legislative" tax regulations.[58] Interpretive regulations are promulgated under the Treasury Department's *general* authority under IRC Section 7805(a) to "prescribe all needful rules and regulations for the enforcement of the Internal Revenue Code." Legislative regulations, on the other hand, are issued under a *specific* grant of Congressional authority to define a statutory term or prescribe a method of executing a statutory provision.[59] However, noting that these distinctions pre-dated *Chevron* and that the "administrative landscape has changed significantly,"[60] the *Mayo* Court held that the level of deference given to an agency's regulation "does not turn on whether Congress's delegation

[51] 467 US at 844.
[52] *Mayo*, 568 F3d at 715.
[53] *Id*.
[54] Bingler v Johnson, 394 US 741, 752 (1969).
[55] *Mayo*, 568 F3d at 715.
[56] *Id* at 713; *cf*. Bob Jones Univ v US, 461 US 574, 596 (1983) ("in an area as complex as the tax system, the agency Congress vests with administrative responsibility must be able to exercise its authority to meet changing conditions and new problems").
[57] Mayo, 568 F3d at 713; see Hickman, "The Need for *Mead*: Rejecting Tax Exceptionalism in Judicial Deference," 90 Minn L Rev 1537 (1994).
[58] Mayo, 568 F3d at 713-714 (citing Rowan Cos v US, 452 US 247, 253 (1981)).
[59] Rowan,452 US at 253; US v Vogel Fertilizer Co, 455 US 16, 24 (1982).
[60] *Mayo*, 568 F3d at 713.

of authority was general or specific."[61] Under the ruling, courts now may regard all Treasury regulations as entitled to the same level of deference in applying the *Chevron* test, regardless of the manner in which they were promulgated.[62]

§ 2.06 *Home Concrete* Clarifies Treasury's "Gap-filling Authority"

In *Mayo,* the Court acknowledged that an administrative agency has the power to formulate policy and make rules "to fill any gap left, implicitly or explicitly, by Congress."[63] And in an earlier opinion, *National Cable & Telecommunications Assn. v. Brand X Internet Services*, [64] the Court had explained that a "court's prior judicial construction of a statute trumps an agency construction otherwise entitled to *Chevron* deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute . . . ."[65] In *Home Concrete*, the Government seized on these prior Court rulings to validate its new regulation, adopted in the midst of litigation on the issue, that an understatement of basis triggers the six-year statute of limitations. The Government argued that since the Court's 1958 holding in *Colony* acknowledged that the predecessor to IRC Section 6501(e) was "not unambiguous," the new regulation merely filled the gap left by the ambiguous statute, as allowed under *Brand X*.[66] The ambiguity, in the Government's view, opened the door to *Chevron* deference and, under that standard, the new regulation "embodied a reasonable, hence permissible, construction of the statute."[67]

The Supreme Court rejected this argument, invalidated the regulation, and held that *Colony's* 1958 interpretation of IRC Section 6501(e) stands.[68] Harmonizing its earlier rulings, the Court stated that its role is to decide "whether, or when, a particular statute in effect delegates to an agency the power to fill a gap, thereby implicitly taking from a court the power to void a reasonable gap-filling interpretation" in an agency rule. [69] Whereas unambiguous language is a "clear sign that Congress did not delegate gap-filling authority to an agency," ambiguous language is at least a "presumptive indication" that Congress intended to delegate to the agency authority to fill the interpretive gap.[70] However, the Court reasoned that since *Colony* was decided 30 years before *Chevron*, "there is no reason to believe that the linguistic ambiguity noted by *Colony* reflects a post-*Chevron* conclusion that Congress had delegated gap-filling power to the agency." [71] To the contrary, the Court held that "there

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[61] *Mayo*, 568 F3d at 714; see *Natl Cable & Telecommunications Assn,* 545 US at 980-81 (Federal Communications Commission's authority to promulgate rules under a general grant of authority entitled to *Chevron* deference); Sullivan v Everhart, 494 US 83, 87, 88-89 (1990) (applying *Chevron* deference to rules promulgated under delegation of general rule-making authority under 42 USC § 405(a) (1982)); Johnson, *Mayo and the Future of Tax Regulations*, Tax Notes, 2011 TNT 60-5 (March 28, 2011) 1547 at 1549.
[62] *Mayo*, 568 F3d at 714.
[63] *Mayo*, 568 F3d at 713 quoting *Chevron*, 467 US at 843 (internal quotation marks omitted).
[64] 545 US 967 (2005).
[65] *Id* at 982.
[66] *Home Concrete*, 132 S Ct at 1843.
[67] *Id*.
[68] *Id* at 1842-44.
[69] *Id* at 1843.
[70] *Id*.
[71] *Id* at 1844.

is every reason to believe" that, despite some lack of clarity, the statute "directly spoke[] to the question at hand," because the *Colony* Court found "persuasive indications" that Congress intended overstatements of basis to fall outside the statute's scope.[72] There being no statutory gap to fill, the Government's gap-filling regulation could not change *Colony's* interpretation of the statute.[73] Accordingly, as a matter of substantive tax law, overstatements of basis, and the resulting understatement of gross income, do not trigger the extended statute of limitations period of IRC Section 6501(e)(1)(A).[74] As a matter of administrative law, a Treasury regulation cannot trump the prior ruling of the Supreme Court as to the meaning of a statute that unambiguously provides a contrary rule.

§ 2.07 Conclusion

While many topics are more interesting than the intersection of administrative law and tax law, these two recent Supreme Court decisions provide important lessons far beyond the arcane tax questions they answer. *Home Concrete* shows that the Court still will invalidate a regulation that runs contrary to clear statutory language, and reiterates the principle underlying *stare decisis* that taxpayers ought to be able to rely on long-standing statutory interpretations. Thus, while an agency rule can overthrow a prior judicial decision as to an ambiguous statute,[75] it cannot do so where the statutory language is clear. The fact remains, nevertheless, that increasingly complex tax statutes are enacted with inherent gaps, conflicts and ambiguities. *Mayo* reaffirms the Treasury's broad power to resolve these statutory inadequacies so long as the gap is filled with a reasonable rule.

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[72] *Id*.
[73] *Id* at 1844 citing *Chevron*, 467 US at 842-843.
[74] The dissent argued that statutory changes to IRC § 6501(e) made in 1954 after *Colony* was issued meaningfully changed the statute and opened the door for the Treasury to interpret the provision as it did in the new regulation. *Home Concrete*, 132 SCt at 1849 (J. Kennedy, dissenting).
[75] *Brand X*, 545 US at 982.

Mary Riley on The Role of the IRS in Consumer Bankruptcies

By Mary Riley*

§ 3.01 Introduction

Under federal law, there are several options available to individual taxpayers to dispute, minimize, or eliminate their federal tax debt.[1] A lesser-utilized option is filing for personal bankruptcy to discharge tax debts. Although filing for personal bankruptcy no longer bears the stigma it once did, the individual who decides to file may still experience stress or bewilderment over her financial predicament. In addition, several rules under the federal Bankruptcy Code apply throughout the duration of the bankruptcy proceeding to ensure that the Internal Revenue Service's interests are adequately protected, both as a creditor involved in the bankruptcy and as a governmental taxing authority. Although taxing authorities have generally enjoyed stronger positions relative to other creditors, the tax provisions under the federal Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA")[2] further simplified tax collection and bolstered the positions of federal, state and local taxing authorities in bankruptcy cases.[3]

While not exhaustive, this article discusses the role of the IRS as a creditor, and specific federal tax compliance requirements for consumer bankruptcy debtors under federal bankruptcy and tax law. In general, federal bankruptcy protection is available to individuals and business entities.[4] Both individuals and business entities may file a Chapter 7, Chapter 11, or Chapter 13 bankruptcy petition, although individual Chapter 11 petitions are infrequent since individuals are typically eligible for Chapter 7 or Chapter 13 relief. Only individuals may file a Chapter 13 bankruptcy petition.[5] Only individuals who are "family farmers" or a "family fishermen" may seek relief under Chapter 12 of the federal Bankruptcy Code.[6] A consumer bankruptcy case is characterized by an individual who mainly has consumer (and not business) debt.[7] The two most common types of individual bankruptcy cases are Chapter 7 and 13 consumer bankruptcy cases.

§ 3.02 Jurisdiction of the Bankruptcy Court

The federal Bankruptcy Code provides that the Bankruptcy Court has jurisdiction to "determine the amount or legality of any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid, and whether or not contested before and adjudicated by a

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[1] These options include amended tax returns, installment agreements, offer-in-compromise, collection due process hearings, timely appeals of collection enforcement actions and audit reconsiderations.

[2] PL 109-8, 119 Stat 23 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol E-2 Collier on Bankruptcy, App Pt 10(a) (Matthew Bender 16th Ed).

[3] History of Tax Treatment in Bankruptcy, 11-TX 1 Collier on Bankruptcy P TX1.02.

[4] Although the term individual is not statutorily defined under the federal Bankruptcy Code, 11 USC § 101(41) defines a "person" as including individuals, partnerships, and corporations. Corporations are further defined at 11 USC § 101(9).

[5] See 11 USC § 109(b), (d) & (e) (who may be a debtor under Chapters 7, 11, and 13 of the federal Bankruptcy Code).

[6] See 11 USC § 101(18) & (19A) (definitions of family farmer and family fisherman) and 11 USC § 109(f).

[7] 11 USC § 101(8).

judicial or administrative tribunal of competent jurisdiction."[8] However, the Bankruptcy Court does not have the authority to determine a tax, fine, penalty or addition when it has previous been contested before and adjudicated by an administrative tribunal or court of competent jurisdiction before the date of filing the bankruptcy petition.[9] In addition, the Bankruptcy Court has no authority to determine the right of the bankruptcy estate to a tax refund until the bankruptcy trustee properly requests the refund from the IRS and either: (a) the IRS makes a determination about the refund; or (b) 120 days have passed since the date of the bankruptcy trustee's request for the refund.[10]

§ 3.03 Requirements for Filing the Bankruptcy Petition

When the individual debtor has federal tax debt and the IRS is a creditor in the bankruptcy case, the debtor must list the tax debt (including interest and penalties) in the bankruptcy petition either as a secured claim, an unsecured priority claim, or a general unsecured claim, regardless of whether the tax debt is disputed by the taxpayer. Depending on the classification of the claim, it necessarily follows that the IRS will be either a secured creditor, an unsecured priority creditor, or a general unsecured creditor of the bankruptcy estate. In addition, the debtor's right to receive a federal income tax refund is an asset of the bankruptcy estate and must be listed on the bankruptcy schedules accordingly.[11]

Along with the Chapter 7 or 13 bankruptcy petition and other required documents, the consumer debtor must generally file with the Bankruptcy Court (unless the court orders otherwise): (1) schedules of assets and liabilities; (2) a schedule of current income and expenditures; (3) a schedule of executory contracts and unexpired leases; and (4) a statement of financial affairs.[12] The debtor must also provide the assigned bankruptcy case trustee with a copy of his federal tax return or transcripts for the most recent tax year; this requirement is a statutorily enumerated duty of the debtor under federal bankruptcy law.[13] If the debtor fails to comply with 11 U.S.C. § 521(e)(2)(A)(i), the Bankruptcy Court must dismiss the case unless the debtor demonstrates that his noncompliance is due to circumstances beyond his control.[14] Chapter 7 and 11 debtors must also file with the IRS and the Bankruptcy Court all required (unfiled and filed) federal tax returns that became due during the three-year period prior to the filing of the bankruptcy petition.[15]

Chapter 13 debtors are held to these same requirements, except that they must file all required tax returns (unfiled and filed) for all tax periods ending within four years of the date the bankruptcy petition is filed, before the date of the initial Section 341 meeting of creditors.[16] If the debtor requires additional time, she may request the trustee to hold the Section 341 meeting open for an additional 120 days to permit her to file the returns (or until the day the returns are due under an automatic IRS

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[8] 11 USC § 505(a)(1).
[9] 11 USC § 505(a)(2)(A).
[10] 11 USC § 505(a)(2)(B).
[11] A federal tax refund is "a liquidated debt owed to the debtor" and is classified as personal property of the debtor. See Bankruptcy Schedule B – Personal Property, Item 18, available online at the United States Courts website, Bankruptcy Forms webpage at http://www.uscourts.gov/formsandfees/forms/BankruptcyForms.aspx.
[12] 11 USC § 521(a)(1)(A)&(B), Fed R Bankr P 1007(b).
[13] 11 USC § 521(e)(2)(A)(i).
[14] 11 USC § 521(e)(2)(B).
[15] 11 USC § 521(f)(2).
[16] 11 USC § 1308(a).

extension, if later).[17] The Bankruptcy Court may extend the period for another 30 days after notice and hearing.[18] The debtor's failure to timely file required tax returns results in either dismissal of the Chapter 13 case or conversion to a Chapter 7 case.[19]

In addition, Chapter 7, 11, and 13 debtors must file all required post-petition tax returns with the IRS during the pendency of the bankruptcy case.[20] If the debtor fails to file a post-petition federal tax return (or request an extension to file) with the IRS when it becomes due, the IRS may request the Bankruptcy Court to convert or dismiss the case.[21]

§ 3.04 Filing the Petition and the Operation of the Automatic Stay

In general, the automatic stay operates to prevent a creditor from taking collection actions against the debtor or (non-exempt) property included in the bankruptcy estate for pre-petition debts.[22] The automatic stay enjoins the IRS from taking a variety of actions against the debtor, including: (1) levying on non-exempt property, (2) foreclosing a federal tax lien on non-exempt property, or seizing non-exempt assets to satisfy pre-petition tax debts. The automatic stay also enjoins the debtor from filing or continuing a pre-petition tax dispute in the United States Tax Court.[23] In such cases the debtor must file a motion requesting that the Bankruptcy Court lift the stay to permit the debtor to file a petition to commence or to continue a proceeding in the U.S. Tax Court.

However, the IRS is still permitted to take certain actions without violating the automatic stay. Under federal bankruptcy law, the automatic stay does not apply to: (1) an audit to determine tax liability; (2) a demand for tax returns; (3) the making of an assessment for any tax and issuance of a notice and demand for payment, including the imposition of a tax lien on non-exempt property as a result of that assessment.[24] However, any tax lien that would otherwise attach to property of the estate by reason of such an assessment must not take effect unless: (1) the tax is a debt of the debtor; (2) the underlying tax debt is nondischargeable bankruptcy debt; and (3) the property or its proceeds are transferred out of the bankruptcy estate to (or is otherwise revested in) the bankruptcy debtor.[25] In addition, the automatic stay does not apply to the IRS' right to intercept a pre-petition federal income tax refund to offset a pre-petition tax debt.[26] This is true even if the debtor's pre-petition tax account is in currently-not-collectible (CNC) status.[27] In cases where the pre-petition tax debt is disputed and the subject of a U.S. Tax Court proceeding, the IRS may hold the tax refund until the resolution of the

[17] 11 USC §§ 1308(b)(1)(A) & (b)(1)(B)(i).
[18] 11 USC §§ 1308(b)(2).
[19] 11 USC § 1307(e).
[20] 11 USC § 521(f)(1).
[21] 11 USC § 521(j)(1).
[22] See generally, 11 USC § 362(a). Post-BAPCPA, this general rule applies if the debtor is not a repeat filer. The debtor who had a prior bankruptcy case pending that was subsequently dismissed within one year of filing the current bankruptcy petition only receives a 30-day automatic stay. A debtor who had two or more subsequently dismissed bankruptcy cases pending within one year of filing the current bankruptcy petition receives no automatic stay at all, and must seek a stay from the Bankruptcy Court. 11 USC § 362(c)(3) & (4).
[23] 11 USC § 362(a)(8).
[24] 11 USC § 362(b)(9)(A)-(D); see also, 11 USC § 505.
[25] 11 USC § 362(b)(9)(D).
[26] 11 USC § 362(b)(26).
[27] See 26 USC § 6402(d)(1).

action unless the Bankruptcy Court grants adequate protection to the IRS' interest in its setoff claim.[28] It should be noted that the IRS, as any other creditor, may request the Bankruptcy Court to lift the automatic stay it if can show that there is, for example, inadequate protection of its claim, or to terminate an installment agreement or offer-in-compromise due to the debtor's noncompliance with the terms of the agreement or offer, and so on.[29]

§ 3.05 Classification and Priority of IRS Claims in Bankruptcy

The IRS may be a creditor holding claim(s) for (1) general, unsecured, pre-petition tax debt; (2) unsecured, priority pre-petition tax debt; and/or (3) secured pre-petition tax debt. The IRS must file a proof of claim for a pre-petition tax debt in the same manner as any other creditor involved in the bankruptcy case, although special rules apply to permit certain late-filed proofs of claim by taxing authorities under certain circumstances.[30] A claim for federal tax debt is a secured claim if the IRS has a lien against the debtor's property and filed a Notice of Lien prior to the commencement of the bankruptcy proceeding.[31] The following pre-petition unsecured tax debts are eighth priority unsecured claims against the bankruptcy estate: (1) taxes that were due within three years before the date of the bankruptcy petition (not including extensions of time to pay); (2) taxes that were assessed within 240 days of the bankruptcy filing; or (3) taxes that were not assessed before, but were assessable under applicable law after the bankruptcy filing, unless the taxes were still assessable because: (1) the taxpayer-debtor failed to file a tax return; (2) the taxpayer-debtor filed a late tax return within two years of the bankruptcy filing date; or (3) a fraudulent return was filed.[32] A general unsecured claim for federal tax debt is for any unsecured tax debt that is not entitled to any priority of payment status under federal bankruptcy law. In a Chapter 7 bankruptcy case, if there are assets to distribute at all, general unsecured claims are only paid in accordance with the claimant's pro rata interest in the remaining funds of the bankruptcy estate, after all secured claims and unsecured priority claims are paid first.[33]

As stated above, debtors are generally required to file post-petition tax returns with the IRS for the duration of the bankruptcy case as part of their compliance with federal bankruptcy law. The consumer debtor should pay post-petition federal income taxes to the IRS as they become due. Normally a Chapter 13 consumer debtor pays any post-petition federal income taxes outside the confirmed repayment plan. However, if the Chapter 13 debtor does not pay the post-petition taxes on time, the IRS may file an administrative expense claim for post-petition taxes or bring a motion to modify the confirmed plan to include the claim for post-petition taxes.[34] Claims for administrative expenses are highest priority unsecured claims, after domestic support obligations, and must be paid in

[28] 26 USC §§ 362(b)(26) & 506(a).
[29] 11 USC § 362(d)(1); see IRM 5.9.4.10, Offers In Compromise and Bankruptcy, IRM 5.9.4.18, Installment Agreements and Bankruptcy (both under IRM 5.9.4, Common Bankruptcy Issues).
[30] See 11 USC §§ 501, 502(a) & (b)(9), and Fed R Bankr P 3002(a) & (c)(1).
[31] See 26 USC §§ 6321-6323. To what extent the bankruptcy trustee may either subordinate a federal tax lien to other bankruptcy creditors' liens, or avoid a federal tax lien against bankruptcy estate property, is beyond the scope of this relatively brief article.
[32] See 11 USC §§ 507(a)(8), 523(a)(1)(B)&(C), and 1322(a)(2). The effect of extensions of time provided to the taxpayer and events causing tolling or suspension of the running of these time periods must also be taken into account when calculating whether these time periods have fully elapsed, for purposes of determining whether tax debt is eighth priority unsecured debt or is merely general unsecured debt.
[33] 11 USC § 726(a).
[34] 11 USC §§ 503(b)(1)(B)(i), 1305(a)(1) & 1329.

full under the terms of the Chapter 13 confirmed repayment plan.[35] Chapter 7 consumer debtors must pay post-petition federal income taxes as they become due since: (1) there is no mechanism by which post-petition taxes can be paid out of the Chapter 7 bankruptcy estate (which is liquidated to pay pre-petition debts of the bankruptcy estate); and (2) post-petition taxes are not dischargeable bankruptcy because the bankruptcy discharge only applies to pre-petition debts not otherwise excepted from discharge.[36]

§ 3.06 Dischargeability of Pre-Petition Federal Tax Debt in Bankruptcy

Of course, consumer debtors want to know to what extent, and under what circumstances, are their federal tax debts dischargeable in bankruptcy? The scope of the bankruptcy discharge generally depends on whether the consumer debtor filed a Chapter 7 or Chapter 13 bankruptcy petition and the nature of the debt, although the BAPCPA amendments have made more consistent the kind of bankruptcy discharge Chapter 7 and 13 debtors receive. The purpose of a bankruptcy discharge is to relieve the bankruptcy debtor of her pre-petition debts in order to provide the debtor with a "fresh start."[37] However, the following tax debts are not subject to the Chapter 7 bankruptcy discharge: (1) tax claims entitled to eighth priority status; (2) taxes for which no tax return was filed; (3) taxes for which a return was filed late and within two years before the bankruptcy petition was filed; (4) taxes filed under a fraudulent tax return; and (5) taxes the debtor willfully attempted to evade or defeat payment thereof.[38] Interest, fines and tax penalties in a Chapter 7 case are generally dischargeable unless the event that gave rise to the interest, fines and tax penalties occurred within three years of the bankruptcy filing and relate to nondischargeable federal tax debt.[39]

The rules for dischargeability of tax debts in a Chapter 13 bankruptcy case are similar to those in a Chapter 7 case. For Chapter 13 bankruptcy cases filed after October 16, 2005, excepted from the general Chapter 13 bankruptcy discharge are for the same "bad acts" as committed by the debtor in a Chapter 7 bankruptcy case (i.e., taxes for which no tax return was filed, taxes for which a return was filed late and within two years of the date of the bankruptcy petition filing, taxes filed under a fraudulent return, and taxes the debtor willfully attempted to evade or defeat payment).[40] However, because the Chapter 13 debtor's priority unsecured claims were included in the confirmed repayment plan, including eighth priority unsecured tax claims pursuant to 11 U.S.C. § 507(a)(8), eighth priority tax claims are generally discharged in bankruptcy so long as the Chapter 13 debtor complied with the terms of the repayment plan.[41] Even in cases where the Chapter 13 debtor has not completed payments under the plan but still receives a bankruptcy discharge, all of the exceptions to a Chapter 7 bankruptcy discharge still apply.[42] The post-BAPCPA amendments also provide that, for Chapter 13 bankruptcy cases filed

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[35] 11 USC §§ 507(a)(2) & 1322(a)(2).
[36] 11 USC § 727(b). Unlike the Chapter 7 debtor, the Chapter 13 debtor devotes a portion of his post-petition income to pay pre-petition debts (and post-petition administrative expenses of the bankruptcy estate) over the period of time specified by the confirmed repayment plan.
[37] See generally, 11 USC § 524(a).
[38] 11 USC § 523(a)(1)(A)-(C).
[39] 11 USC §§ 507(a)(8)(G) and 523(a)(7).
[40] 11 USC § 523(a)(1)(A)-(C). Before the enactment of BAPCPA, a Chapter 13 debtor enjoyed a much broader bankruptcy discharge than a Chapter 7 debtor, known as the "superdischarge." BAPCPA did away with this glaring discrepancy by making the bankruptcy discharge provisions for Chapter 7 and 13 debtors more consistent.
[41] 11 USC § 1328(a).
[42] 11 USC § 1328(c).

after October 17, 2005, excepted from discharge are all debts for which creditors did not receive sufficient notice of the Chapter 13 case to file a timely proof of claim against the bankruptcy estate.[43] For both Chapter 7 and 13 consumer debtors, excepted from discharge are debts incurred to pay otherwise nondischargeable tax debts.[44] However, if none of the exceptions to discharge apply to the Chapter 7 or 13 consumer debtor's pre-petition tax debts, then they are dischargeable in bankruptcy.

§ 3.07 Post-Bankruptcy Discharge and Federal Tax Liens

Last but not least, it should be kept in mind that, while eligible debts are discharged in bankruptcy, liens generally survive the bankruptcy discharge. The bankruptcy discharge only serves to discharge the debtor's personal liability for the debt. Assuming that the bankruptcy trustee did not remove a lien using his broad avoidance powers, the surviving lien would still attach to the pre-petition property of the debtor and permit the lienholder to enforce the lien against the attached property.[45] Unfortunately, many consumer debtors are under the mistaken impression that a Chapter 7 or 13 bankruptcy discharge will entitle them to a mortgage-free house or lien-free motor vehicle. Even worse for the consumer debtor, while other lienholders' liens typically attach to a specific piece of the debtor's property – for example, real estate securing a mortgage, or a motor vehicle as collateral to secure the purchase price – the federal tax lien statute specifically states that the tax lien attaches to "all property and rights to property, whether real or personal, belonging to such person."[46] The federal tax lien arises by operation of law, and once the lien has come into existence it attaches immediately to any property acquired by the taxpayer during the existence of the lien, including the taxpayer's after-acquired property.[47] Thus, the IRS has the power to enforce the surviving federal tax lien against any of the debtor's property that: (1) was subject to the tax lien, and (2) for which notice was filed prior to the date of the debtor's bankruptcy filing.[48]

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[43] 11 USC § 523(a)(3).
[44] 11 USC § 523(a)(14) (for example, using a credit card to pay a nondischargeable tax debt).
[45] Johnson v Home State Bank, 501 US 78 (1991) ("Thus, a bankruptcy discharge extinguishes only one mode of enforcing a claim -- an *in personam* action -- while leaving intact another -- an *in rem* action").
[46] 11 USC § 6321.
[47] IRM 5.17.2.5, Property to Which the Tax Lien Attaches, under IRM 5.17.2, Federal Tax Liens.
[48] See generally, Office of Chief Counsel Internal Revenue Service Memorandum No 200634012, IRS CCA 200634012, 2006 IRS CCA LEXIS 31 (June 23, 2006).

Elaine Hightower Gagliardi on Treasury Transforms the Portability Election: Making the DSUE Amount a Reliable Planning Tool

By Elaine Hightower Gagliardi*

§ 4.01 Introduction

With the issuance of temporary regulations, Treasury pulls back the cloak of uncertainty and reveals a portability election that proves to be relatively dependable and a useful planning tool. The temporary portability regulations,[1] issued June 15, 2012, remove the "now you see it, now you don't"[2] quality of the deceased spousal unused exclusion ("DSUE") amount as enacted by Congress. With a sleight of hand, Treasury rewrites the plain wording of the statute to eliminate uncertainty. The temporary regulations provide a clear path for avoiding loss of the DSUE amount on remarriage. The regulations allow donors to make gifts without fear of losing applicable exclusion amount, eliminate the possibility of the dreaded claw-back, and suggest the ability to use a QTIP election regardless of the value of decedent's assets. This article discusses the impact of the temporary portability regulations, specifically noting the corrections and additions made to the statute as enacted by Congress. It also analyzes the planning considerations following from these changes.

The goal of portability is to simplify estate planning for married couples. As enacted by Congress, however, the statute falls short in its intent to provide an effective means for couples to avoid the necessity of making pre-death transfers and of using a credit shelter trust in order to ensure full use of the applicable exclusion amount by both spouses.[3] The plain wording of the statute creates an ambiguity as to calculation of the DSUE amount, which in turn leads to a number of questions as to whether the surviving spouse may effectively use the DSUE amount. If the surviving spouse makes a taxable gift does the DSUE amount shelter the gift or does the applicable exclusion amount of the surviving spouse shelter the gift? Can the surviving spouse make gifts triggering payment of estate tax without reducing the surviving spouse's applicable exclusion amount? If the surviving spouse remarries after making gifts using the DSUE amount of the spouse from the prior marriage, can there be a claw back of transfer tax on the earlier gift? At what point does the surviving spouse become eligible to use the DSUE amount of a predeceased spouse? The temporary portability regulations answer each of these questions so as to allow the surviving spouse the ability to favorably plan for full use of the DSUE amount elected by the predeceased spouse's estate, even in the event of remarriage.

The only uncertainty remaining and irresolvable by the temporary regulations is the possibility that the portability election will sunset at the end of 2012.[4] Congress must act to extend the portability

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[1] Treas Dec 9593, 2012 IRB LEXIS 333 (June 15, 2012).

[2] See Elaine Hightower Gagliardi on The Deceased Spousal Unused Exclusion Amount: Now You See It, Now You Don't, 2012-03 Lexis® Federal Tax Journal Quarterly 2, § 2.01 *et seq*. (Matthew Bender).

[3] See Taxation of Wealth Transfers Within a Family: A Discussion of Selected Areas for Reform, JCX-23-08 at 10 (April 2, 2008).

[4] Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, PL 111-312, 124 Stat 3296 § 303 (Dec 17, 2010).

election for it to be available after December 31, 2012. Understandably the temporary regulations do not discuss the ability to use a DSUE amount after the sunset occurs. The temporary portability regulations apply to estates of decedents dying and gifts made after 2010 and in a year when the applicable exclusion amount is determined by aggregating the basic exclusion amount and any DSUE amount. They expire by their terms on June 15, 2015. The effective date provisions of the temporary portability regulations, thus, recognize the portability statute is slated to sunset as of 2013.[5]

§ 4.02 Changes in Calculation of the DSUE Amount Made by the Temporary Regulations

Congress set the groundwork to achieve the purposes of the portability election by defining applicable exclusion amount to include the aggregate of the basic exclusion amount and the DSUE amount.[6] The unused basic exclusion amount of the predeceased spouse upon election by that spouse's executor becomes portable for use by the surviving spouse in the form of a DSUE amount. Thus, a married couple need no longer worry about losing the ability to use the basic exclusion amount of a spouse in the event that the spouse does not own sufficient assets to fully use the applicable exclusion amount prior to that spouse's death. Also, spouses need no longer include a credit shelter trust as part of their estate plan to fully use the basic exclusion amount of the predeceased spouse, but instead may transfer assets outright to the surviving spouse, who in turn can apply the predeceased spouse's unused basic exclusion amount. In order to encourage a couple to create an estate plan in reliance on the portability election, the temporary regulations recognize the need to ensure the surviving spouse can use the DSUE amount with some certainty as to it availability, and consequently provide clarifying rules increasing reliability of the portability election.

[1] Technical Correction Made by the Portability Regulations

Treasury corrects the ambiguous definition of DSUE amount set forth in the statute. The statute limits the DSUE amount to the lesser of the "basic exclusion amount" or "the basic exclusion amount of the last ... deceased spouse of [the] surviving spouse" less the "amount with respect to which the tentative tax is determined...on the estate of such deceased spouse."[7] The reference to "basic exclusion amount" in both limitations makes the first reference superfluous and raises a myriad of questions with regard to ordering and ability to use the DSUE amount. In fact, the Joint Committee on Taxation acknowledges a drafting error on the part of Congress in an Errata indicating: "A technical correction may be necessary to replace the reference to the basic exclusion amount of the last deceased spouse of the surviving spouse with a reference to the applicable exclusion amount of such last deceased spouse, so that the statute reflects intent."[8] If enacted as had been anticipated, the first limitation would have had meaning and effect as the second limitation in a second marriage situation could have exceeded the basic exclusion amount.

The temporary regulations make the correction and define DSUE amount as "the unused portion of a decedent's applicable exclusion amount to the extent this amount does not exceed the basic

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[5] Temp Treas Regs §§ 20.2010-1T(e)(2011 date effective for sub-sections (a) - (c), and (d)(1)); 20.2010-2T(e); 20.2010-3T(f); 25.2505-1T(e); 25.2505-2T(g).
[6] IRC § 2010(c)(2).
[7] IRC § 2010(c)(4).
[8] Errata "General Explanation of Tax Legislation Enacted in the 111th Congress," JCS-2-11 (March 2011).

exclusion amount in effect in the year of the decedent's death."[9] The regulations ignore the wording of the statute and restate the determination of the DSUE amount generally as follows:

> [T]he DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts-
>
> (i) The basic exclusion amount in effect in the year of the death of the decedent; or
> (ii) The excess of-
>
> (A) The decedent's applicable exclusion amount; over
> (B) The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which together is the amount on which the tentative tax on the decedent's estate is determined under section 2001(b)(1).[10]

This new formulation of the DSUE amount essentially replaces the language of the statute as the Errata suggests.[11] It also clarifies the basic exclusion amount at issue as the one effective on date of death, and the determination of the amount on which the tentative tax is imposed as the aggregate of the taxable estate and adjusted taxable gifts. Interestingly, in restating the second limitation, the temporary regulations eliminate the reference to "the last such deceased spouse" but nevertheless interpret use of the DSUE amount by the surviving spouse in relation to the last deceased spouse.

> The preamble to the temporary regulations justifies making this correction:
> Treasury and the IRS have carefully considered this issue. … Based on the principle that a statute should not be construed in a manner that renders a provision of that statute superfluous and consistent with the indicia of legislative intent reflected in the Technical Explanation and the General Explanation, and in the exercise of the express authority granted by Congress in sections 2010(c)(6) and 7805, Treasury and the IRS have determined that the reference in section 2010(c)(4)(B)(i) to the basic exclusion amount is properly interpreted to mean the applicable exclusion amount. Thus, the temporary regulations adopt this interpretation.[12]

The correction makes it unnecessary to wait for Congress to provide a technical correction.

By adopting these changes, the temporary regulations give credence to the example initially provided in the Conference Report issued by the Joint Committee on Taxation, but not supported by the plain wording of the statute. The regulations now make sense of the example which demonstrates determination of the DSUE amount as follows:

> Hal dies in 2011, having made taxable transfers of $3 million and leaving no taxable estate. Hal's executor makes a portability election. As a result the applicable exclusion

[9] Temp Treas Reg § 20.2010-1T(d)(4).
[10] Temp. Treas. Reg. § 20.2010-2T(c)(1).
[11] IRC § 2010(c)(4)(B)(i). See Errata "General Explanation of Tax Legislation Enacted in the 111th Congress," JCS-2-11 (March 2011).
[12] Treas Dec 9593, 2012 IRB LEXIS 333 at 19-21.

amount of Hal's surviving spouse Sara equals $7 million, the aggregate of her 2011 $5 million basic exclusion amount plus $2 million DSUE amount from Hal's estate. Sara remarries, but makes no taxable transfers and dies in 2011 with a taxable estate of $3 million. Assuming a DSUE election is made by Sara's executor, Sara's second spouse obtains a DSUE amount of $4 million from Sara's estate equal to her unused exclusion amount of $4 million (which is less than the basic exclusion amount at her death), calculated by subtracting her $3 million taxable estate from her $7 million applicable exclusion amount.[13]

This example reflects the formulation of the DSUE amount as now provided by the portability regulations.

[2] Rules Added to Address Computation of Adjusted Taxable Gifts

In order to provide the stability needed to ensure use of the portability election, Treasury supplements the technical correction redefining the DSUE amount with rules that change the meaning of adjusted taxable gifts for purposes of determining the DSUE amount. Key to making the computation of the DSUE amount work as anticipated by the Joint Committee on Taxation is the following adjustment made by the portability regulations:

> Solely for purposes of computing the decedent's DSUE amount, the amount of the adjusted taxable gifts of the decedent ... is reduced by the amount, if any, on which gift taxes were paid for the calendar year of the gift(s)."[14]

Absent this change in the determination of adjusted taxable gifts, a taxable gift triggering payment of estate tax could cause a donor to lose the benefit of the applicable exclusion amount. This change ensures that to the extent decedent paid tax on adjusted taxable gifts, those gifts will not reduce the applicable exclusion amount for purposes of determining the DSUE amount.

The temporary regulations highlight the impact of this important adjustment to the calculation of adjusted taxable gifts for purposes of the DSUE amount with examples similar to the following:

> **Example A:** In 2002, Herb makes a taxable gift of $1 million. He has not previously made any taxable gifts. Herb reports the gift on a timely filed gift tax return, and pays no tax on the gift because it falls within the applicable exclusion amount and the tax is fully offset by the unified credit. Herb dies on September 29, 2011, survived by his spouse Stella. Both Herb and Stella are U.S. citizens and neither has previously married. Herb's taxable estate is $1,000,000. His executor timely files the estate tax return and elects portability because Herb's estate did not fully use his applicable exclusion amount, thus, allowing Stella to benefit from Herb's DSUE amount computed by his executor to be $3 million. The $3

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[13] See Technical Explanation of the Revenue Provisions Contained in the "Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010," Scheduled for Reconsideration by the United States Senate, JCX-55-10 at 53 (Dec. 10, 2010); General Explanation of Tax Legislation Enacted in the 111th Congress, JCS-2-11 at 555 (March 2011).

[14] Temp Treas Reg § 20.2010-2T(c)(2).

million DSUE amount is calculated as follows: The lesser of the $5 million basic exclusion amount in 2011, or the excess of Herb’s $5 million applicable exclusion amount less $1 million taxable estate and less $1 million adjusted taxable gifts, which equals $3 million.[15]

Example B: Assume the same facts as in Example A above, except that Herb makes a $2 million gift in 2002 (instead of a $1 million gift). As a result of this gift Herb owes tax on the amount of the gift exceeding the then $1 million applicable exclusion amount, and pays the tax. On Herb's death, the executor of his estate computes the DSUE amount to be $ 3,000,000, the same as in Example A. The $3 million DSUE amount is calculated as follows: the lesser of the $ 5,000,000 basic exclusion amount in 2011, or the excess of Herb’s $5,000,000 applicable exclusion amount less his $1,000,000 taxable estate and less only $ 1,000,000 of the adjusted taxable gifts. Herb's adjusted taxable gifts of $2,000,000 are reduced for purposes of this computation by $1,000,000, the amount of taxable gifts on which gift taxes were paid.[16]

Absent the special adjustment for adjusted taxable gifts on which the decedent paid tax, the DSUE amount elected by Herb’s estate would only be $2 million (instead of the $3 million it should be), with the portion of the $2 million transfer triggering payment of gift tax inadvertently using up applicable exclusion amount meant to shelter assets from transfer tax. Given the special adjustment to adjusted taxable gifts, the portability election now works as intended.

[3] QDOT Adjustments Added by the Portability Regulations

The portability regulations provide special rules for determining the DSUE amount when property passes to a qualified domestic trust or QDOT for the benefit of a surviving spouse who is not a U.S. citizen. The special portability rules acknowledge the fact that tax will continue to be paid on certain distributions from the QDOT to the surviving spouse following the decedent’s death. Adhering to the policy that the “DSUE amount first and foremost belongs to the decedent...,”[17] the adjustment for property passing to a QDOT requires that the DSUE amount be redetermined “upon the occurrence of the final distribution or other event (generally the death of the surviving spouse or the earlier termination of all QDOTs for that surviving spouse) on which estate tax is imposed….”[18] Thus, the DSUE amount of the decedent remains to offset transfers from the QDOT trust subject to estate tax under I.R.C. Section 2056A. When property passes to a QDOT, decedent’s executor preliminarily computes the DSUE amount, with that amount being redetermined to reflect an appropriate reduction in the DSUE amount upon final distribution or other taxable event triggering estate tax under I.R.C. 2056A.[19] Consequently, the surviving spouse, who is beneficiary of a QDOT, may not use the DSUE amount until the final estate tax liability of the decedent pursuant to I.R.C. § 2056A comes due.[20] The preamble to the temporary regulations acknowledges that after reviewing proposals for determining the DSUE amount when a QDOT trust receives property from decedent’s estate, “[e]ach of the proposals raises

[15] See Temp Treas Reg § 20.2010-2T(c)(2), (c)(5) example 1.
[16] See Temp Treas Reg § 20.2010-2T(c)(2), (c)(5) example 2.
[17] Treas Dec 9593, 2012 IRB LEXIS 333 at 35.
[18] Temp Treas Reg § 20.2010-2T(c)(4).
[19] Temp Treas Reg § 20.2010-2T(c)(4).
[20] Temp Treas Reg § 20.2010-3T(c)(2).

issues of fairness, complexity, and administrability."[21] Treasury asks for further comment regarding the proposal chosen.

Given the limitations on using the DSUE amount when a QDOT is use, consideration should be given to using a traditional credit shelter-marital deduction plan to ensure immediate use of the decedent's applicable exclusion amount. Assuming the decedent owns assets less than the applicable exclusion amount available to the decedent's estate, use of a credit shelter trust avoids the more complicated reporting and redetermination of tax required with a QDOT. Likewise, if decedent owns assets in excess of the applicable exclusion amount, full use of the decedent's applicable exclusion amount by placing assets in a credit shelter trust protects the later appreciation of those assets from thereafter triggering estate tax on distribution to the surviving spouse from the QDOT.

[4] Interaction of the DSUE Amount with Other Estate Tax Credits

The portability regulations indicate that additional guidance is expected to address the interaction of the portability election with estate tax credits such as the tax on prior transfers credit. The preamble to the temporary regulations states: "The issue of the impact of the credits in sections 2013 to 2015 on computing the DSUE amount merits further consideration. The temporary regulations reserve [space] to provide future guidance on this issue."[22] The regulations do not provide any specific suggestion as to how future regulations might address this issue.

§ 4.03 Ability of the Surviving Spouse to Use the DSUE Amount

Just as changes prove necessary to clarify calculation of the DSUE amount available for use by the surviving spouse upon a valid portability election, further changes are required to protect the basic exclusion amount of the surviving spouse and to ensure against a clawback of gift tax in the event a surviving spouse makes a gift using the DSUE amount of a predeceased spouse. In response, the temporary portability regulations add an anti-clawback rule and an ordering rule.

Absent the addition of these rules, the "last deceased spouse" requirement of the statute as enacted raises the possibility that a DSUE amount previously available for use by the surviving spouse could vanish. Disappearance of the DSUE amount could lead to unexpected recovery or clawback of gift tax on a later transfer because the formula for calculating gift and estate tax requires determination of transfer tax based on aggregate lifetime transfers. Thus, a transfer previously sheltered by a formerly available DSUE amount would be added to determine later gifts, but the DSUE amount would no longer be available, and as a result the tax earlier sheltered by the DSUE amount would be clawed back in the calculation of the later gift tax. The anti-claw back rule of the temporary regulations prevents this from occurring. An additional ordering rule further protects the surviving spouse's basic exclusion amount by directing that an available DSUE amount is used first.

[1] The Last Deceased Spouse Requirement

The ability of the surviving spouse to use the DSUE amount of a predeceased spouse depends on whether the predeceased spouse is the surviving spouse's "last deceased spouse." The surviving

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[21] Treas Dec 9593, 2012 IRB LEXIS 333 at 35.
[22] Treas Dec 9593, 2012 IRB LEXIS 333 at 21.

spouse may only use the DSUE amount of a predeceased spouse if the DSUE amount is that of the "last deceased spouse" of the surviving spouse.[23] Remarriage by a surviving spouse may change the identity of the last deceased spouse.

The regulations define "last deceased spouse" as "the most recently deceased individual who, at that individual's death after December 31, 2010, was married to the surviving spouse."[24] The definition clarifies that remarriage in and of itself by the surviving spouse does not impact the identity of the "last deceased spouse." Only if, upon remarriage by the surviving spouse, the subsequent spouse dies does the identity of the last deceased spouse change in relation to the surviving spouse.[25] Also, if upon remarriage by the surviving spouse, the surviving spouse thereafter divorces, the temporary portability regulations explain that death of the divorced spouse will not impact the identity of the "last deceased spouse."[26]

The last deceased spouse limitation requires a surviving spouse on remarriage to affirmatively plan in order to ensure full use the DSUE amount from the estate of a former spouse. If a spouse remarries and does not fully use the DSUE amount of a former deceased spouse, that DSUE amount could be lost on the death of a subsequent spouse.

[2] The Anti-Clawback Rule

In the event of remarriage, the temporary portability regulations allow a surviving spouse to use the DSUE amount of a predeceased spouse by making a gift without fear of a later clawback or a loss of the surviving spouse's basic exclusion amount. The plain wording of the statute as enacted does not specifically address the issue of gifts by the surviving spouse on remarriage, but the regulations provide a special anti-clawback rule to allow for such planning. In the event that a surviving spouse applies the DSUE amount of one or more predeceased spouses to taxable gifts, the applicable exclusion amount of the surviving spouse as of death is increased by the amount so applied even if the identity of the last deceased spouse changes in the interim between making the taxable gift and the surviving spouse's death.[27] An ordering rule also applies so that the DSUE amount of the last deceased spouse is first applied toward sheltering any taxable gift made by the surviving spouse.[28] Similar rules apply in determining the applicable exclusion amount of the surviving spouse for purposes of subsequent taxable gifts by the surviving spouse.

The anti-clawback rule of the temporary portability regulations specifically provides that the surviving spouse's applicable exclusion at death or as of the date of a taxable gift is the surviving spouse's basic exclusion amount supplemented by a DSUE amount equal to the aggregate of the following two amounts:

(1) the DSUE amount of the surviving spouse's last deceased spouse; and,

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[23] Temp Treas Reg § 20.2010-3T(a)(1); Temp Treas Reg § 25.2505-2T(a)(1).
[24] Temp Treas Reg § 20.2010-1T(d)(5).
[25] Temp Treas Reg § 20.2010-3T(a)(3); Temp Treas Reg § 25.2505-2T(a)(3).
[26] Temp Treas Reg § 20.2010-3T(a)(3); Temp Treas Reg § 25.2505-2T(a)(3).
[27] Temp Treas Reg § 20.2010-3T(b)(1); Temp Treas Reg § 25.2505-2T(c)(1).
[28] Temp Treas Reg. § 25.2505-2T(b).

(2) "[t]he DSUE amount of each other deceased spouse of the surviving spouse, to the extent that such amount was applied to one or more taxable gifts of the surviving spouse."[29]

This anti-clawback rule ensures the ability of a surviving spouse to effectively plan for full use of the DSUE amount elected by the estate of each spouse to whom the surviving spouse is married during his or her lifetime, and not just the DSUE amount of the last deceased spouse.

In its quest to make the portability election useable, Treasury essentially eliminates the last deceased spouse restriction for those surviving spouses who remarry and are willing to make gifts in an amount necessary to use the available DSUE amount. The impediment to making such a transfer rests in the fact that by making the gift the surviving spouse loses the ability to continue to use the gifted property. If the surviving spouse is concerned about not having sufficient funds upon making the gift, the surviving spouse should consider creation of an irrevocable trust not subject to creditor claims with terms allowing, but not requiring an unrelated trustee, to make distributions in the trustee's complete discretion to the surviving spouse. Such a transfer has been determined by the Service to be a completed gift[30] and not subject to estate tax in the grantor's estate.[31] The surviving spouse, however, makes such a gift at the expense of losing any control over the transferred property. Nevertheless, the trust terms allow the trustee to make distributions to the surviving spouse in the trustee's discretion.

Exceptions to the availability of the DSUE amount on the death of the predeceased spouse exist if (1) the executor of the decedent's estate supersedes the portability election by timely filing a subsequent estate tax return indicating it does not make a portability election; (2) the DSUE amount subsequently is reduced by a valuation adjustment or the correction of an error in calculation; or (3) the surviving spouse cannot substantiate the DSUE amount claimed on the surviving spouse's return.[32] This last exception places the burden for proving the DSUE amount on the surviving spouse, and suggests that documentation of value should be attached to the predeceased spouse's return to the extent feasible. In light of the uncertainty with respect to value of the DSUE amount, in making a gift for the purpose of fully using a former deceased spouse's DSUE amount consideration also should be given to using a defined value formula clause similar to those used in making gifts of family limited partnership interests so that if the DSUE amount is changed, the amount of any gift by the surviving spouse likewise changes.[33]

[3] The Ordering Rule

The temporary portability regulations clarify that any DSUE amount available to a surviving spouse will first be applied to any transfer made by that surviving spouse.[34] This ordering rule preserves the basic exclusion amount of the surviving spouse until such time as the surviving spouse fully exhausts any available DSUE amount. It is also necessary for the effective functioning of the anti-clawback rule. The plain wording of the statute as enacted by Congress neglects to clarify whether a gift by a surviving spouse uses an available DSUE amount first, last or proportionately. Treasury's choice of ordering rule

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[29] Temp Treas Reg § 20.2010-3T(b)(1); Temp Treas Reg § 25.2505-2T(c)(1).
[30] Treas Reg § 25.2511-2(b).
[31] PLR 200944002 (July 15, 2009).
[32] Temp Treas Reg § 20.2010-3T(c)(1).
[33] Wandry v Commr, TC Memo 2012-88 (Tax Court in a memorandum decisions approves use of a defined value formula clause even in the absence of a charitable beneficiary to take the spillover in the event of an increase in value).
[34] Temp Treas Reg § 25.2505-2T(b).

encourages use of the portability election. Without such a rule, the calculation of the DSUE amount, and as a result, the applicable exclusion amount of the surviving spouse, would either remain uncertain or make the ability to use the DSUE amount uncertain, both of which results would be opposed to the efforts of Treasury to make the portability election useable and reliable.

The regulations include the following explanatory example of the interaction of the anti-clawback and ordering rules:

> **Example:** Henry, Sally's first husband, passed away on January 15, 2011, survived by Sally. Neither Henry nor Sally made any taxable gifts during Henry's life. Henry's executor elects portability of his DSUE amount, and computes Henry's DSUE amount on the estate tax return as $5,000,000. On December 31, 2011, Sally makes taxable gifts to her children valued at $2,000,000, and reports those gifts on a timely-filed gift tax return. Sally is considered under the regulations to have applied $2,000,000 of Henry's DSUE amount to the taxable gift as reported, and no gift tax is owed. After the gift, Sally has a remaining applicable exclusion amount of $8,000,000 ($3,000,000 of Henry's remaining DSUE amount plus Sally's own $ 5,000,000 basic exclusion amount because the ordering rules deem Henry's DSUE amount to be used first by Sally). After Henry's death, Sally remarries Robert II. Sally and Robert's marriage is short lived, and Robert II dies in June 2012. Robert's executor elects portability of Robert II's DSUE amount of $2,000,000 as computed on Robert II's estate tax return. Sally then dies in October of 2012. Sally's applicable exclusion amount as of her death is $9,120,000, which equals Sally's basic exclusion amount of $5,120,000 plus an aggregate DSUE amount equal to the $2,000,000 DSUE amount of Robert II, her last deceased spouse, and the $2,000,000 DSUE amount of Henry that was applied by Sally to her 2011 taxable gifts.[35] The regulations further clarify that if Sally wanted to make an additional taxable gift after Robert II's death and prior to her own death, that following Robert II's death, she would be able to use the $9,120,000 applicable exclusion amount as calculated above.[36]

This example demonstrates the importance of the ordering and anti-clawback rules. The special anti-clawback rule, in conjunction with the ordering rule, allows more certainty in using the DSUE amount in a client's estate plan.[37] Without these rules clarifying application of the statutory language as passed by Congress, it would not be possible to plan with any certainty for use of the DSUE amount. These rules allow the surviving spouse to avoid any issue of loss of the surviving spouse's applicable exclusion amount on remarriage by offering the surviving spouse the opportunity to make a taxable gift using the predeceased spouse's DSUE amount without concern that a tax could later be "clawed-back" due to a reduction in the applicable exclusion amount on a later transfer by the surviving spouse.

[4] Time When a DSUE Amount May Be Used

The temporary portability regulations clarify that the surviving spouse generally may use the DSUE amount of a predeceased spouse as of the date of death of that spouse without the necessity of

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[35] Temp Treas Reg § 20.2010-3T(b)(2). (The example indicates Sally's applicable exclusion amount is only $9,000,000, but that amount does not take into account the inflation indexing of the 2011 basic exclusion amount to yield a 2012 basic exclusion amount of $5,120,000.) See also, Temp Treas Reg § 25.2505-2T(c)(2).
[36] Temp Treas Reg § 25.25050-2T(c)(2).
[37] Temp Treas Reg § 20.2010-3T(b); Temp Treas Reg § 25.2505-2T(b).

waiting until the predeceased spouse's estate makes a portability election.[38] The regulations state as a general rule that the predeceased spouse's DSUE amount increases the surviving spouse's applicable exclusion amount and applies to transfers after the death of the predeceased spouse.[39] The regulations, however, provide for specific exceptions to this rule as previously noted with respect to use of a QDOT, and in the event the portability election is not made, its value is adjusted by the Service, or the surviving spouse is unable to substantiate its amount.[40]

§ 4.04 Requirements of the Portability Election

In order for a surviving spouse to use the DSUE amount of a predeceased spouse, the estate of a predeceased spouse must make a portability election. An effective portability election requires the estate of the predeceased spouse to comply with the following:

(1) The predeceased spouse's executor must timely file a federal estate tax return.
(2) The federal estate tax return must be complete and properly-prepared pursuant to regulations.
(3) At such time as required by Instructions to Form 706, the estate tax return must include a calculation of the DSUE amount.

The temporary portability regulations make clear that the portability election is available only to a U.S. citizen or resident decedent. A nonresident alien's estate may not make the election.[41]

[1] Estate Tax Return Filing Requirement

In order to preserve a decedent's unused exclusion amount for use by that decedent's surviving spouse or the surviving spouse's estate, the decedent's estate must timely file an estate tax return.[42] An estate tax return is required to make the portability election even if such a return would not otherwise be required because decedent's assets do not exceed the filing requirement. Recognizing that the Code does not provide any filing deadline for estates not required to file, the temporary portability regulations fill this gap by coordinating the time for filing the return by those estates that would not otherwise be required to file with the date applicable to those estates required to file a return. The time for filing the return required to make the portability election, thus, is the date nine months from the date of decedent's death, or if an extension is obtained, the last day for timely filing under the extension.[43]

Other than timely filing a complete and properly prepared estate tax return calculating the DSUE amount, nothing more need be done to make the portability election.[44] No box need be checked. No notice need be given the surviving spouse's estate. The choice by Treasury to make the election automatic upon timely filing of the estate tax return reflects Treasury's attempt to make the election as uncomplicated as possible based on the assumption that most decedents' estates will want to make the election.

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[38] Temp Treas Reg § 20.2010-3T(c)(2).
[39] Temp Treas Reg § 20.2010-3T(c)(1).
[40] Temp Treas Reg § 20.2010-2T(c)(4); Temp Treas Reg § 20.2010-3T(c)(1).
[41] Temp Treas Reg § 20.2010-2T(a)(5); Temp Treas Reg § 25.25050-2T(f).
[42] IRC §2010(c)(5); Temp Treas Reg § 20.2010-2T(a).
[43] Temp Treas Reg § 20.2010-2T(a)(1).
[44] IRC §2010(c)(5); Temp Treas Reg § 20.2010-2T(a).

Special provision is made for certain estates of decedent's dying in the first half of 2011. Estates of 2011 decedents, who die prior to July 1, survived by a spouse, and with an estate not exceeding the $5 million basic exclusion amount, may file the estate tax return without incurring a late filing penalty so long as the return is filed within 15 months of decedent's date of death accompanied by a Form 4768 requesting an extension of time to file.[45] The Service essentially eliminates the need to timely obtain an extension, and simply grants an extension to all qualifying estates provided the Form 4768 accompanies the return when filed within the 15 month period. The Service gives the reason for this exception: "[C]ommentators noted that the executors of estates of decedents dying in 2011, particularly during the early part of 2011, did not have the benefit of guidance on electing portability of the decedent's DSUE amount and, further, that executors of estates having assets with a value not in excess of $5,000,000 might not have known about the requirement to file Form 706 to make the portability election at all."[46]

[2] Person Entitled to Make Portability Election

The "executor" makes the portability election.[47] The simplicity of this rule belies its complexity. The term executor may include an executor appointed by a court or a beneficiary of decedent's assets. Recognizing the need to provide clarity, the temporary portability regulations address the possibility of multiple elections, and set forth an order of priority. Prioritizing who is finally deemed to make the election proves important because the portability election becomes irrevocable as of the due date for filing the return, including extensions, and up until that time a prior election may be superseded.[48] The last timely filed return controls whether or not a portability election has been made.[49]

For purposes of the portability election, treasury regulations categorize persons who may file as an executor into two categories: (1) appointed executors, and (2) non-appointed executors. An appointed executor is one appointed by a court, and an appointed executor has priority over a non-appointed executor. An appointed executor may file a portability election or may elect not to make the portability election.[50] In contrast, a non-appointed executor is one who is in "actual or constructive possession" of decedent's property if "there is no appointed executor."[51] A non-appointed executor may also make a portability election or elect not to make the election, however, once the portability election is made by a non-appointed executor, it "cannot be superseded by a contrary election made by another non-appointed executor of that same decedent's estate (unless such other non-appointed executor is the successor of the non-appointed executor who made the election)."[52] This implies that a later appointed executor, prior to the due date of the return, including extension, may supercede the election of a non-appointed executor.

If any concern exists regarding multiple elections on the part of the person entitled to be appointed executor pursuant to state law, that person should apply for appointment as executor of decedent's estate by an appropriate court. Once appointed no one else may make the decision as to

[45] Notice 2012-1, 2012-10 IRB 450.
[46] *Id*.
[47] IRC § 2010(c)(5)(A). See IRC § 2203; Treas Reg § 20.2203-1.
[48] Temp Treas Reg § 20.2010-2T(a)(4).
[49] Treas Dec 9593, 2012 IRB LEXIS 333; Temp Treas Reg § 20.2010-2T(a)(4).
[50] Temp Treas Reg § 20.2010-2T(a)(6)(i).
[51] Temp Treas Reg § 20.2010-2T(a)(6)(ii).
[52] *Id*.

whether to make the portability election because a non-appointed executor by definition can act only when there is no appointed executor. As between potential non-appointed executors the regulations also indicate the first one to file gets to control whether or not a portability election is made, so timing for a non-appointed executor is key. If a person in receipt of decedent's property wishes to control the decision to make a portability election in absence of a formal court appointment, the regulations indicate that person needs to be the first to file.

[3] Choosing Not to Make the Portability Election

If an estate not otherwise required to file decides against making the portability election, the estate simply should not file any return.[53] If on the other hand, an estate must file a return, but does not want to make the portability election, the return should so indicate. Specifically the executor must state either on a statement attached to the return or at the top of the first page of the return: "[T]he estate is not electing portability under section 2010(c)(5)."[54] Although the bulk of estates would want to make the portability election to preserve the decedent's unused applicable exclusion amount, some would not.

An estate may choose not to make a portability election in order to limit the ability of the Service to audit the decedent's estate tax return to the applicable period of limitations. If a portability election is made, the Service may "examine a return of the deceased spouse to make determinations with respect to" the DSUE amount available to the surviving spouse even after the period of limitations has expired.[55] Upon examination, the Service may decrease or eliminate the DSUE amount available to the surviving spouse.[56] It, however, may not assess additional tax on the estate of the predeceased spouse if the statute of limitations for redetermination of tax has run on the predeceased spouse's return.[57] In order to foreclose the opportunity of the Service to audit the predeceased spouse's estate tax return for purposes of determining the DSUE amount available to a surviving spouse, a portability election should not be made.

An estate which includes hard to value assets, especially when a discount or other valuation adjustment is taken, should carefully consider whether drafting to use a credit shelter/marital deduction plan or a partial QTIP election is preferable to making the portability election. Use of a formula marital deduction typically results in a zero estate tax even on revaluation of assets. As a consequence, it is unlikely the Service would choose to audit a return if revaluation would not increase estate tax owed. By fully funding the credit shelter trust, a portability election becomes unnecessary and the likelihood of the Service auditing the predeceased spouse's return remains exceedingly low. To the extent of the decedent's basic exclusion amount discount planning in this situation likely would escape the scrutiny of the Service if the surviving spouse lived beyond the period of limitations applicable to the predeceased spouse's return. Use of a credit shelter trust also provides the added advantage of sheltering appreciation occurring after the decedent's death from taxation in the surviving spouse's estate that would occur if a portability election had been made, and allows full use of a predeceased spouse's unused generation skipping tax exemption as portability does not apply to the GST exemption.

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[53] Temp Treas Reg § 20.2010-2T(a)(3)(ii).
[54] Temp Treas Reg § 20.2010-2T(a)(3)(i).
[55] IRC § 2010(c)(5)(B).
[56] Temp Treas Reg § 20.2010-3T(d); Temp Treas Reg § 25.2505-2T(e).
[57] *Id*.

An estate that would not otherwise be required to file an estate tax return may choose not to make the portability election in order to avoid the added costs and fees of preparing a return. This would likely be the choice if the couple anticipates their combined estate would never exceed twice the basic exclusion amount available to the couple. Given uncertainty as to whether the basic exclusion amount will in fact remain at $5 million or at such time when Congress acts (or does not act) will be reduced, couples whose combined assets will likely exceed the $1 million applicable exclusion amount for 2013 in the event Congress fails to extend the 2010 amendments, should strongly consider making the portability election if one of the spouses dies in 2012. The temporary portability regulations provide some relief as to valuation costs for estates that would not otherwise be required to file an estate tax return.

[4] Complete and Properly Prepared Return Requirement

An effective portability election not only requires timely filing of an estate tax return after taking into account extensions granted, it also requires the return be "complete and properly-prepared."[58] Subject to an exception in the event of certain marital and charitable deductions, the temporary portability regulations indicate a return meets this standard only if it complies with the Instructions to the Form 706 for preparation of an estate tax return.[59] As a result, unless the exception applies, the estate must report and value each asset.

A special reporting exception, however, applies to estates that would not otherwise be required to file a return but for the decision to make a portability election.[60] Those estates may take advantage of relaxed reporting requirements for certain property passing pursuant to a marital or charitable deduction. Specifically, those estates may file the estate tax return without obtaining sometimes costly date of death appraisals for property passing pursuant to the marital deduction or the charitable deduction provided that none of the following four circumstances exist:[61]

(1) The value of the property subject to the marital or charitable deduction "affects, or is needed to determine, the value passing from the decedent to another recipient."[62]

(2) The value of the property subject to the marital or charitable deduction is needed in order to determine eligibility for alternate valuation, special use valuation, or payment of estate tax in installments on closely held business interests pursuant to IRC Section 6166.[63]

(3) Less than the entire value of a property interest includible in the gross estate is subject to the marital or charitable deduction.[64]

[58] Temp Treas. Reg. § 20.2010-2T(a)(2); Temp Treas Reg § 20.2010-2T(a)(7)(i).

[59] Temp Treas Reg §20.2010-2T(a)(7)(i) citing compliance with Treas Reg §§ 20.6018-2, 20.6018-3, 20.6018-4.

[60] Temp Treas Reg §20.2010-2T(a)(7)(ii). It should be noted that the temporary regulations, § 20.2010-2T(a)(7)(ii)(A) specifically applies the special reporting rule to "estates in which the executor is not required to file an estate tax return under section 6018(a)." Under IRC § 6018(a) estates not required to file are those that do not exceed "the *basic exclusion* amount in effect … for … date of death" reduced by adjusted taxable gifts and any "aggregate amount allowed as a specific exemption under section 2521[prior to its repeal]." The examples provided by the temporary, however, apply the special reporting rule to those estates not exceeding "the excess of the *applicable exclusion* amount for the year of his death over the total amount of H's adjusted taxable gifts and any specific exemption under section 2521." Temp Treas Reg § 20.2010-2T(a)(7)(ii)(C). Thus, there is an ambiguity with respect to the application of the special reporting rule.

[61] Temp Treas Reg § 20.2010-2T(a)(7)(i).

[62] Temp Treas Reg § 20.2010-2T(a)(7)(ii)(A).

[63] *Id*.

(4) "A partial disclaimer or partial qualified terminable interest property (QTIP) election is made with respect to a bequest, devise, or transfer of property includible in the gross estate, part of which is marital deduction property or charitable deduction property..."[65]

If the estate qualifies for the special exception allowing it to file a complete and properly-prepared return without valuing the assets passing pursuant to the marital or charitable deduction, then for each asset the estate need report only the property description, ownership, and/or beneficiary, and all other information necessary to establish allowance of the marital or charitable deduction with respect to the property.[66] In lieu of appraisals, the executor need only provide an estimate of the value of the total gross estate rounded to the nearest $250,000 in accordance with return instructions.[67] In making the estimate of value, the executor must exercise due diligence to make its best estimate of the value of the total gross estate.[68]

The following example illustrates the parameters for filing a complete and properly-prepared return:

> **Example:** Holly dies in 2011, and is survived by her spouse Wyatt. Both are United States citizens. Holly's gross estate does not exceed the excess of the applicable exclusion amount for the year of her death over the total amount of adjusted taxable gifts and any specific exemption under section 2521, in other words her estate would fall within the requirements for applicability of the special reporting rule.[69] Holly's uncontested will passes her entire estate to a QTIP trust for Wyatt's benefit. In addition to probate assets passing to the QTIP trust, Holly's gross estate includes a life insurance policy payable to her children of a prior marriage. Holly's executor files the estate tax return identifying all assets included in the gross estate on the proper schedule, but does not include the date of death value of assets passing to the QTIP trust. The executor makes a QTIP election and attaches Holly's will to the return. The return, thus, describes each asset and its ownership to establish the estate's entitlement to the marital deduction. The life insurance policy payable to children is reported on the return as generally required with a Form 712 establishing fair market value. Holly's executor exercises due diligence to arrive at a best estimate of the fair market value of the total gross estate, and certifies the amount on the return. Holly's executor has filed a complete and properly-prepared return, and has elected portability.[70]

Further examples provided by the Service stress that in the event a decedent's estate makes a partial QTIP election, the estate will not be able to take advantage of the special exception allowing the estate to save the cost of valuing the assets as of date of death.[71] Also, in the event a decedent's estate uses a formula clause to divide decedent's assets as between a QTIP trust and a credit shelter trust or other recipient, the estate will not be able to take advantage of the special exemption and thereby avoid

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[64] *Id*.
[65] *Id*.
[66] *Id*.
[67] Temp Treas Reg § 20.2010-2T(a)(7)(ii)(B).
[68] *Id*.
[69] Temp Treas Reg § 20.2010-2T(a)(7)(ii)(C) suggests that the applicable exclusion amount, as opposed to the basic exclusion amount, should be the beginning point for applying the special reporting rule. But see, Temp Treas Reg § 20.2010-2T(a)(7)(ii)(A).
[70] Temp Treas Reg § 20.2010-2T(a)(7)(ii)(C) example 2.
[71] Temp Treas Reg § 20.2010-2T(a)(7)(ii)(C) example 2(iii).

reporting the date of death value of the assets.[72] This results because the value of the property passing to the marital trust relates to or affects the value passing to the credit shelter trust or other beneficiary.[73]

An estate should carefully consider the appropriateness of not obtaining a date of death appraisal of certain assets. For example, it would be important to obtain an appraisal for depreciable property passing on decedent's death. Pursuant to I.R.C. Section 1014 property receives a step up in basis at date of death, and the increased depreciation deductions for purposes of income tax can be very valuable. Also, if it is anticipated it will be difficult to later obtain a date of death value of assets passing to the surviving spouse, the estate should consider obtaining a current appraisal because the temporary portability regulations place the burden for substantiating the DSUE amount on the surviving spouse's estate.[74]

§ 4.05 Planning for Portability with a QTIP Trust

The temporary portability regulations provide welcomed examples that appear to confirm the ability to use a QTIP trust in conjunction with a portability election even when an estate would not otherwise need to make a QTIP election in order to avoid estate tax because the assets of the decedent do not exceed the basic exclusion amount available to shelter assets at death.[75] Revenue Procedure 2001-38[76], issued many years prior to the advent of the portability election, initially raised an issue as to whether it was possible for an estate to make a QTIP election if it would not otherwise incur estate tax. The revenue procedure indicates that to the extent a QTIP election is unnecessary to avoid payment of estate tax it is null and void if the decedent's assets do not exceed the available applicable exclusion amount. This ruling was a taxpayer friendly ruling at the time it was issued allowing estates to avoid inclusion of QTIP assets in the survivor's gross estate if a QTIP election was inadvertently made in the predeceased spouse's estate under certain circumstances. The ruling does not apply if estate assets exceed the applicable exclusion amount and a partial QTIP election is unnecessarily made or a formula marital deduction clause is used.[77] The example in the temporary portability regulations appropriately indicates that taxable and non-taxable estates will be able to take advantage of QTIP trusts in conjunction with a portability election on the same footing. Application of the revenue procedure by the Service in a manner that would preclude a nontaxable estate from taking advantage of the QTIP election makes little sense as it would put those estates to a difficult choice.

A QTIP trust provides flexibility to determine at decedent's death whether or not to make a portability election. If a decedent's estate plan passes decedent's assets to a QTIP trust, the executor may choose whether or not to make the QTIP election for all assets or for only a portion of the assets held by the trust.[78] To the extent the executor makes a partial QTIP election, the assets in the QTIP trust for which a QTIP election is not made will typically be sheltered by the applicable exclusion amount, which if fully used, negates the need for a portability election. On the other hand, to the extent that the executor makes the QTIP election and the decedent's applicable exclusion amount is not fully used, the executor likely would make a portability election. Just as QTIP trusts have always provided flexibility

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[72] Temp Treas Reg § 20.2010-2T(a)(7)(ii)(C) example 3.
[73] *Id*.
[74] Temp Treas Reg § 20.2010-3T(c)(1).
[75] Temp Treas Reg § 20.2010-2T(a)(7)(ii)(C) example 2. See also Temp Treas Reg § 20.2010-2T(a)(7)(ii)(A)(4).
[76] Rev Proc 2001-38, 2001-2 CB 124.
[77] *Id*.
[78] Treas Reg § 20.2056(b)-7(b)(2)(i).

to make post mortem planning decisions as to use of the unified credit, they do so again with regard to the portability election.

For couples who have children from prior marriages, the QTIP trust proves an invaluable estate planning tool if the couple wishes to obtain a marital deduction and at the same time ensure that on the death of the surviving spouse the remaining assets held in trust will pass to the transferor spouse's descendants or as the transferor otherwise chooses. For the same reason, it proves an important planning tool for a couple concerned that the surviving spouse will later remarry. Absent the interpretation provided in the temporary portability regulations acknowledging that a QTIP trust can be used to allow a nontaxable estate to make a portability election, the QTIP trust would not be a clearly viable option for clients who wish to use a QTIP trust when the decedent's assets do not exceed the available applicable exclusion amount given the holding of Revenue Procedure 2001-38.[79] Without the QTIP option as provided in the temporary regulations, a credit shelter trust would be the remaining option for client's with assets less than the applicable exclusion amount who wish to ultimately protect assets for distribution to descendants on the death of the surviving spouse.

The QTIP trust allows the added advantage of an additional step up in basis for appreciation occurring from the date of death of the predeceased spouse to the date of death of the surviving spouse.[80] The ability to obtain the step up in basis as of the surviving spouse's death encourages use of the QTIP trust as opposed to a credit shelter trust for those client's who anticipate the couple's assets will not exceed the applicable exclusion amount available, including the DSUE amount, as of the survivor's death. For couples that can fully shelter assets of both spouse's by use of the applicable exclusion amount, the QTIP trust will provide an added income tax advantage of the step up in basis with no offsetting estate tax cost. If client's anticipate combined assets will result in a taxable estate on the death of the survivor after taking anticipated appreciation into account, client's likely would be better off choosing to use a credit shelter trust or making a partial QTIP election as opposed to making the portability election in order to avoid payment of estate tax on appreciation of the sheltered assets as of the survivor's death. The trade off, of course, is the income tax benefits of a step up in basis on the appreciation as balanced against an increase in estate tax.

In addition, couples who wish to make generation skipping transfers should consider the importance of being able to fully use the GST exemption available to both spouses. A QTIP trust may provide advantages for achieving generation skipping transfer tax objectives that an outright gift to a spouse would not achieve in light of the ability to make the reverse QTIP election. Use of the GST exemption of both spouses is an important consideration and provides another reason for welcoming the acknowledgement in the temporary portability regulations that a decedent whose estate does not exceed the applicable exclusion amount may still use the QTIP trust in conjunction with the portability election.

§ 4.06 Conclusion

The temporary portability regulations provide certainty when using the portability election, and minimize potential concerns arising from the plain wording of the statute. The temporary regulations make technical corrections to the plain wording of the statute, provide rules allowing decedent and decedent's spouse to make taxable gifts without causing a loss of basic exclusion amount available to

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[79] See Rev Proc 2001-38, 2001-2 CB 124.
[80] IRC § 1014(b)(10).

the donor spouse, and eliminate the possibility of a claw back causing a potential tax on phantom property. In addition the regulations ensure that both taxable and nontaxable estates can take advantage of the estate, income and generation skipping transfer tax benefits associated with the QTIP election. The portability election is now a viable planning option.

Neil Aragones on IRS Approach to Foreign Tax Credit Generators and Recent Decisions

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§ 5.01 Introduction

In July, member states of the Association of Southeast Asian Nations (ASEAN) left their regional summit in Cambodia without issuing a final joint statement for the first time since the association's establishment in 1967.[1] The failure to issue a joint statement was due to the group's inability to come to an agreement on the South China Sea (SCS),[2] a portion of the Pacific Ocean that stretches approximately from Singapore in the southwest to Taiwan in the northeast[3] and that has been the source of tension between ASEAN members and other countries asserting territorial claims in the resources-rich area.[4] Specifically, the point of contention at the summit's conclusion was whether to include in the joint statement a reference to the recent standoff between Chinese and Philippine vessels in the Scarborough Shoal, a disputed area of the SCS.[5] Beyond the failure of ASEAN to end the July summit in agreement, competing interests in the SCS and opposing territorial claims over island chains and atolls have characterized regional relations for years.[6] Proximity is the basis of most countries' territorial claims over portions of the SCS, as in the case of the Philippines and Vietnam, but other nations claim vast portions of the SCS without such geographic proximity.[7] The ongoing dispute over the SCS illustrates the long and wide reach of some nations seeking to assert their interests far beyond their shores. Another example of a nation's expansive reach beyond its borders is the United States' system of worldwide taxation, under which U.S. taxpayers are taxed on their worldwide income. The foreign tax credit regime is an important component of the U.S.'s worldwide system of taxation, and for U.S. multinational corporations and banks navigating that system, the benefits of the foreign tax credit regime require that foreign tax credits receive significant attention. However, when the benefits of foreign tax credits appears to be the primary motivation for structuring transactions, the interest of the Internal Revenue Service is focused, and the transactions will be scrutinized for a valid business purpose beyond the enjoyment of those benefits.

In May, the federal government secured a second win in a series of cases in which the Service is challenging highly-structured financial transactions that the Service has identified as improper foreign

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[1] Prak Chan Thul and Stuart Grudgings, *SE Asia Meeting in Disarray Over Sea Dispute with China*, REUTERS (July 13, 2012), www.reuters.com/article/2012/07/13/us-asean-summit-idUSBRE86C0BD20120713; *ASEAN Struggles with Sth China Sea Topic*, SKY NEWS (July 13, 2012), www.skynews.com.au/topstories/article.aspx?id=771119&vId=.
[2] *Id*.
[3] *Analysis Briefs, South China Sea*, U.S. Energy Information Administration, http://www.eia.gov/countries/regions-topics.cfm?fips=SCS.
[4] Prak Chan Thul and Stuart Grudgings, *SE Asia Meeting in Disarray Over Sea Dispute with China*, REUTERS (July 13, 2012), www.reuters.com/article/2012/07/13/us-asean-summit-idUSBRE86C0BD20120713; *ASEAN Struggles with Sth China Sea Topic*, SKY NEWS (July 13, 2012), www.skynews.com.au/topstories/article.aspx?id=771119&vId=.
[5] *Id*.
[6] For example, see *Roiling the Waters, Tensions Rise Between China and Vietnam in the South China Sea*, THE ECONOMIST (July 7, 2012), www.economist.com/node/21558262.
[7] *Analysis Briefs, South China Sea*, U.S. Energy Information Administration, http://www.eia.gov/countries/regions-topics.cfm?fips=SCS. Distant countries Russia, India, and the United States have oil interests in the SCS and have been awarded explorations rights in the SCS. See Daniel Ten Kate and Nicole Gaouette, *ASEAN Fails to Reach Accord on South China Sea Disputes*, BLOOMBERG (July 12, 2012), www.businessweek.com/news/2012-07-12/asean-fails-to-reach-accord-on-south-china-sea-disputes.

tax credit generators. The decision in favor of the Service in *Hewlett-Packard v. Commissioner*[8] in the Tax Court follows the Service's victory last fall in *Pritired 1, LLC v. United States*[9] in the United States District Court for the Southern District of Iowa.

In 2007, at the time of the issuance of the temporary and proposed regulations on foreign tax credit generators, the Service stated that "foreign tax credit abuse is among the IRS's top compliance concerns for large corporate taxpayers."[10] In 2009, an IRS official indicated that the Service's pursuit of foreign tax generator cases was part of its strategy of obtaining favorable judgments in several jurisdictions and involving several factual scenarios.[11] The official also indicated that the Service's strategy would involve the application of judicial doctrines such as substance over form and economic substance, anti-abuse regulations, and technical statutes.[12]

The conduct of corporations with respect to foreign tax credits has changed in the wake of the issuance of those regulations, as observed by the Commissioner of Internal Revenue in 2009,[13] and also in the wake of the foreign tax credit generator litigation. Structuring financial transactions to generate foreign tax credits is no longer common.[14] However, the importance of foreign tax credits has not diminished, and corporations will continue to take advantage of their benefits within and along the borders of the rules and at times, in the view of the Service, beyond them. The foreign tax credit generator decisions are significant because of their impact on foreign tax credit planning and because the decisions reveal the Service's arguments and the courts' receptiveness to those arguments in cases involving complex banking and financial transactions and disputed tax benefits.

Below is a brief discussion of foreign tax credit basics and the IRS field directive on foreign tax credit generators, followed by a review of the final regulations and a look at the *Pritired* and *Hewlett-Packard* decisions.

Foreign Tax Credit Basics. IRC Section 901 allows a credit for the amount of income, war profits, or excess profits tax paid to any foreign country.[15] The purpose of the foreign tax credit is to prevent foreign income to be taxed twice, once by a foreign country and a second time by the United States.[16] As explained by the Service, the foreign tax credit regime "permits a U.S. taxpayer to claim a credit against its U.S. income tax liability for foreign taxes imposed on foreign income" and that the

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[8] TC Memo 2012-135; 2012 Tax Ct Memo LEXIS 134 (May 14, 2012).
[9] 816 F Supp 2d 693; 2011 US Dist LEXIS 116366 (SD Iowa, Sept 30, 2011).
[10] IR-2007-73 (March 29, 2007), IRS Issues Regulations on Transactions Designed to Artificially Generate Foreign Tax Credits.
[11] *IRS Honing its Strategy as FTC Cases Head to Court, Official Says*, Tax Analysts Worldwide Tax Daily, 2009 WTD 103-1 (June 2, 2009).
[12] *Id*.
[13] IR-2008-116 (Dec 10, 2009), Prepared Remarks of Commissioner Douglas Shulman before the 22nd Annual George Washington University International Tax Conference. At the conference, the Commissioner stated: "On the specific topic of foreign tax credit generators, we have seen significant changes in corporate behavior following our publication of temporary regulations focusing on structures designed to create credits for taxes that a US taxpayer does not economically bear. We are continuing to litigate cases that arose prior to those regulations, and we stand ready to litigate future cases which raise similar issues."
[14] Vanessa Houlder, Megan Murphy, Financial Times, and Jeff Gerth, ProPublica, *Tax wars: A fight worth billions*, FINANCIAL TIMES (Sept 20, 2011), www.ft.com/intl/cms/s/0/b21b51e0-e524-11e0-bdb8-00144feabdc0.html.
[15] Treas Reg § 1.901-2(a); IRC § 901.
[16] LMSB-04-0109-002 (Feb 19, 2009).

regime "is necessary to prevent double taxation of income because U.S. taxpayers are subject to U.S. tax on their worldwide income."[17]

The regulations provide that a foreign levy is an income tax "if and only if" it is a tax and "the predominant character of that tax is that of an income tax in the U.S. sense."[18] The regulations further provide that a foreign levy is a tax "if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes."

§ 5.02 IRS Field Directive on Foreign Tax Credit Generators

In 2009, the Large and Midsize Business Division of the Internal Revenue Service issued its revised field directive on foreign tax credit generators, recognizing the importance of the issue.[19] The memorandum provides the following brief, but instructive description of FTC generators:

> FTC Generators are highly structured transactions that exploit the FTC regime. Some of these transactions are designed to recover the foreign tax claimed as an FTC, so that, in substance, the transaction incurs no foreign tax cost. Other types of transactions are structured to eliminate the income that results in the FTC. Some transactions do both, and in either case, the FTC is inappropriate because the taxpayer claims an FTC where no double taxation of income occurs. In these situations, the FTC becomes an unintended monetary benefit generated by the transaction, which the parties to the transaction share. The parties adjust interest rates on loans or pay fees to share the US FTC benefit.

The memorandum states that these highly-structured transactions are "particularly offensive because they are designed strictly to generate credits in any amounts desired by the parties." The memorandum further states that "[a] strategic approach to address this issue is appropriate due to the significant compliance risk and the extensive commitment of resources needed to resolve these cases" and that, "[a]ccordingly, the Service has designated this transaction a Tier I issue under its issue focus processes and has formed an Issue Management Team (IMT)."[20]

§ 5.03 Final Regulations

[1] In General

The IRS field directive discussed above notes that the Service and Treasury issued temporary and proposed regulations in 2008 to address transactions involving FTC generators.[21] These regulations

[17] *Id*.
[18] Treas Reg § 1.901-2(a).
[19] LMSB-04-0109-002 (Feb 19, 2009).
[20] The memorandum points out: "The majority of the known transactions involve taxpayers in the Financial Services Industry. This makes reporting of these transactions appear as a part of their general business operations and may be indistinguishable from other financing arrangements/transactions. They are thus more difficult to identify through regular audit inquiries or regulatory disclosure requirements."
[21] TD 9416, 73 FR 40727 (July 16, 2008) (Final and temporary regulations); 73 FR 40792 (July 16, 2008) (Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing).

were made final in 2011.[22] The preamble to the final regulations provides that “amounts paid to a foreign taxing authority that are attributable to a structured passive investment arrangement are not treated as an amount of tax paid for purposes of the foreign tax credit.”[23] The final regulations retain the approach of the 2008 regulations and rely upon “objective, generally applicable standards to the extent possible.”[24] The preamble notes that the Service and Treasury believe that the approach “will appropriately disallow any foreign tax credits arising from artificial structures that are utilized to generate foreign tax credits and material duplicative foreign tax benefits.”[25]

[2] Conditions for Structured Passive Investment Arrangements

Six Conditions for Structured Passive Investment Arrangements. Regulations Section 1.901-2(e)(5)(iv) provides that an amount paid to a foreign country, a “foreign payment,” is not an amount of tax paid if the foreign payment is attributable to a structured passive investment arrangement.[26] The regulations lay out six conditions that point to a structured passive investment arrangement, and, as noted in the preamble, if an arrangement satisfies the six conditions, it will be treated as a structured passive investment arrangement.[27] The regulations provide that an arrangement is a structured passive investment arrangement if all of the six conditions are satisfied.

Special Purpose Vehicle Condition. The first condition in the regulations, the Special Vehicle Purpose (“SPV”)[28] condition, is that the arrangement utilizes an entity[29] that meets two requirements.[30] The first requirement is that substantially all of the gross income (for U.S. tax purposes) of the entity, if any, is passive investment income[31], and substantially all of the assets of the entity are assets held to produce such passive investment income.[32] The second requirement is that there is a foreign payment attributable to income of the entity, and if the foreign payment were an amount of tax paid, it would be paid or accrued in a U.S. taxable year in which the entity meets the requirements of Section 1.901-2(e)(5)(iv)(B)(1)(i) (*i.e.*, the first requirement).[33] The foreign payment is to be determined under the laws of the foreign country to which such foreign payment is made, and the foreign payment may be made by either the entity itself or the entity’s owner(s).[34] The regulations provide that income of an entity includes the entity's share of income of a lower-tier entity that is a branch or pass-through entity under the laws of such foreign country.[35] The regulations further provide that a foreign payment

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[22] TD 9535, 2011-2 CB 415 (Sept 26, 2011) (Final regulations and removal of temporary regulations).
[23] *Id*.
[24] *Id*.
[25] *Id*.
[26] Treas Reg § 1.901-2(e)(5)(iv).
[27] Treas Reg § 1.901-2(e)(5)(iv)(B); TD 9535, 2011-2 CB 415 (Sept 26, 2011) (Final regulations and removal of temporary regulations).
[28] Treas Reg § 1.901-2(e)(5)(iv)(C)(8) provides that the term SPV means the entity described in Treas Reg § 1.901-2(e)(5)(iv)(B)(1) (see discussion of Special Purpose Vehicle Condition).
[29] Treas Reg § 1.901-2(e)(5)(iv)(C)(3) provides that the term “entity” includes a corporation, trust, partnership, or disregarded entity described in Treas. Reg. § 301.7701-2(c)(2)(i).
[30] Treas Reg § 1.901-2(e)(5)(iv)(B)(1); TD 9535, 2011-2 CB 415 (Sept 26, 2011).
[31] Treas Reg § 1.901-2(e)(5)(iv)(C)(5) provides that the term “passive investment income” income described in IRC § 954(c), as modified by paragraphs (i) and (ii) of Treas Reg § 1.901-2(e)(5)(iv)(C)(5).
[32] Treas Reg § 1.901-2(e)(5)(iv)(B)(1)(i); TD 9535 (Sept 26, 2011).
[33] Treas Reg § 1.901-2(e)(5)(iv)(B)(1)(ii); TD 9535 (Sept 26, 2011).
[34] Treas Reg § 1.901-2(e)(5)(iv)(B)(1)(ii); TD 9535 (Sept 26, 2011).
[35] Treas Reg § 1.901-2(e)(5)(iv)(B)(1)(ii).

attributable to income of an entity includes a foreign payment attributable to income that is required to be taken into account by an owner of the entity, if the entity is a branch or pass-through entity under the laws of such foreign country.[36]

U.S. Party Condition. The second condition in the regulations is that a U.S. party[37] is a person who is eligible to claim a credit under IRC Section 901(a), including a credit for foreign taxes deemed paid under IRC Section 902 or 960 for all or a portion of the foreign payment if the foreign payment were an amount of tax paid.[38]

Direct Investment Condition. The third condition in the regulations is that the U.S. party's proportionate share of the foreign payment or payments is (or is expected to be) substantially greater than the amount of credits, if any, that the U.S. party reasonably would expect to be eligible to claim under Section 901(a) for foreign taxes attributable to income generated by the U.S. party's proportionate share of the assets owned by the SPV if the U.S. party directly owned such assets.[39] The regulations provide that direct ownership, for purposes of this provision, does not include ownership through a branch, a permanent establishment, or any other arrangement (such as an agency arrangement or dual resident status) that would result in the income generated by the U.S. party's proportionate share of the assets being subject to tax on a net basis in the foreign country to which the payment is made.[40] The regulations further provide that a U.S. party's proportionate share of the SPV's assets is to be determined by reference to such U.S. party's proportionate share of the total value of all of the outstanding interests in the SPV that are held by its equity owners and creditors. However, per the regulations, a U.S. party's proportionate share of the SPV's assets do not include any assets that produce income subject to gross basis withholding tax.[41]

Foreign Tax Benefit Condition. The fourth condition in the regulations is that the arrangement is reasonably expected to result in a credit, deduction, loss, exemption, exclusion, or other tax benefit under the laws of a foreign country that is available to a counterparty[42] or to a person related[43] to the counterparty.[44] The regulations provide that a foreign tax benefit in the form of a credit must correspond to 10 percent or more of the amount of the U.S. party's share (for U.S. tax purposes) of the foreign payment.[45] The regulations further provide that a foreign tax benefit in the form of a deduction, loss, exemption, exclusion, or other tax benefit must correspond to 10 percent or more of the foreign base with respect to which the U.S. party's share (for U.S. tax purposes) of the foreign payment is imposed.[46]

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[36] *Id*.
[37] Treas Reg § 1.901-2(e)(5)(iv)(C)(9) provides that the term "U.S. party" means a person described in Treas Reg § 1.901-2(e)(5)(iv)(B)(1) (see discussion of U.S. Party Condition).
[38] Treas Reg § 1.901-2(e)(5)(iv)(B)(2).
[39] Treas Reg § 1.901-2(e)(5)(iv)(B)(3).
[40] *Id*.
[41] *Id*.
[42] The regulations provide that, for purposes of Treas Reg § 1.901-2(e)(5)(iv), the term "counterparty" means a person described in Treas Reg § 1.901-2(e)(5)(iv)(B)(5).
[43] Treas Reg § 1.901-2(e)(5)(iv)(B)(7) provides that two persons are related if (i) one person directly or indirectly owns stock (or an equity interest) possessing more than 50 percent of the total value of the other person; or (ii) the same person directly or indirectly owns stock (or an equity interest) possessing more than 50 percent of the total value of both persons.
[44] Treas Reg § 1.901-2(e)(5)(iv)(B)(4).
[45] *Id*.
[46] *Id*.

Where an arrangement involves more than one U.S. party or more than one counterparty or both, the regulations provide that the aggregate amount of foreign tax benefits available to all of the counterparties and persons related to such counterparties is compared to the aggregate amount of all of the U.S. parties' shares of the foreign payment or foreign base, as the case may be.[47] In addition, where a U.S. party indirectly owns interests in an SPV that are treated as equity interests for both U.S. and foreign tax purposes, the regulations provide that a foreign tax benefit available to a foreign entity in the chain of ownership that begins with the SPV and ends with the first-tier entity in the chain does not correspond to the U.S. party's share of the foreign payment attributable to income of the SPV to the extent that such benefit relates to earnings of the SPV that are distributed with respect to equity interests in the SPV that are owned directly or indirectly by the U.S. party for purposes of both U.S. and foreign tax law.[48]

Counterparty Condition. The fifth condition in the regulations is that the arrangement involves a counterparty. The regulations define a counterparty as a person that, under the tax laws of a foreign country in which the person is subject to tax on the basis of place of management, place of incorporation, or similar criterion or otherwise subject to a net basis tax, directly or indirectly owns or acquires equity interests in, or assets of, the SPV.[49]

A counterparty does not include the SPV or a person with respect to which the same domestic corporation, U.S. citizen, or resident alien individual directly or indirectly owns more than 80 percent of the total value of the stock (or equity interests) of each of the U.S. party and such person.[50] A counterparty also does not include a person with respect to which the U.S. party directly or indirectly owns more than 80 percent of the total value of the stock (or equity interests), but only if the U.S. party is a domestic corporation, a U.S. citizen, or a resident alien individual.[51] Finally, per the regulations, a counterparty does not include an individual who is a U.S. citizen or resident alien.[52]

Inconsistent Treatment Condition. The sixth condition in the regulations is that the arrangement is treated inconsistently by the U.S. and an applicable foreign country[53] under their respective tax systems and "that the U.S. treatment results in either materially less income or a materially greater amount of foreign tax credits than would be available if the foreign law controlled the U.S. tax treatment."[54] Per the preamble, the condition is "intended to limit the disallowance of credits to those arrangements that exploit inconsistencies in U.S. and foreign law to secure a foreign tax credit benefit."[55]

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[47] *Id*.
[48] *Id*.
[49] Treas Reg § 1.901-2(e)(5)(iv)(B)(5).
[50] *Id*.
[51] *Id*.
[52] *Id*.
[53] The term "applicable foreign country," as used in Treas Reg § 1.901-2(e)(5)(iv), is defined in the regulations as each foreign country to which a foreign payment described in Treas Reg § 1.901-2(e)(5)(iv)(B)(1)(ii) is made or which confers a foreign tax benefit described in Treas Reg § 1.901-2(e)(5)(iv)(B)(4). Treas Reg § 1.901-2(e)(5)(iv)(C)(1).
[54] Treas Reg § 1.901-2(e)(5)(iv)(B)(5); TD 9535, 2011-2 CB 415 (Sept 26, 2011).
[55] TD 9535, 2011-2 CB 415 (Sept 26, 2011).

Per the regulations, to satisfy the inconsistent treatment condition, the U.S. and the applicable foreign country must treat at least one or more "aspects of the arrangement" differently under their respective tax systems.[56] The four "aspects of the arrangement" are provided in Section 1.901-2(e)(5)(iv)(B)(6)(i) through (iv) of the regulations. In addition, the regulations require that, for one or more tax years when the arrangement is in effect, one or both of the following two conditions must apply:[57]

(1) The amount of income attributable to the SPV that is recognized for U.S. tax purposes by the SPV, the U.S. party or parties, and persons related to a U.S. party or parties is materially less than the amount of income that would be recognized if the foreign tax treatment controlled for U.S. tax purposes; or

(2) the amount of credits claimed by the U.S. party or parties is materially greater than it would be if the foreign tax treatment controlled for U.S. tax purposes.[58]

As noted above, to satisfy the inconsistent treatment condition, the U.S. and the applicable foreign country must treat one or more "aspects of the arrangement" differently under their respective tax systems.[59] Per the regulations, the four aspects of the arrangement are:

(1) The classification of the SPV (or an entity that has a direct or indirect ownership[60] interest in the SPV) as a corporation or other entity subject to an entity-level tax, a partnership or other flow-through entity or an entity that is disregarded for tax purposes;

(2) The characterization as debt, equity or an instrument that is disregarded for tax purposes of an instrument issued by the SPV (or an entity that has a direct or indirect ownership interest in the SPV) to a U.S. party, a counterparty or a person related to a U.S. party or a counterparty;

(3) The proportion of the equity of the SPV (or an entity that directly or indirectly owns the SPV) that is considered to be owned directly or indirectly by a U.S. party and a counterparty; and

(4) The amount of taxable income that is attributable to the SPV for one or more tax years during which the arrangement is in effect.[61]

In summary, as noted in the preamble to the final regulations, the regulations "address certain highly structured transactions that produce inappropriate foreign tax credit results," and the IRS and Treasury will review a transaction to determine whether the six conditions discussed above are satisfied and, accordingly, whether the arrangement is a structured passive investment arrangement.[62] In addition to the expression in the final regulations of the Treasury and Service's approach to such highly-structured transactions, the Service's approach is further revealed in the recent decisions reviewed below.

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[56] Treas Reg § 1.901-2(e)(5)(iv)(B)(6).
[57] *Id*.
[58] *Id*.
[59] *Id*.
[60] Treas Reg § 1.901-2(e)(5)(iv)(C)(4), providing the definition for the term "indirect ownership," states that indirect ownership of stock or another equity interest (such as an interest in a partnership) shall be determined in accordance with the principles of IRC § 958(a)(2), regardless of whether the interest is owned by a U.S. or foreign entity.
[61] Treas Reg § 1.901-2(e)(5)(iv)(B)(6).
[62] TD 9535, 2011-2 CB 415 (Sept 26, 2011) (Final regulations and removal of temporary regulations).

§ 5.04 Recent Decisions

In two recent decisions, one by a United States district court and the other by the Tax Court, the IRS was successful in proving that certain highly structured transactions were foreign tax credit generators. In the two cases, the Service attacked the transactions on different fronts. In the *Pritired* case, the IRS attacked the transaction on several grounds, including lack of an equity investment, violation of the Anti-Abuse Rule, and lack of economic substance. In the *Hewlett-Packard* case, the IRS attacked the transaction on the grounds that the transaction was in essence a loan for federal income tax purposes. Examination of the cases is instructive in how the Service may attack a structured transaction it has targeted as a foreign tax credit generator.

[1] *Pritired I, LLC v. United States*: Lack of Equity Investment, Lack of Economic Substance, Violation of the Anti-Abuse Rule, and Lack of Substantial Economic Effect

In September 2011, the Service prevailed in the first of the foreign tax credit generator cases to be decided. In *Pritired I, LLC v. United States*,[63] a case involving an "exceedingly complex" set of facts, the United States District Court for the Southern District of Iowa concluded that the purpose of the structured financial transaction conceived by the taxpayer was to generate improper tax credits.[64] The case involved two U.S. companies, Principal Life Insurance Company ("Principal") and Citibank North America ("Citibank"), which, upon Citibank's initiative, formed a partnership named Pritired 1, LLC ("Pritired" or "the partnership") to enter into a transaction with two French banks, Bred Banque Populaire and Natexis Banque Populaire ("French banks"), in October 2000.[65] In the transaction, designed by Citibank, the partnership transferred $300 million in cash to the French banks and in turn received $300 million in securities ($291 million of Perpetual Certificates "PCs" and $9 million in "B shares") from two entities of the French banks collectively referred to as "SAS".[66] In return for the investment, the partnership received interest from the PCs and dividends from the B shares.[67] As to the French component of the transaction, the French banks provided $930 million to SAS, which, when combined with the $300 million from the partnership, totaled a $1.23 billion investment in SAS.[68] SAS then used the funds to assume an existing portfolio of high quality debt securities from the French banks and other securities for which the French banks were counterparties.[69] As summarized by the court, the $1.23 billion investment was used to earn income from low risk financial instruments, and the American partners received some cash from these investments.[70] SAS paid French corporate taxes on all the income, and the Pritired partnership was allocated most of the taxes and corresponding foreign tax credits.[71] As summarized by the court, the transaction enabled the French banks to borrow $300 million

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[63] 816 F Supp 2d 693; 2011 US Dist LEXIS 116366 (SD Iowa, Sept 30, 2011).
[64] *Id*. at 696.
[65] *Id*. at 696-697.
[66] *Id* at 696-697. The partnership's share of the PCs was $4.5 million and its share of the B Shares was $145.5 million. *Id*. at 704. The PCs carried a floating interest rate of 3-month US$ LIBOR (London Inter-Bank Offered Rate), plus a 1% spread, and the PCs were "stapled" to the B shares. *Id* at 704. As "stapled" securities, neither the PCs or B shares could be sold, redeemed, or liquidated without each other. *Id* at 704. LIBOR is the rate of interest for loans between major international banks in London. "US$ LIBOR" represents the LIBOR rate denominated in U.S. dollars. *Id* at 703-704.
[67] *Id* at 704.
[68] *Id* at 704-705.
[69] *Id* at 705.
[70] *Id* at 696.
[71] *Id* at 713.

dollars from Principal and Citibank at rates below market-level, and Principal and Citibank "received a high return on an almost risk free investment."[72] The transaction was unwound in December 2005, and the transaction resulted in $21 million in foreign tax credits claimed by Principal against its taxable income for 2002 and 2003.[73]

In December 2007, the Service issued a Notice of Final Partnership Administrative Adjustment ("FPAA"), which concluded that Principal was not entitled to claim an allocation of the partnership's share of the foreign tax credits for 2002 and 2003 and disallowed the credits for Principal and Citibank.[74] The Service contended that the transaction was an abusive arrangement and disallowed the foreign tax credits based on five grounds.

(1) the PCs and B Shares were debt instruments and not equity,
(2) the transaction was a loan because Pritired was not a partner in SAS,
(3) pursuant to the Anti-Abuse Rule in Treasury Regulations Section 1.701-2, the transaction should be re-characterized as a loan because the PCs and B Shares were debt instruments,
(4) the special allocation of foreign tax credits to Pritired lacked economic effect, and
(5) the transaction that generated the foreign tax credits lacked economic substance.[75]

Principal, the tax matters partner of the partnership, petitioned for readjustment of partnership item based on the FPAA and filed an action seeking a refund of the taxes resulting from the FPAA.[76] In the end, the court held that Principal did not make the requisite showing that the Commissioner's decision in the FPAA was in error.[77] In its analysis, the court reviewed the five reasons set forth by the Service for disallowing the partnership's foreign tax credits.[78]

As noted by the court, the first two reasons were based on the argument that the PCs and B Shares were debt and not equity and that, therefore, the transaction constituted a loan.[79] The court agreed and held that the transaction was designed to be a loan.[80] Principal had argued that the PCs and B shares were equity and that the transaction was an equity investment rather than a loan (1) because the PCs were swapped into an equity-like return under the PC swaps, and (2) because the doctrine of substance over form controlled, and the PCs were in substance equity, although the form suggested that they were debt.[81] The Service countered that the PCs were designed to look like equity but were in substance debt and that Principal entered into the partnership solely to recoup foreign tax credits.[82] The court determined that the attributes of the PCs and B shares weighed in favor of finding that the PCs and B shares were debt and in the nature of a loan[83], and the court stated that it must "consider the nature of the original investment in ascertaining the relationship intended to be created."[84] The court found that

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[72] *Id* at 696.
[73] *Id* at 697.
[74] *Id* at 696-697.
[75] *Id* at 698-699.
[76] *Id* at 696-697.
[77] *Id* at 744.
[78] *Id* at 731-732.
[79] *Id* at 732.
[80] *Id* at 735.
[81] *Id* at 732.
[82] *Id*.
[83] *Id* at 734.
[84] *Id* at 734 (quoting Kraft Foods Co v Commr, 232 F2d 118, 126 (2d Cir 1956)).

Pritired had intended to recover its $300 million investment at the end of the investment period and regardless of the performance of SAS and that "there was a reasonable expectation of payment that would always involve tax credits."[85] The court concluded that "[a]ll together, [the] characteristics and attributes weigh in favor of finding that the PCs and B Shares were debt instruments and the substance of the transaction was a loan."[86] "Peeling back the layers of the partnership agreements makes it clear that the structure and characteristics of the Pritired transaction were meant to create the appearance of equity when it was not," stated the court.[87] The court held that the "parties acted with the intent to structure a transaction that appeared to be equity but was debt in substance."[88]

The court then considered the issue of whether the Pritired transaction lacked economic substance. In analyzing the issue, the court applied the Eighth Circuit's two-prong test for identifying a "sham transaction" as enunciated in *IES Industries, Inc. v. United States*, 253 F3d 350 (8th Cir 2011).[89] In *IES Industries*, the court of appeals stated that "a transaction will be characterized as a sham if 'it is not motivated by any economic purpose outside of tax considerations' (the business purpose test), and if it 'is without economic substance because no real potential for profit exists' (the economic substance test)."[90]

As to the business purpose test, the court stated that the test was a subjective one and that the proper inquiry for a court, as stated in *IES Industries*, was "whether the taxpayer was induced to commit capital for reasons only relating to tax considerations or whether a non-tax motive, or legitimate profit motive, was involved."[91]

As to the economic substance test, the court stated that the test required "an objective determination of whether a reasonable possibility of profit from the transaction existed apart from tax benefits."[92] The court stated that "when the form of the transaction comports with its substance, the form will be respected for tax purposes, however, when the form of the transaction is nothing more than 'the simple expedient of drawing up papers,' . . . when the objective economic realities are to the contrary,' the substance of the transaction controls."[93] The court further stated that "the economic substance doctrine is case-specific and requires a very fact-intensive analysis."[94]

With respect to the business purpose test, the court stated that it "strains to find any credible business purpose to the transaction not involving the FTCs"[95] and that the business purposes claimed by Principal "does not override the fact that, at its core, this is a $300 million loan that allowed French Banks to borrow below their ordinary borrowing cost and converted the yield on exceedingly low-risk securities to an exceedingly high rate" and that "the only way to get this outcome was with the FTCs."[96]

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[85] *Id* at 734.
[86] *Id* at 735.
[87] *Id*.
[88] *Id*.
[89] *Id* at 736.
[90] IES Industries, Inc v US, 253 F3d 350, 353 (8th Cir 2011) (quoting Rice's Toyota World, Inc v Commr, 752 F2d 89, 91-92 (4th Cir 1985)).
[91] 253 F3d at 354-355 (quoting Shriver v Commr, 899 F2d 724, 725-726 (8th Cir 1990)).
[92] *Pritired I, LLC*, 816 F Supp 2d at 737 (quoting Rice's Toyota World, 752 F2d at 94).
[93] *Id* at 737 (quoting Consolidated Edison Co of New York v US, 90 Fed Cl 228, 266 (2009)).
[94] *Id* at 737.
[95] *Id* at 739.
[96] *Id*.

The court found that the transaction "was not desirable for Principal other than to generate and claim FTCs" and that "the real 'business purpose' of the transaction seemed to be the use of FTCs to improve, or leverage, French borrowing power and enhance low risk yields through the FTCs."[97] The court concluded that "the subjective business purpose of the Pritired transaction was to enhance low yield investments through the FTCs."[98]

With respect to the economic substance test, the court stated that it would look "to whether there was any objective determination of a reasonable possibility of profit or that the economic realities suggested a real expectation of profit."[99] The court found that "the economic realities indicate that the Pritired transaction was not an 'exercise of good business judgment,' but was an investment designed to appear like something that it was not" and that "the Pritired transaction was designed to have almost no risk to the U.S. Taxpayers."[100] Citing the Tenth Circuit in *Sala v. United States*, the court stated that merely "the existence of some potential profit [was] 'insufficient to impute substance into an otherwise sham transaction' where a 'common-sense examination of the evidence as a whole' indicate[d] the transaction lacked economic substance."[101] The court concluded that "[f]rom the outset, the parties all planned for Pritired to primarily generate its return through FTCs and this [was] an abusive arrangement."[102] In addition to finding that the transaction failed both prongs of the *IES Industries'* test separately, the court held that the transaction also lacked economic substance "when looking at the transaction cumulatively."[103] The court concluded that "[o]n balance . . . the Pritired transaction was designed to appear as a partnership equity investment, but was primarily structured to generate FTCs."[104]

The court next considered the issue of whether the Pritired transaction violated the Anti-Abuse Rule of Treasury Regulations Section 1.701-2.[105] The Service asserted that the primary purpose for establishing and using the French entities was to obtain foreign tax credits and that "the partnership was formed and used contrary to the intent of Subchapter K because the purpose of the Pritired transaction was for tax avoidance."[106] The court articulated the anti-abuse rule in Section 1.701-2 as follows:

(1) The partnership must be bona fide and each partnership transaction or series of related transactions (individually or collectively, the transaction) must be entered into for a substantial business purpose.

(2) The form of each partnership transaction must be respected under substance over form principles.

(3) Except as otherwise provided in this paragraph (a)(3), the tax consequences under subchapter K to each partner of partnership operations and of transactions between the

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[97] *Id*.
[98] *Id*.
[99] *Id*.
[100] *Id* at 740.
[101] *Id* at 740 (citing Sala v US, 613 F3d 1249, 1254 (10th Cir 2010) (quoting, Keeler v Commr, 243 F3d 1212 (10th Cir 2001)).
[102] *Pritired 1, LLC*, 816 F Supp 2d at 740.
[103] *Id* at 741.
[104] *Id*.
[105] *Id*.
[106] *Id*.

> partner and the partnership must accurately reflect the partners' economic agreement and clearly reflect the partner's income.[107]

The court stated that the three requirements had to be met in order for it to determine whether Principal and the Pritired transaction had violated the anti-abuse rule.[108] The court further stated that like the economic substance test, the anti-abuse provision "focuses on what the primary motivation and economic realities of the Pritired transaction entailed."[109]

As to the first requirement of the regulations, the court noted its earlier finding that the Pritired transaction was not a bona fide partnership and stated that "[a]s a practical matter, the Pritired transaction did not intend to form a partnership because the transaction was designed to be a loan to the French Banks (and SAS) and not an equity investment."[110] Furthermore, as to the requirement of a "substantial business purpose," the court cited its earlier discussion of "business purpose" and concluded that "substantial business purpose" implied a higher standard than a "business purpose".[111] The court found that the Pritired transaction likewise did not have "substantial business purpose".[112] Per the court, "[t]he Pritired transaction was designed to transfer and shift the payment of French taxes to instruments that would otherwise have a low and undesirable return" and "[o]n this reason alone . . . the Pritired transaction [ran] afoul of the anti-abuse rule of Treas. Reg. § 1.701-2(a)."[113]

Although the court found that the Pritired transaction violated the anti-abuse rule by failing to meet the first requirement, the court briefly addressed the second and third requirements of the rule as applied to the case. The court noted that it had "expounded at length upon why the substance of the transaction was a loan and not an equity investment," and the court concluded that the Pritired transaction also failed to meet the second requirement of the anti-abuse rule.[114]

As to the third requirement of the rule, the court stated that it was "clearly apparent that the 'partnership operations and of transactions between the partner and the partnership [did not] accurately reflect the partners' economic agreement and clearly reflect the partner's income."[115] The court noted that "[unlike the examples contained in Treas. Reg. § 1.701-2, the special allocation of the FTCs to Pritired did not have substantial economic effect because 'any purported business purpose for the transaction [was] insignificant in comparison to the tax benefits that would result.'"[116] The court concluded that "in applying the anti-abuse regulation, the Pritired partnership may be disregarded and this result[ed] in disallowing the FTCs claimed by the U.S. Taxpayers for French taxes purportedly paid by SAS."[117]

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[107] *Id* at 741-742.
[108] *Id* at 742.
[109] *Id* at 743.
[110] *Id*.
[111] *Id*.
[112] *Id*.
[113] *Id*.
[114] *Id*.
[115] *Id* at 743 (quoting Treas Reg § 1.701-2(a)(3)).
[116] *Id*. at 743 (quoting Treas Reg § 1.701-2(d), Example 7).
[117] *Id* at 743.

Finally, as to the issue of whether the Pritired transaction lacked substantial economic effect, the court stated that "pursuant to Treas. Reg. § 1.704-1(b)(2), in order for an allocation to have substantial economic effect, the special allocation must have 'economic effect' and the effect must be 'substantial.'"[118] Citing Regulations Section 1.704-1(b)(2)(ii), the court stated that "economic effect" was "an economic benefit or economic burden that corresponds to an allocation, and the partner to whom the allocation is made must receive such economic benefit or bear such economic burden."[119] Per the court, an allocation is substantial only "if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences."[120] The court further stated that an allocation was not substantial if:

(1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement, and

(2) there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.[121]

The court concluded that it did not need to reach the question of whether the Pritired transaction had substantial economic effect because it had ruled in favor of the Service on all the other proposed findings in the FPAA.[122]

In the end, the court concluded: "The Pritired transaction was designed in a very complicated and *multi-level* manner to mask what was in substance, a loan from the U.S. Taxpayers to the French Banks. Yet the facts demonstrate that Principal's focus and interest in the transaction was to generate FTCs."[123]

The *Pritired* decision highlights the probable grounds on which the Service will challenge FTC generator transactions – debt vs. equity, violation of the Anti-Abuse Rule, lack of economic effect, and lack of economic substance – and the decision provides insight on the analysis of such transactions by the courts. The court's decision in *Pritired* relied upon a detailed analysis of the facts, including an examination of the negotiations leading to the transaction, an examination of the transaction's structure and performance, and an examination of the transaction's debt and equity attributes, and the decisions in the pending foreign tax credit generator cases will likely rely upon a similar analysis.

[2] *Hewlett-Packard v. Commissioner*: Characterization of Transaction as a Loan for Federal Income Tax Purposes

In May 2012, the Service prevailed in the second of the foreign tax credit generator cases to be decided. In *Hewlett-Packard v. Commissioner*, the Tax Court concluded that the investment by the Hewlett-Packard Company ("H-P") in a foreign corporation was a loan and not equity for federal

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[118] *Id* at 744.
[119] *Id*.
[120] *Id* at 744 (quoting Treas Reg § 1.704-1(b)(2)(iii)).
[121] *Id* at 744.
[122] *Id*.
[123] *Id*.

income tax purposes and upheld the Service's disallowance of foreign tax credits claimed by H-P.[124] Also, the court, in a second ruling not directly related to the FTC issue, held that H-P was not entitled to a capital loss deduction it had claimed.[125]

The facts in the *Hewlett-Packard* are less complicated than the facts in *Pritired I*, but the *Hewlett-Packard* also involved a complex structured transaction essentially designed to generate foreign tax credits. A summary of the facts follows. In 1996, H-P purchased shares in Foppingadreef (FOP), a Netherlands Antilles corporation, from AIG Financial Products Corporation ("AIG-FP"), a subsidiary of American International Group, Inc. ("AIG") for approximately $202 million.[126] In addition, H-P purchased certain warrants for approximately $6 million through its subsidiary, Hewlett-Packard Europe B.V. ("HP Europe").[127] Earlier that year, FOP had been formed by AIG-FP and a Dutch banking group, ABN AMRO Bank N.V. ("ABN"), to execute a stepped coupon contingent interest note (CIN) transaction, which was designed to produce a stream of preferred dividends and significant foreign tax credits. [128] ABN's interest in FOP was four time's greater than AIG-FP, and, as summarized by the court, FOP's "business activities were effectively limited by its articles of incorporation and a shareholders agreement to include only the purchase of contingent interest notes from the separate foreign shareholder."[129]

The warrants purchased by H-P with its purchase of FOP shares were covered by existing put and call option agreements, including a warrant put option agreement under which the option holder had the right to put the warrants and certain shares of FOP to ABN in January 2003 ("2003 warrant put option").[130] Also, as part of H-P's purchase of the shares from AIG-FP, the parties also negotiated a clawback adjustment, under which AIG-FP was required to return to H-P a portion of the "premium" if the FOP transaction ended prior to its intended term under certain defined circumstances.[131] As noted by the court, the adjustment "essentially represented a rebate of the 'premium' HP paid to AIG-FP to compensate HP in the event the desired tax results of the transaction were not realized."[132]

From 1996 to 2003, during the period of FOP's existence, H-P received distributions, characterized as distributions, from FOP, less the withholding tax paid to the Netherlands Tax Authority's Office Taxation Service Large Companies at Amsterdam (Dutch Tax Authority).[133] H-P claimed foreign tax credits attributable to the withholding taxes for 1997 to 2003.[134] The FTCs were not used to reduce H-P's income in those years because of limitations provided for in IRC Section 904, but H-P's income for those years was increased by corresponding adjustments pursuant to IRC Section 78.[135] In 2003, HP Europe transferred the warrants to a wholly-owned indirect subsidiary of H-P, Hewlett-Packard Nederland Investments B.V. (HPNI), which then exercised the 2003 warrant put option

[124] Hewlett-Packard Company v Commr, TC Memo 2012-135; 2012 Tax Ct Memo LEXIS 134.
[125] *Id* at 89-92. The court concluded that H-P had failed to satisfy its burden of proof for deducting the amount of a "premium" H-P had paid in connection with the purchase of shares in FOP from AIG-FP.
[126] *Id* at 1, 20, 36.
[127] *Id* at 37.
[128] *Id* at 4-5.
[129] *Id* at 1, 5.
[130] *Id* at 21.
[131] *Id* at 37.
[132] *Id* at 37.
[133] *Id* at 44.
[134] *Id* at 45.
[135] *Id* at 2, 3, 46.

and sold all of the warrants to ABN.[136] As noted by the court, H-P and its subsidiaries incurred a $13.8 million loss on the exercise of the warrants and related swaptions.[137] In 2004, the sale of H-P's shares in FOP was consummated, and H-P transferred the shares to ABN for approximately $168 million.[138] The sale resulted in a $15.6 million long-term capital loss to H-P.[139] The Service issued two notices of deficiency to H-P for the 1999, 2000, and 2003 tax years, disallowing foreign tax credits claimed for the tax years at issue and disallowing the $15.6 million capital loss deduction claimed by H-P for 2003.[140]

The Service asserted several grounds for disallowing the foreign tax credits and the capital loss deduction claimed by H-P, but the court stated that the case "rest[ed] on the substance of HO's investment in FOP," and the court considered the primary issues of: (1) whether H-P's investment in FOP was "more appropriately characterized as debt, rather than equity," and (2) whether H-P's investment in FOP was a "sham under the economic substance doctrine."[141]

The court stated that classification of an interest as debt or equity had to be "considered in the context of the overall transaction".[142] Furthermore, the court stated that "[s]ubstance, not form, controls the characterization of a taxable transaction" and that "[c]ourts will not tolerate the use of mere formalisms solely to alter tax liabilities."[143] The court further stated that "[g]enerally, the focus of the debt-versus-equity inquiry narrows to whether there was an intent to create a debt with a reasonable expectation of repayment and, if so, whether that intent comports with the economic reality of creating a debtor-creditor relationship"[144] and that "[t]he key to this determination is primarily the taxpayer's actual intent, as revealed by the circumstances and condition of the transfer."[145]

The court cited the following factors used by the Ninth Circuit Court of Appeals for evaluating whether an advance to a corporation was a bona fide debt as opposed to an equity investment:

(1) the labels on the documents evidencing the alleged indebted-ness;
(2) the presence or absence of a maturity date;
(3) the source of payments;
(4) the right of the alleged lender to enforce payment;
(5) participation in management;
(6) a status equal to or inferior to that of regular corporate creditors;
(7) the intent of the parties;
(8) the adequacy of the (supposed) borrower's capitalization;
(9) whether stockholders' advances to the corporation are in the same proportion as their equity ownership in the corporation;
(10) the payment of interest out of only "dividend money"; and

[136] *Id* at 48.
[137] *Id* at 48-49. "Swaptions" are interest rate swap options. As noted by the court, H-P sold two swaptions to AIG-FP to hedge an interest rate risk. *Id* at 42.
[138] *Id* at 49-50.
[139] *Id* at 50.
[140] *Id* at 2.
[141] *Id* at 3.
[142] *Id* at 54 (quoting Hardman v US, 827 F2d 1409, 1411 (9th Cir 1987)).
[143] *Id* at 54.
[144] *Id*.
[145] *Id* at 54-55.

(11) the borrower's ability to obtain loans from outside lenders.[146]

Noting that the "list is not exclusive, and no factor is determinative,"[147] the court proceeded to examine the facts of the FOP transaction under the factors.[148] As to factor 1, pertaining to the labels on the documents, the court stated that "[t]he issuance of a stock certificate indicates an equity contribution, whereas the issuance of a bond, debenture, or note indicates a bona fide indebtedness," and the court determined that it was "uncontested that HP's in-vestment in FOP was, in form, equity."[149] However, the court stated that "formal documentation is not controlling" and that "[a] valid loan may exist even when there is no formal debt instrument."[150] The court concluded that although the factor weighed in favor of treating H-P's investment as equity, the factor's value was "diminished in the light of [the court's] review of the overall transaction."[151]

As to factor 2, pertaining to the presence or absence of a fixed maturity date and H-P's creditor rights, the court stated that "[t]he presence of a fixed maturity date indicates a fixed obligation to repay, a characteristic of a debt obligation" and that "the absence of the same on the other hand would indicate that repayment was in some way tied to the fortunes of the business, indicative of an equity advance."[152] The court agreed with the Service's contention that the initial put date in 2003 in effectively functioned as the investment's maturity date.[153] The court further found that FOP's articles of incorporation and other agreements pertaining to FOP gave H-P "an apparatus to enforce creditor rights."[154]

As to factors 3 and 10, pertaining to the source of payments, the court stated that "[a]n equity investment is indicated if any repayment is contingent upon earnings or is to come from a restricted source, such as a judgment recovery, dividends, or profits."[155] The court concluded that "the transactional documents obligated FOP to pay HP periodic, predetermined amounts and that HP was assured to be repaid the principal amount of its investment at the end of the transaction's term, if not sooner" and that "HP's rights under such circumstances are more indicative of those of a creditor, rather than those of an equity holder."[156]

As to factor 5, pertaining to the right to participate in management, the court stated that "[t]he right to participate in the management of a business by the entity advancing funds demonstrates that the advance may not have been bona fide debt and instead was intended as an equity investment."[157] The court concluded: "Although HP was afforded basic voting rights in FOP, . . . it did not value those rights. Furthermore, the rights afforded HP after a 'Change of Control Event' did not meaningfully advance HP's participation in the management of FOP. Rather, they served as a means by which HP would be able to expediently exit the transaction with its investment repaid in full."[158]

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[146] *Id* at 57.
[147] *Id*.
[148] *Id* at 65-88.
[149] *Id* at 66.
[150] *Id*.
[151] *Id* at 66-67.
[152] *Id* at 68 (quoting Estate of Mixon, 464 F2d 394, 404 (5th Cir 1972)).
[153] *Id* at 72.
[154] *Id* at 74.
[155] *Id* at 75.
[156] *Id* at 79.
[157] *Id*.
[158] *Id* at 81.

As to factor 6, pertaining to H-P's status in relation to other creditors, the court stated that "[w]hether an advance is subordinated to obligations to other creditors bears on whether the taxpayer advancing the funds was acting as a creditor or an investor" and that "[t]aking a subordinate position to other creditors may suggest an equity investment."[159] The court found that "[i]n substance, HP's rights would never be subordinated to any creditor's," that "[w]hile FOP did engage in some investments, it could not incur significant debt or have general creditors," and that "HP effectively had first claim to FOP's assets."[160] The court concluded that these rights were "indicative of those of a creditor."[161]

As to factor 7, relating to the intent of the parties, the court stated that "the inquiry of a court in resolving the debt-equity issue is primarily directed at ascertaining the intent of the parties"[162] and that "[t]he critical factor in finding that an investment is in substance a loan is to 'ask whether, when the funds were advanced, the parties actually intended repayment.'"[163] The court concluded: "When HP's FOP investment is viewed in its entirety, it becomes clear that HP never intended to absorb the risk of the FOP venture. Rather, it sought a definite obligation, repayable in any event."[164]

In concluding its analysis of the debt-equity factors, the court considered the remaining factors, some of which, as noted by the court, were not significantly relevant to the court's inquiry.[165] The court held that H-P's investment in FOP should be treated as a loan for federal income tax purposes and concluded: "The determination of debt or equity is no mere counting of factors. However, after considering the above factors, [the court] finds that HP's investment in FOP exhibited more qualitative and quantitative indicia of debt than equity."[166]

The *Hewlett-Packard* opinion highlights the tax court's analysis of the attributes of a financial transaction that generates the foreign tax credits in dispute. In *Hewlett-Packard*, the tax court's examination of the characteristics of the FOP transaction entered into by H-P and the court's debt-equity analysis led to the determination that the transaction could only be characterized as a loan. The decisions in the pending FTC generator cases will likely include the same analysis, and the analysis is clearly a part of the Service's approach in disallowing foreign tax credits.

§ 5.05 Conclusion

At the time of the writing of this article, there are three remaining foreign tax generator cases pending before the courts. The cases are *AIG v. United States* in the Southern District of New York,[167] *Sovereign Bancorp Inc. v. United States* in the U.S. District Court for Massachusetts,[168] and *Bank of New York Mellon Corp. v. Commissioner*[169] in the Tax Court.[170] In the *AIG* case, AIG is seeking a

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[159] *Id* at 81-82.
[160] *Id* at 82.
[161] *Id*.
[162] *Id*. at 83 (quoting AR Lantz Co v US, 424 F2d 1330, 1333 (9th Cir 1970)).
[163] *Id* at 83 (quoting Welch v Commr, 204 F3d 1228, 1230 (9th Cir 2000)).
[164] *Id* at 83.
[165] *Id* at 86-88.
[166] *Id* at 89 (citations omitted).
[167] AIG v US, No 09-cv-1871 (SDNY).
[168] Sovereign Bancorp Inc v US, No 1:09-cv-11043-GAO (D Mass 2009).
[169] Bank of New York Mellon Corp v Commr, No 026683-09 (TC).

refund of tax payments that resulted from the Service's disallowance of foreign tax credits arising from AIG's transactions that involved eight foreign entities, including FOP, the entity in the *Hewlett-Packard* case.[171] In the *Sovereign Bancorp* case, Sovereign Bancorp, a holding company, is seeking to recover federal income taxes, penalties, and interest it paid relating to the Service's disallowance of foreign tax credits claimed by Sovereign Bancorp.[172] As described in Sovereign Bancorp's complaint filed with the district court, the foreign tax credits were claimed for taxes Sovereign Bancorp paid to the United Kingdom in relation to a financing transaction under which Barclays Bank PLC provided Sovereign Bank, a subsidiary of Sovereign Bancorp, with funding at a rate below Sovereign Bank's usual cost of funds.[173] Finally, in the *Bank of New York Mellon Corp* case, the bank is asking the Tax Court to uphold a $900 million tax benefit relating to foreign tax credits claimed by BNY Mellon arising also from funding from Barclays.[174]

As in *Pritired* and *Hewlett-Packard*, the courts' decisions in the three pending cases will likely include an in-depth analysis of the facts relating to the complex structured transactions at issue. As noted earlier, such highly-structured transactions have diminished since the issuance of the IRS directive and the Treasury regulations and the initiation of the foreign tax credit generator litigation, and the decisions in *Pritired* and *Hewlett-Packard*, as well as the decisions in the pending cases, regardless of outcome, will further discourage such activity. However, foreign tax credits are an important part of the United States' system of taxation on worldwide income, and the benefits of foreign tax credits will continue to be a significant component of tax planning and strategy. The *Pritired* opinion highlights the critical significance of a financial transaction's business purpose beyond obtaining such foreign tax credit benefits, and the *Pritired* and *Hewlett-Packard* opinions both highlight the importance of the characteristics of a transaction in a court's debt-equity analysis in foreign tax credit cases.

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[170] *U.S. Government Bags Another FTC Generator Win in Hewlett-Packard*, Tax Analysts Worldwide Tax Daily, 2012 WTD 96-1 (May 17, 2012).

[171] Lynnley Browning, *AIG Sues U.S. for Return of $306 Million in Tax Payments*, THE NEW YORK TIMES (March 20, 2009), www.nytimes.com/2009/03/20/business/20aig.html?_r=1; 2009 TNT 39-2, *AIG Sues IRS for Refund While Accepting New Federal Bailout Funds*, Tax Notes Today, 2009 TNT 39-2 (March 3, 2009).

[172] See the complaint filed by Sovereign Bancorp in the U.S. District Court for the District Court of Massachusetts, available at 2009 TNT 117-20, *Sovereign Bancorp Files Complaint Over Denied Credits*, Tax Notes Today (June 22, 2009).

[173] *Id*.

[174] Tim McLaughlin, *BNY Mellon Readies Defense of $900 Million Tax Benefit*, REUTERS (March 20, 2012), www.reuters.com/article/2012/03/20/us-bnymellon-taxes-idUSBRE82J0YJ20120320.

Current Developments

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§ 6.01 ACCOUNTING

Rev Proc 2012-19
2012-14 IRB 689

Changes in Accounting Periods and Methods of Accounting

Synopsis: The IRS has issued procedures for obtaining automatic consent from the IRS to change to the methods of accounting provided in Temporary Treasury Regulation Sections 1.162-3T, 1.162-4T, 1.263(a)-1T, 1.263(a)-2T, and 1.263(a)-3T for taxable years beginning on or after January 1, 2012.

On December 27 2011, the IRS issued Temporary Treasury Regulations under Temporary Treasury Regulation Sections 1.162-3T, 1.162-4T, 1.263(a)-1T, 1.263(a)-2T, and 1.263(a)-3T (TD 9564). These Temporary Treasury Regulations specifically require a taxpayer seeking to change to a method of accounting provided in the temporary regulations to secure the consent of the IRS. Revenue Procedure 2011-14 provides the procedures by which a taxpayer may obtain automatic consent from the Commissioner to change to a method of accounting.

The IRS has now issued Revenue Procedure 2012-19 which modifies Revenue Procedure 2011-14 and is effective for tax years beginning after December 31, 2011. This new revenue procedure provides rules in regards to materials and supplies, amounts paid or incurred for repairs and maintenance, capital expenditures, amounts paid or incurred for the acquisition and production of tangible property, and amounts paid or incurred for the improvement of tangible property.

Rev Proc 2012-20
2012-14 IRB 700

Changes in Accounting Periods and Methods of Accounting

Synopsis: The IRS has issued procedures for obtaining automatic consent from the IRS to change to the methods of accounting provided in Temporary Treasury Regulation Sections 1.167(a)-4T, 1.168(i)-1T, 1.168(i)-7T, and 1.168(i)-8T for taxable years beginning on or after January 1, 2012.

These newly issued Temporary Regulations (TD 9564) also require a taxpayer seeking to change to a method of accounting provided in the temporary regulations to secure the consent of the IRS as outlined in Revenue Procedure 2011-14. The IRS has issued Revenue Procedure 2012-20 which also modifies Revenue Procedure 2011-14. The changes made by Revenue Procedure 2012-20 apply to a taxpayer that wants to change its methods of accounting to comply with Temporary Treasury Regulation Section 1.167(a)-4T for MACRS property and certain depreciable intangible assets that the taxpayer placed in service after December 31, 1986, or with Temporary Treasury Regulation Sections 1.168(i)-1T, 1.168(i)-7T, or 1.168(i)-8T for MACRS property.

§ 6.02 CORPORATIONS

Notice 2012-15
2012-9 IRB 424

Cross-border Stock Transfers

Synopsis: The IRS has issued guidance under IRC section 367(a) and (b) in the case of some transfers of stock to foreign corporations in exchange for property under IRC Section 304. The Treasury and IRS will amend the section 367 rules to incorporate the guidance.

IRC Section 367(a)(1) generally provides that if a United States person transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 356, or 361, the foreign corporation will not be considered a corporation for purposes of determining the extent to which the United States person recognizes gain on such transfer. IRC Section 367(a)(2) and (3) provide specific exceptions to the general rule.

Treasury Regulation Section 1.367(a)-3 provides exceptions to the general rule of section 367(a)(1) for certain transfers by a U.S. person of stock or securities to a foreign corporation. In some cases, these exceptions require the U.S. person to file a gain recognition agreement (GRA). Treasury Regulation Section 1.367(a)-8 provides guidance pertaining to GRAs, including examples addressing when a GRA needs to be filed, when it will be triggered, and when exceptions to these triggering events apply. The triggering event exceptions address distributions in redemption of stock, including by reason of the application of IRC Section 304(a)(1).

In Notice 2012-15 the IRS revises the approach to the interaction of IRC Sections 367 and 304 by providing that IRC Section 367(a) and (b) apply fully to the deemed Section 351 exchange. The notice states that they will amend the IRC Section 367 rules to provide that an IRC Section 351 exchange that is deemed to occur in an IRC Section 304 transaction is subject to IRC Section 367(a) and (b) in the manner described in Notice 2012-15.

Notice 2012-15 provides that to the extent that under IRC Section 304(a)(1), a U.S. person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in a deemed IRC Section 351 exchange, the transfer is subject to IRC Section 367(a) and the applicable rules, including the exceptions described in Treasury Regulation Section 1.367(a)-3(b)(1) and (c)(1). Thus, a transferor in an IRC Section 304 transaction that is a U.S. person may in some cases be allowed to enter into a gain recognition agreement under Treasury Regulation Section 1.367(a)-8 to avoid the recognition of gain under IRC Section 367(a)(1). Further, to the extent that under IRC Section 304(a)(1), a foreign corporation acquires the stock of a foreign corporation in a deemed IRC Section 351 exchange, the exchange is subject to IRC Section 367(b) and the applicable rules.

§ 6.03 EMPLOYMENT

Notice 2012-9
2012-4 IRB 315

Employees' Receipts

Synopsis: The IRS has issued interim guidance on informational reporting to employees of the cost of their group health insurance coverage under IRC Section 6051(a)(14). Notice 2012-9 modifies and supersedes Notice 2011-28, which solicited comments on various aspects of the reporting requirement.

The interim guidance is applicable to Forms W-2 issued for 2012 and later. IRC Section 6051(a)(14) generally requires the aggregate cost of applicable employer-sponsored coverage to be reported on Form W-2. This reporting requirement is for informational purposes only. All employers that provide applicable employer-sponsored coverage during a calendar year are subject to this reporting requirement. However, this requirement does not apply to employers filing fewer than 250 Forms W-2. The notice provides that employers may include the cost of coverage under programs not required to be included under applicable interim relief, such as the cost of coverage under a health reimbursement arrangement. The notice explains how to calculate the reportable amount for coverage only a part of which constitutes coverage under a group health plan and how to calculate the reportable amount when coverage extends over the payroll period that includes December 31.

Notice 2012-9 also describes how to calculate the reportable amount if an employer is given notice after December 31 of events that occurred on or before December 31 that affect the previous year's coverage, such as an employee providing an employer notice of a divorce or other change in family status that occurred during a previous calendar year. The guidance further clarifies the application of the exception for some hospital indemnity or other fixed indemnity insurance offered by an employer on an after-tax basis. Moreover, the notice specifies that the reportable amount doesn't have to be included on a Form W-2 provided by a third-party sick-pay provider.

Notice 2012-13
2012-9 IRB 421

Tax Credit for Hiring Qualified Veterans

Synopsis: The IRS has issued guidance on a recently expanded work opportunity tax credit for hiring qualified veterans.

IRC Section 51 provides for a work opportunity tax credit for employers that hire individuals who are members of targeted groups. Before claiming the credit, an employer must obtain certification from a designated local agency that an individual is a targeted group member. An employer generally must submit Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Credit, to the designated local agency by the 28th day after the individual begins work.

Notice 2012-13 explains how to electronically file Form 8850 using electronic signatures. An employer may submit Form 8850 to the designated local agency electronically if its system satisfies the requirements in Announcement 2002-44. The new guidance also lets employers use two alternative methods of certification using electronic signatures. First, an employer may print out a paper copy of Form 8850 that was signed electronically by both the applicant and the employer and transmit that paper copy to the designated local agency. Second, an employer may file Form 8850 using a method under which the applicant signs electronically but the employer signs in ink. An employer electing the second method must satisfy five conditions listed in the guidance. As an alternative to the electronic signature method, Form 8850 can be submitted by fax if conditions set forth in the guidance are satisfied.

Employers are also provided with additional time to file Form 8850. Any employer who hires a qualified veteran after November 21, 2011, and before May 22, 2012, will be considered to satisfy the certification requirements if the employer submits the completed Form 8850 to the designated local agency by June 19, 2012.

New IRC Section 3111(e) allows qualified tax-exempt organizations that hire qualified veterans after November 21, 2011, to claim a credit against the employer share of Social Security tax. The requirements for certification apply to qualified tax-exempt organizations as well as to taxable employers. The filing extension and guidance provided in Notice 2012-13 also apply qualified tax-exempt organizations. Qualified tax-exempt organizations must use Form 5884-C, Work Opportunity Credit for Qualifying Tax-Exempt Organizations Hiring Qualified Veterans, to claim the credit.

Notice 2012-17
2012-9 IRB 430

IRS Guidance on Affordable Care Act Provisions

Synopsis: The IRS has issued guidance providing answers to frequently asked questions from employers and other stakeholders on Affordable Care Act provisions regarding automatic enrollment of full-time employees in an employer's health plan, employer shared responsibility, and the 90-day limitation on waiting periods.

Beginning after December 31, 2013, large employers will be required to meet certain requirements designed to expand access to affordable health care. The Patient Protection and Affordable Care Act (Affordable Care Act) includes the requirements that large employers will have to satisfy. These requirements include: automatic enrollment of full-time employees in an employer's health plan, shared responsibility of employers regarding health coverage, coverage to be offered through State-based Affordable Insurance Exchanges, premium tax credits to assist individuals in purchasing coverage through Exchanges, and other related provisions.

Notice 2012-7 provides information on questions from employers and other stakeholders regarding automatic enrollment, employer shared responsibility, and the 90-day limitation on waiting periods. The Notice also identifies various approaches that the departments of Labor, Health and Human Services, and Treasury are considering proposing in forthcoming guidance.

§ 6.04 EXEMPT ORGANIZATIONS

Final Treasury Regulations, TD 9581

Final Regulations Clarify IRS Rules on Disclosure of Exemption Rulings

Synopsis: Final regulations revise the rules on, and formalize the IRS's current practice of, disclosing documents regarding the denial or revocation of an organization's tax-exempt status.

The final regulations adopt, with some changes, the proposed regulations (REG-116215-07) issued in 2007. The proposed regulations were issued as a result of *Tax Analysts v IRS*, where the D.C. Circuit held that parts of Treasury Regulation Sections 301.6104(a)-(1)(i) and 301.6110-1(a) violated IRC Section 6110, which relates to information pertaining to written determinations made publicly available by the IRS. Before the *Tax Analysts* decision, the IRS relied on those regulations to withhold letter rulings denying or revoking tax-exempt status from public inspection. In accordance with the decision, the IRS now makes those letter rulings available to the public.

The final regulations amend Treasury Regulation Sections 301.6104(a)-1(i) and 301.6110-1(a) to eliminate the portions of the previous rules that the D.C. Circuit held violated IRC Section 6110. Treasury Regulation Section 301.6104(a)-1 is also amended so the regulation conforms to other current laws and administrative practices.

News Release, IR 2012-34
2012 IRB LEXIS 183

IRS Offers Online Tool for Searching Exempt Organization Information

Synopsis: The Internal Revenue Service has launched a new online search tool, *Exempt Organizations Select Check*, to help users more easily find key information about tax-exempt organizations.

The new online search tool allows users to easily access key information about tax-exempt organizations, such as federal tax status and filings. Users may rely on this information provided to determine deductibility of contributions. The site offers improved search functions and provides new pop-up help text to assist users in understanding the significance of auto-revocation search results, including the meaning of, and distinctions between, revocation dates and revocation posting dates.

§ 6.05 LIKE-KIND EXCHANGES

Fort Properties Inc v American Master Lease LLC
2012 US App LEXIS 3900

Like-kind Exchange Investment Strategy Not Patent Eligible

Synopsis: The Federal Circuit affirmed a district court decision that applied the machine-or-transformation test and held that a patent for an IRC Section 1031 like-kind exchange investment strategy did not meet patent subject matter eligibility requirements.

At issue was a patent that discloses an investment tool designed to enable property owners to buy and sell properties without incurring tax liability by utilizing the benefits provided by IRC Section 1031. This was done by aggregating numerous properties into a "real estate portfolio." The property interests in this portfolio are then divided into shares and sold to investors. The district court invalidated all of the patent claims for failing to claim patent-eligible subject matter under 35 USC Section 101.

35 USC Section 101 specifies four independent categories of inventions or discoveries that are eligible for protection: processes, machines, manufactures, and compositions of matter. In its review of the case, the Circuit Court evaluated whether the real estate investment tool disclosed can be classified as a process. The Court, after a review of the applicable case law, determined that the patent was attempt to capture unpatentable abstract subject matter rather than a patentable process.

§ 6.06 PARTNERSHIPS

Proposed Treasury Regulations, 76 FR 72875
REG-109369-10

Material Participation under Passive Activity Loss Rules

Synopsis: The IRS has published proposed Treasury Regulations on the definition of an interest in a limited partnership as a limited partner for purposes of determining whether a taxpayer materially participates in an activity under IRC Section 469.

For purposes of the passive activity loss rules, an individual materially participates in an activity only if one of seven criteria under Treasury Regulation Section 1.469-5T(a) are met. An individual may establish material participation in a limited partnership, but the rules constrain the individual to only three of the seven criteria. Treasury Regulation Section 1.469-5T(e)(3)(i) explains when a partnership interest shall be treated as a limited partnership interest, and Treasury Regulation Section 1.469-5T(e)(3)(ii) provides a general partner exception that allows an individual to demonstrate material participation through any of the seven criteria.

The Proposed Treasury Regulations provide that an interest in an entity will be treated as an interest in a limited partnership under IRC Section 469(h)(2) if the entity in which the interest is held is classified as a partnership under Treasury Regulations Section 301.7701-3 and the holder of the interest does not have rights to manage the entity at all times during the entity's tax year under the law of the jurisdiction in which the entity was organized and under the governing agreement. The rights to manage include the power to bind the entity.

The preamble provides that the rules concerning a limited partnership interest are provided only for purposes of IRC Section 469. No inference is intended that the same rules would apply for any other tax code provisions requiring a distinction between a general partner and a limited partner. The Proposed Treasury Regulations also eliminate the current rules' reliance on limited liability for purposes of determining whether an interest is an interest in a limited partnership as a limited partner under IRC Section 469(h)(2). The Proposed Treasury Regulations instead adopt an approach that relies on the individual partner's right to participate in the management of the entity.

§ 6.07 PENSION PLANS

Proposed Treasury Regulations, 77 FR 5443
REG-115809-11

Longevity Annuity Contracts

Synopsis: The IRS has issued proposed regulations that would modify rules on minimum distribution requirements to encourage greater participation in longevity annuities, also commonly referred to as longevity insurance.

The Treasury Department and the IRS determined that participation in longevity annuities at an advanced age would help participants minimize the risk of drawing down their benefits too quickly and then outliving their retirement savings. As a result, the IRS issued proposed regulations that modify the required minimum distribution rules under IRC Section 401(a)(9) in order to encourage the purchase of a deferred annuity that is scheduled to commence at an advanced age, such as age 80 or 85. Under the proposed rules, prior to annuitization, the participant would be permitted to exclude the value of a longevity annuity contract that meets certain requirements from the account balance used to determine required minimum distributions. Thus, a participant would never need to commence distributions from the annuity contract before the advanced age in order to satisfy the required minimum distribution rules and, accordingly, the contract could be designed with a fixed annuity starting date at the advanced age (and would not need to provide an option to accelerate commencement of the annuity).

Proposed Treasury Regulations, 77 FR 5454
REG-110980-10

Synopsis: The IRS has issued proposed regulations modifying minimum present value requirements for partial annuity distribution options for defined benefit plans. This would allow plan participants to elect to receive a portion of their retirement benefits in annuity form, with the remainder distributed through accelerated payments. Because both portions of such a distribution option are subject to minimum present value requirements under IRC Section 417(e)(3), the proposed regulations create an exception for plans with bifurcated accrued benefits.

These proposed regulations amend the IRC Section 417(e) regulations to simplify the treatment of certain optional forms of benefit that are paid partly in the form of an annuity that is excepted from the minimum present value requirements of IRC Section 417(e)(3). Where a defined benefit plan offers a single-sum distribution or other form of accelerated distribution as an optional form of benefit in addition to the required qualified joint and survivor annuity, many participants have been reluctant to elect lifetime payments to insure against unexpected longevity, choosing instead an accelerated distribution form in order to maximize their liquidity. However, participants who elect a single sum or other accelerated form of distribution may face a greater challenge in protecting themselves against the risk of outliving their retirement savings.

The IRS and the Treasury Department believe that many participants would be better served by having the opportunity to elect to receive a portion of their retirement benefits in annuity form (which provides financial protection against unexpected longevity) while receiving accelerated payments for the remainder of the benefit to provide increased liquidity during retirement. Under current regulations, both portions of such a distribution option are subject to the minimum present value requirements of section 417(e)(3).

The proposed regulations would provide an exception to this rule in the case of a plan with a bifurcated accrued benefit as defined in the proposed regulations. Under this exception, such a plan is permitted to provide that, if a participant selects two different distribution options with respect to separate portions of the bifurcated accrued benefit, then the two different distribution options are treated as two separate optional forms of benefit for purposes of applying the requirements of IRC Section 417(e)(3). Thus, if this rule applies to treat two separate distribution options selected with respect to separate portions of a bifurcated accrued benefit as two separate optional forms of benefit, and one of those separate optional forms of benefit is exempt from the requirement to use the IRC Section 417(e)(3) assumptions, then that exemption would apply to that separate optional form of benefit. In such a case, the plan would have to apply the IRC Section 417(e)(3) assumptions only to the separate optional form of benefit that is not so exempted (rather than apply those assumptions to the entire optional form of benefit).

§ 6.08 S CORPORATIONS

Taproot Administrative Services, Inc v Commissioner
2012 US App LEXIS 5865

Appeals Court Affirms Roth IRA Cannot be a S Corporation Shareholder

Synopsis: The Ninth Circuit affirmed a Tax Court decision that held that a corporation that elected S corporation treatment was taxable as a C corporation because its sole shareholder, a Roth IRA, was an ineligible S corporation shareholder.

To elect to be taxed as a S corporation, a small business corporation must first meet all of the eligibility requirements which includes limitations as to the types of shareholders. IRC Section 1361 limits S corporation shareholders to domestic individuals, estates, certain trusts, and certain tax-exempt entities. After making the S corporation election, Taproot issued all outstanding shares of its stock to a custodial Roth IRA account. The taxpayer argued that the Roth IRA was merely the form of the investment account and the beneficiary was the actual shareholder. In affirming the Tax Court's decision that a Roth IRA was not a valid S corporation shareholder, the Ninth Circuit determined that the meaning of "individual" in IRC Section 1361 excludes IRA and Roth IRA accounts. The Court relied on the premises that words of statutes should be interpreted in their ordinary, everyday senses and on Revenue Ruling 92-73, which provides persuasive guidance that IRAs are ineligible for S corporation shareholders.