Tax Management

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HIGHLIGHTS

Rules Would Clarify When Derivative Exchanges Occur During Transfers

IRS issues final, temporary, and proposed rules (T.D. 9538; REG-109006-11) that, if finalized, will clarify that there is no exchange to a nonassigning counterparty under §1001 when a securities dealer or clearinghouse transfers or assigns a derivative contract to another dealer or clearinghouse. The rules would amend and expand §1001 to include derivative contracts other than notional principal contracts. The need to amend that section was increased by the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203), which IRS says will necessitate, in some cases, the movement of entire books of derivatives contracts. **907**

IRS Issues Directive on Applying Codified Economic Substance Doctrine

IRS issues a long-awaited directive (LB&I-4-0711-015) for examiners to use in determining whether and when to seek high-level review in asserting the codified economic substance doctrine and its associated strict liability penalty. The guidance requires examiners to undertake a four-step inquiry before asking an IRS director of field operations to assert the penalty. It sets out lists of factors to delineate cases where it likely would be appropriate to assert the economic substance doctrine and cases where it would be unlikely, after many months of questions on how taxpayers can identify transactions that would fall under the aegis of new §7701(o). **911**

Updated UTP Guidance Clarifies Treatment of Net Operating Loss

IRS offers more guidance to taxpayers on how they should report their uncertain tax positions to the government, addressing key questions surrounding the recording of a tax reserve and the treatment of net operating loss carryforwards, among other significant issues. The updated set of frequently asked questions and answers comes as the deadline approaches for the first wave of taxpayers to file the Schedule UTP, *Statement of Uncertain Tax Position*. The guidance adds eight new questions to the FAQ first unveiled in March and updates one existing question on whether interest and penalties should be included when taxpayers are ''ranking'' their positions on the new schedule. **891**

FOCUS: Is Subpart F Here to Stay?

The author of this week's *Focus* writes that whatever model the U.S. tax system takes under future reform efforts, the controlled foreign corporation rules will at least be a component of that system. ''Many territorial countries use some form of CFC rules to eliminate a perceived incentive for taxpayers to shift passive or other types of income offshore,'' the author notes. ''Even if the United States were to move to a territorial system (which would take time to implement), it seems Subpart F, in some form, is likely to continue.'' The author addresses aspects of Subpart F that deserve renewed attention. **901**

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APPLICABLE FEDERAL RATES: IRS issues applicable federal interest rates for August 2011. **913**

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BNA AUDIOCONFERENCE

TRUSTS: A Tax Management audioconference, **How to Design, Explain, and Implement Dynasty Trusts And Asset Protection Trusts And Maximize Benefits**, will be held July 26. To register, call 800-372-1033, opt. 6 or visit http://www.bna.com/tax-accounting-events.

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TAX MANAGEMENT

WEEKLY REPORT

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Current Developments

Disclosure

IRS Issues Uncertain Tax Position Guidance, Clarifies Definition Of Recording a Reserve

The IRS offered more guidance July 19 to taxpayers about reporting their uncertain tax positions to the government, addressing key questions surrounding the recording of a tax reserve and the treatment of net operating loss carryforwards, among other significant issues.

The updated set of frequently asked questions and answers (FAQ) comes as the deadline approaches for the first wave of taxpayers to file the Schedule UTP, *Statement of Uncertain Tax Position*. The guidance adds eight new questions to the FAQ first unveiled in March and updates one existing question on whether interest and penalties should be included when taxpayers are ''ranking'' their positions on the new schedule.

Stakeholders said the guidance is welcome. Lawrence Hill, a practitioner with Dewey & LeBoeuf LLP in New York, said, ''The new FAQs provide constructive guidance on a number of common questions that are being confronted by corporate taxpayers, including when interest and penalties must be included in a ranking of the tax position, the definition of a reserve, reporting related to merged corporations and in the case of an intention to litigate, clarification of the recording of NOLs, and the application of the transition rules.''

He noted that the guidance issued will be part of the 2011 instructions, ''but does clarify the issues for taxpayers who have not yet filed their 2010 returns.''

Recording a Reserve Defined. In general, under the IRS initiative, taxpayers are required to report uncertain positions for which they have recorded a reserve, but many have said there is uncertainty about what that term means. In Question 6, the IRS clarified that a reserve is recorded when an uncertain tax position or a liability under Financial Accounting Standards Board Interpretation 48 (FIN 48) is stated anywhere in the financial statements and footnotes of a corporation or related party.

Michelle Koroghlanian, a technical manager with the American Institute of Certified Public Accountants, said July 19 that, ''We're very pleased to see the guidance and appreciate that the government has been so open to listening to taxpayers. The new additional FAQs really do touch on a lot of areas that have been of concern.''

She noted that the clarification of what it means to record a reserve is especially helpful. IRS said that some types of financial statement entries that, alone or in tandem, indicate the recording of a reserve include:

- an increase in a current or non-current liability for income taxes, interest, or penalties payable, or a reduction of a current or non-current receivable for income taxes and/or interest with respect to a tax position; or
- a reduction in a deferred tax asset or an increase in a deferred tax liability with respect to the tax position.

Net Operating Loss Guidance. In the NOL area, IRS posted an example where a taxpayer carries forward an NOL from its 2010 tax return that will not be utilized to reduce tax liability until 2012. However, the taxpayer records a reserve for the position that is reflected on an audited financial statement in 2010. IRS said that this reporting in 2010 is the only reporting required and the taxpayer does not have to do any additional reporting in 2012.

''Even though the future use of the NOL or credit carryforward is a tax position for which the corporation recorded a reserve, the IRS will not require reporting with respect to the future use of NOLs or credit carryforwards,'' the agency said.

Addressing several other issues, IRS said in broad terms that:

- taxpayers should not file blank Schedules UTP if they have no 2010 tax positions for which reserves have been recorded;
- taxpayers who reconsider their tax positions during the course of an audit and record a reserve in a later year must report those positions on a Schedule UTP in that later year, even if IRS is already aware of the position;
- taxpayers must report a position either if they record a reserve, or if they do not record a reserve because they expect to litigate, even if that decision to record or not record occurs because of a change in circumstances in a later year;
- taxpayers are not required to report accruals of interest on a tax reserve recorded with respect to a tax position taken on a pre-2010 tax return; and
- taxpayers do not have to include interest and penalties in ranking the size of a tax position, or in computing whether a position is a major position, unless they are separately identified in the books and records associated with that position.

Clarifying Taxpayer Questions. The questions and associated answers ''are going to be very helpful for taxpayers trying to sort out what their reporting responsibilities are under the Schedule UTP,'' said Ken Kuykendall, a practitioner with PricewaterhouseCoopers LLP in Washington, D.C., to BNA July 19.

He said the guidance ''goes a long way" in clarifying answers to many questions that taxpayers had. ''You get an answer as to what the Service means by recording a reserve, how to handle reserves that are part of NOLs in 2010 and after, and how to deal with UTPs that arise in business combinations," he said.

Kuykendall said that the definition of recording a reserve is broad, but does offer taxpayers clarity. ''By having a broad definition the Service is really leveraging financial accounting reporting,'' he said, noting that the

definition appears to be flexible enough to deal with other accounting frameworks, such as international financial reporting standards.

With regard to IRS's addressing of the NOL issue, ''I think it was probably the best answer that taxpayers could have hoped for, as it eliminates the need for taxpayers to potentially disclose these UTPs multiple times,'' Kuykendall said. He noted that under the new IRS guidance, taxpayers will only need to report NOLs in the initial year the position was taken that created the tax attribute.

Strong Links Seen to Financial Accounting. This approach is more closely linked to financial accounting for these attributes, the PwC practitioner said. He noted that more clarification may be useful in IRS's definition of taking a position on a return, which currently encompasses any line item on a tax return that is impacted by an uncertain position, even informational portions of a return.

''The Service may need to look at this,'' Kuykendall said, noting that this could touch on areas that have impact on informational portions of returns that have not given rise to a tax liability. He said an example could be the area of earnings and profits, where under the IRS guidance, if a calculation for a foreign subsidiary has some associated uncertainty, it could trigger reporting even though there is no current liability.

BY ALISON BENNETT

Health and Welfare Benefit Plans

HHS Proposes Rule on Nonprofit CO-OPs, Says Consumers Will Have Greater Choice

The Health and Human Services Department July 18 proposed standards for private, nonprofit organizations that seek to offer health plans through the insurance exchanges scheduled for operation in 2014.

HHS said in a proposed rule that the consumer-governed plans created by the Consumer Operated and Oriented Plan (CO-OP) are designed to provide affordable, responsive, coordinated care in both the individual and small-group markets.

The Patient Protection and Affordable Care Act (P.L. 111-148) created the CO-OP program, and Congress has made available $3.8 billion in loans to develop CO-OPs. The proposed rule includes information about qualifying for such loans, and a funding opportunity announcement is expected soon, according to HHS officials.

Organizations that wish to offer plans through the insurance exchanges would have to satisfy or be reasonably be expected to satisfy standards in §1322(c) of the Affordable Care Act.

Section 1322(c) added a new §501(c)(29) to the Internal Revenue Code, spelling out requirements for tax exemption for qualified nonprofit health insurance issuers. The IRS March 10 issued guidance on tax-exemption requirements for qualified nonprofit health insurance issuers described in §501(c)(29) (Notice 2011-23).

Consumer Choices. ''CO-OPs will provide consumers more choices, greater plan accountability, and help ensure a more competitive insurance market,'' Steve Larsen, director of HHS's Center for Consumer Information and Insurance Oversight, said in a statement. ''Today's announcement shows how the Affordable Care Act is bringing new choices and giving consumers a voice in insurance markets throughout the nation.''

Larsen told reporters on a conference call that the role each CO-OP plays will vary, based on the needs of the market in which it operates.

Robert Zirkelbach, a spokesman for the trade group America's Health Insurance Plans, said that the group is reviewing the proposed rule to determine its effects on existing insurers—and whether all plans would be treated fairly under the regulation.

''There must be a level playing field where all companies providing insurance, including co-ops, are required to abide by the same rules and regulations,'' he said.

The proposed rule was published in the July 20 *Federal Register*. Comments are due Sept. 16.

CO-OP Standards, Loans. HHS said it aims to help establish a new CO-OP in every state ''in order to expand the number of qualified health plans available in the Exchanges with a focus on integrated care and greater plan accountability.''

Only a few states—Washington, Idaho, Minnesota, and Wisconsin—have insurers that meet the consumer-focused standards set forth in the proposed rule, according to HHS. Those insurers cover more than 1 million people for a 1% market share of the private market.

Under the proposed rule, only new organizations are able to become CO-OPs. Specifically, if the organization or any related entity was an insurance issuer on July 16, 2009, the organization is ineligible. States and local governments also are ineligible.

The proposed rule also requires that the governance of a CO-OP be subject to a majority vote of its members and that any profits be used to benefit members, such as by lowering premiums or improving benefits. Each CO-OP also must adhere to the same rules as any other insurer operating in the state.

To help CO-OPs develop, the federal government will give out loans for start-up costs and to help each CO-OP meet the reserve and solvency requirements of the state it operates in. Start-up loans will have a repayment period of five years, and solvency loans will have a repayment period of 15 years.

HHS said in the proposed rule that it expects 65% of the solvency loans and 60% of the start-up loans will be repaid. Larsen said the department was cautious in developing its estimates and does not expect such low rates of repayment.

The proposed rule was developed with input from an advisory board. The group April 15 approved a draft report for HHS on the program's structure and rules.

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International

Talks Pursued With U.S. Officials to Resolve Tax Evasion Concerns With Swiss Banks

Switzerland is still pursuing talks with the United States on a possible agreement aimed at resolving outstanding matters with Swiss financial institutions suspected of assisting clients in evading U.S. taxes, despite reports that American authorities have rejected the idea, a Swiss government official said July 21.

Roland Meier, Swiss Department of Finance spokesman, declined to comment on a report in the Swiss weekly newspaper *SonntagsZeitung* that the United States has informed Switzerland it is not interested in pursuing such an agreement.

''Switzerland is in discussions with the U.S. authorities about a general solution to settle tax problems of the past,'' Meier told BNA. ''We do not comment on the development of these talks. Switzerland is willing to find a solution within the framework of Swiss legal norms.''

SonntagsZeitung reported July 17 that U.S. authorities sent a letter two weeks earlier to Michael Ambuhl, Switzerland's State Secretary for International Financial and Tax Matters, declaring that the United States was not interested in negotiating an agreement aimed at resolving outstanding tax matters concerning all Swiss financial institutions suspected of assisting U.S. clients to evade U.S. taxes. The weekly cited an unnamed source with ''inside knowledge'' of the matter.

The talks continue as U.S. authorities on July 21 charged three former Credit Suisse employees and the founder of a Swiss trust company with conspiring with other Swiss bankers to defraud the United States by helping U.S. customers hide $3 billion in Swiss accounts. In February, four others were charged in an indictment for their roles in the conspiracy.

Heading Off Another UBS Affair. The Swiss efforts are intended to head off a repeat of the 2009 UBS affair, when Switzerland's largest bank, was forced to hand over details on more than 4,000 secret bank accounts held by U.S. nationals in order to settle proceedings that could have led to the loss of the bank's operating license in the United States for facilitating tax fraud. It was once estimated that those accounts held $18 billion in assets.

UBS also agreed earlier that year to hand over details on 255 accounts held by U.S. taxpayers and pay a $780 million fine to settle allegations of conspiring to defraud the U.S. government.

Those efforts appear to have failed after Credit Suisse, Switzerland's second largest bank, acknowledged July 15 that it is under investigation by the U.S. Justice Department as part of ongoing efforts by U.S. authorities to crack down on tax evasion through offshore and private Swiss banking entities.

Pressure to Reveal Secret Accounts. The move marks the latest setback for the Swiss banking system, which has been under mounting pressure from the United States and neighboring European Union countries to reveal information about secret Swiss bank accounts held by their nationals.

The Swiss Bankers Association, which represents the country's banking industry, declined to comment on the Swiss-U.S. talks.

Walter Boss, a tax attorney with the Zurich law firm Poledna Boss Kurer AG, said the problem in the negotiations has been that U.S. authorities not only want an ''enormous amount of money'' from the Swiss banks for settling the matter but also a great amount of data on bank clients and client advisers.

''This is contrary to Swiss law which has already been 'bent' in the case of UBS,'' Boss declared, adding it is ''commonly acknowledged'' that the Swiss parliament was unlikely to approve a second Swiss-U.S. tax settlement similar to the one it was asked to approve for the UBS settlement last year.

The fallout from the American tax evasion investigation involving Credit Suisse and other private Swiss banking entities could have a chilling effect on financial institutions dealing with U.S. clients.

HSBC Private Bank, for example, has decided to no longer offer wealth management services to U.S. private clients from locations outside of the United States.

''After a review of services that can be provided to U.S. clients from locations outside of the U.S., we believe that U.S. clients will be better served by our Private Banking teams in the United States,'' said a HSBC Private Bank spokesman in Geneva.

Facing Problems With Other Countries. Swiss authorities are also refusing to comment on reports that a separate agreement with Germany on resolving outstanding tax matters was also at risk because Swiss banks were balking at paying billions to German tax authorities as part of the deal.

Germany's *Handelsblatt* newspaper reported July 19 that Swiss banks may be obliged to reach a deal by making an upfront payment of up to 4 billion euro ($5.75 billion) and another payment equivalent to 30% of the income generated by the secret Swiss accounts of German nationals over the past 10 years.

With an estimated 150 billion euro ($215 billion) of private German funds currently stashed away in Swiss banks, the cost of the income charge could be as high as 10 billion euro ($14 billion), *Handelsblatt* said, adding that the Swiss-German talks were expected to continue through the fall.

Meier declined to comment on the Swiss-German negotiations, which Swiss president Micheline Calmy-Rey said last May were expected to be concluded by the middle of the year.

The agreement with Germany, as well as a separate agreement currently being negotiated with the United Kingdom, would impose a withholding tax on the earnings of Swiss bank accounts held by German and U.K. nationals, with most of the money collected then being transferred to Germany.

Balking at Some Agreements. Unlike an existing agreement between Switzerland and the European Union which imposes a withholding tax on interest earnings, the deals with Germany and the U.K. would include the possible taxation of earnings from dividends, income from collective investments, capital gains, and other possible earnings sources.

Boss said the problem for Swiss banks is that they would have to guarantee payments to Germany up to a

certain agreed amount. Should German account holders decide to abandon Switzerland and transfer their money elsewhere, which Swiss authorities cannot prevent, Swiss banks could end up fully footing the bill from their own funds, he said.

In addition, some Swiss banks are balking at participating in such an agreement on the grounds that they do not hold unreported German funds and should therefore be excluded from footing part of the bill, Boss added.

BY DANIEL PRUZIN

Tax Collection

IRS Doubles Whistleblower Collections In 2010 While Tipsters Wait for Payouts

The IRS collected $464.6 million as a result of whistleblower claims in fiscal year 2010, more than twice what it collected in 2009, although whistleblowers received only $18.7 million in awards, the annual whistleblower report to Congress revealed.

Whistleblower attorneys told BNA July 20 that the increase in amounts collected shows that the program is working, but that it is taking too long for claims to be paid out.

In 2009, the IRS collected $206 million from tips on tax evaders and paid $5.8 million in awards. However, that year the IRS changed its policy on the definition of the point at which proceeds in a tax case are available to be made for an award. This resulted in lower payments, the IRS said.

New Policy Delays Payout. The Office of Chief Counsel at IRS determined that it should not pay claims even when the taxpayer has not filed an appeal until the period for filing an appeal has lapsed. Therefore, the IRS did not pay some claims that it would otherwise have paid in fiscal year 2009 until FY 2010 or FY 2011, the report said.

While the amounts IRS collected between FY 2008 and FY 2009 stayed about the same, $155.9 million and $206 million respectively, the amounts awarded to whistleblowers in FY 2009 dropped significantly, from $22.3 million to $5.8 million.

''IRS said we are no longer going to issue award determinations until both the 6501 and 6511 period of limitations are closed, and because of that you saw a huge dip in the FY 2009 award determinations,'' Scott Knott, a tax partner at the Ferraro Law Firm in Washington, said.

The IRS collected the money in 2009, but made whistleblowers wait until the period of limitations on refunds had closed before they paid an award. ''They have added up to two years to the time it takes for the case to pay out,'' he said. According to Knott, the policy should be changed back to what it was prior to July 2009.

FY 2010 Claims. In FY 2010, the IRS received 431 whistleblower submissions relating to 5,429 taxpayers that appeared to meet the $2 million tax, penalties and interest, and additions to tax threshold in §7623(b). IRS said many who submitted information to the IRS claimed to have inside knowledge of the reported transaction often with extensive documentation to support their claims.

Only nine of 97 fully paid claims in FY 2010 involved collections of more than $2 million. However, because whistleblowers submitted all of the claims paid in 2010 under an old Informant Award Program, IRS said it is difficult to estimate how claims will fare under the new statute enacted by the Tax Relief and Health Care Act of 2006, IRS said.

Definitions Need Clarification. For the IRS's part, the report expressed concerns about the undefined nature of some of the definitions relating to whistleblower claims. IRS said the lack of definition creates uncertainty for administration of the program and determining whether the U.S. Tax Court has jurisdiction to consider appeal.

''The individual's 'gross income limitation' was apparently included in the law to ensure that the focus of the award program under §7623(b) is on relatively high income taxpayers,'' IRS said.

However, in the absence of a definition, IRS said it must look to other provisions of the Internal Revenue Code to determine how to calculate gross income.

''The IRS questions whether this effort is intended or justified, given that failure to satisfy the gross income threshold generally shifts the claim from a mandatory Section 7623(b) claim to a discretionary Section 7623(a) claim,'' the report said.

Collected Proceeds and NOLs. Another IRS administration issue was that the definition of collected proceeds does not extend to all recoveries from taxpayers.

Potential taxpayer liabilities are sometimes resolved in a manner that does not result in collected proceeds from which an award can be paid. IRS said this occurs when the taxpayer has a net loss carried forward from a prior period or carried back from a subsequent period.

Erika Kelton, attorney with Phillips & Cohen in Washington, told BNA that the whistleblower office is apparently dissatisfied that the definition of collected proceeds is not being extended to all taxpayers.

Net operating losses may be extinguished in the process of resolving a whistleblower claim and the Treasury Department may not collect cash but there is a net gain to the Treasury because NOLs are being reduced or extinguished, Kelton said.

''In other areas of law where there are whistleblower programs that kind of noncash recovery is a basis for a whistleblower reward and this has been an area of contention,'' she said. The Whistleblower Office may feel that where there is a net gain to the Treasury in collected proceeds—even if it is noncash gain—that should result in an award to the whistleblower.

Claims Under 7623(b). In FY 2011 the IRS will begin paying awards for claims made under §7623(b). In June 2010, the IRS published procedures and criteria for making award determinations under 2006 amendments to the statute. As a result whistleblowers will be given an opportunity to comment on award recommendations before a final award determination is made.

IRS said it is a top priority to update formal published guidance on §7623, and this includes much-

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publicized efforts to finalize rules on collected proceeds.

By Diane Freda

☐ *Text of the Fiscal Year 2010 Report to the Congress on the Use of Section 7623 can be found on the web at http://www.irs.gov/pub/whistleblower/annual_report_to_congress_fy_2010.pdf*

Tax Treaties

Broad Range of Tax Treaty Provisions Affect Individuals, Practitioner Says

A broad range of tax treaty provisions exists to prevent double taxation of individuals and encourage cross-border economic activity, a practitioner said July 19.

Mark Williamson of Alston & Bird LLP in Atlanta said on a webcast sponsored by BNA Tax & Accounting that although not all taxpayers are subject to double taxation, and domestic laws frequently help when they are, treaties usually address remaining problems for residents or nationals of friendly nations by providing benefits in the foreign country, not the home country.

He spoke at a time when the increasingly global economy means that more and more U.S. workers are operating overseas and the functioning of tax treaties is becoming ever more important in deciding the taxes they will pay.

Williamson said that often, the treaty benefit does not reduce a taxpayer's aggregate international tax liability, but instead eliminates a requirement to file and/or pay in the foreign country.

Some 'Cherry-Picking' Allowed. He explained that treaty rules generally are not mandatory if non-treaty internal law produces a more favorable result, with few limitations on what he called "cherry-picking."

In general, he said, "Treaties encourage cross-border economic activity, simplify the taxation of international transactions, and foster goodwill among friendly nations."

The Alston & Bird practitioner described a wide spectrum of treaty provisions affecting individuals, including so-called residency tie-breaker rules, savings clauses, and the treatment of independent workers, employees, government workers, directors, artists, and athletes.

Williamson noted that generally, residency is equated with worldwide taxation. Tie-breaker rules apply only when an individual is deemed a resident in both countries, he said. Tax authorities look to whether a taxpayer has a permanent home in one country or the other, whether a "center of vital interests" is in one country or the other, and at the location of the taxpayer's habitual abode, he said.

Other factors considered are the taxpayer's citizenship and decisions made by mutual agreement between countries, the practitioner said on the webcast.

Savings Clauses Explained. Williamson also described the operation of "savings clauses," intended to prevent U.S. citizens and residents from invoking treaty benefits to reduce U.S. tax, with some exceptions.

Countries will apply tie-breaker rules first, then take that result into account in deciding whether to apply the savings clause, he said. While the usual result is that governments will ignore the treaty in taxing the U.S. citizen or resident, or in taxing expatriates for 10 years, there are some exceptions.

Many exceptions are available to everyone, including those involving special foreign tax credits, nondiscrimination provisions, mutual agreements and competent authority decisions, foreign social security and child support, and some pension benefits, he said.

Some exceptions are also available to temporary residents, who do not have citizenship or a green card, Williamson said, including those for foreign pension plan benefits, governmental and diplomatic work, and student and business apprentice income.

By Alison Bennett

Exempt Organizations

IRS to Rely Heavily on HHS Decisions For Tax Exempt Health Care CO-OP Status

The IRS will largely piggyback on Health and Human Services Department determinations when it comes to deciding whether new health care cooperatives should be granted tax exempt status, Doug Mancino, partner with Hunton & Williams, told BNA July 19.

The new Consumer Operated and Oriented Plans (CO-OPs), which have been touted as an alternative to current health insurance, must be approved by both HHS and IRS.

Mancino said he believes those that have proven to HHS that they meet the requirements for getting a contract with HHS—a realistic business plan, proper governance structure, and other requirements—will be granted the equivalent of deemed tax exempt status by IRS.

"The IRS will peg its determination as to tax-exempt status on the fact that the organization has successfully gone though all the hoops with HHS," he said.

Because health care in its entirety is so important to the current administration, health policy will almost always trump tax policy, a tax source who asked not to be named told BNA July 21. "It doesn't mean the IRS will end up taking positions that are clearly inconsistent with tax laws, but those responsible for promulgating health policy will be taking the lead on this."

Sticking to Commonly Used Terms. Under the program, HHS will award loans and grants to entities applying to become qualified nonprofit health insurance issuers. The loans and grants will provide assistance in meeting start-up costs and the solvency requirements of the states in which the groups seek to be licensed as qualified health plan issuers.

Following the recent rollout of proposed HHS regulations for tax exempt CO-OPs (see related report in this issue), and previously issued IRS guidance, Mancino said IRS is likely to apply existing interpretations of commonly used terms for exempts to the CO-OPs. Terms already defined and that have long been in application in the tax code for exempts—such as outright prohibitions against inurement of net earnings

and electioneering, and limitations on lobbying—are likely to be picked up from IRS Notice 2011-23, which addressed some of the IRS requirements for CO-OPs.

Mancino said he is working on a letter to IRS on behalf of the American Bar Association Section of Taxation that will recommend that IRS not adopt separate new terms, and rely on long-standing, well-understood terminology in relation to the CO-OPs.

Raising the Money. The most repetitive comment at a packed meeting July 18 to roll out HHS proposed regulations on CO-OPs was that it is difficult to get seed money for funding, he said.

HHS proposed standards for the private, nonprofit organizations that seek to offer health plans through the insurance exchanges scheduled for operation in 2014.

''One of the questions that came out at the meeting was if someone else front-ends the costs of starting up a CO-OP whether they can be reimbursed from loan proceeds,'' Mancino said. The answer to that is not yet clear and will probably emerge as part of the comment process, he said.

Only 50 to 100 CO-OPs are expected to make the grade, and with good reason, Matthew Amodeo, partner with Drinker Biddle in Albany, N.Y., told BNA July 21.

''On top of the money they are going to have to borrow from the federal government, they will also have to raise, independently, enough money to satisfy whatever the state regulatory requirements are for reserves,'' he said. ''A lot of people are going to have cold water thrown on them in terms of how many of these will get off the ground.''

Furthermore, since the CO-OPs are targeted to individuals and small businesses—the two riskiest insurance markets, with susceptibility to high dollar claims—many of them will have a hard time competing against conventional insurers who are better situated financially to withstand those risks.

Milt Cerny, counsel with McGuireWoods, said HHS has forecast a high default rate on the loans, but if that happens IRS is not likely to take the position that there was private inurement—disproportionate benefit flowing to a CO-OP insider—in violation of IRS rules. If the loans and their application were made in conformance with HHS rules, that will be good enough, he said.

Lobbying and Marketing. Other information that emerged from the HHS meeting, Mancino said, included that none of the loan proceeds can be used for lobbying or marketing. The difficulty will be in interpreting what is marketing versus education and outreach, he said. On governance, he said it was clarified that a majority of the CO-OP board must be members of the CO-OP. On how to define ''substantially all'' in rules that say substantially all of the CO-OP business must be the provision of individual and small group health plans, Mancino said he expects IRS to bypass its traditional interpretation that the term means 85%, and once again rely on HHS's determination of compliance.

By Diane Freda

Tax Shelters

IRS Economic Substance Directive May Ease Concerns for Energy Investors, PWC Says

New IRS guidance on the codified economic substance doctrine may ease worries for investors in renewable energy, PricewaterhouseCoopers LLP said in an alert sent to clients July 18.

There has been concern that IRS could apply the doctrine, put into law last March, to transaction structures that allocate energy tax credits among investors, PwC said.

The IRS guidance to which PwC referred came July 12 in the form of a long-awaited directive (LB&I-4-0711-015) for examiners to use in determining whether and when to seek high-level review in asserting the doctrine and its associated strict liability penalty.

''The LB&I directive appears to clarify that many transactional structures—both within and without delineated IRS safe harbors—can be viewed as fully consistent with both Congressional intent for the energy tax credits and the economic substance doctrine,'' PwC said in the alert.

Careful Planning Still Needed, PwC Says. It cautioned, however, that because existing safe harbors are incomplete, ''companies should examine these issues carefully when planning renewable energy transactions.''

The directive requires examiners to undertake a four-step inquiry before asking an IRS director of field operations to assert the penalty, and sets out lists of factors to delineate cases where it likely would be appropriate to assert the economic substance doctrine and cases where it would not be likely to do so.

In a key point, PwC said, step one of the process instructs IRS personnel that the application of the doctrine ''likely is not appropriate'' for a ''[t]ransaction that generates targeted tax incentives [that] is, in form and substance, consistent with Congressional intent in providing the incentives.''

PwC said although examiners might continue analyzing transactions under Step One to evaluate issues such as nontax profit potential or whether the transaction is highly structured, step three of the directive requires the specific approval of an examiner's manager in consultation with local IRS counsel in order to assert that an alternative energy credit transaction lacks economic substance.

All such assertions must be referred to LB&I's director of field operations for final approval, PwC said.

Uncertainties Described. The Big Four accounting firm said this language may ease concerns that existed even though the Joint Committee on Taxation's report on the original legislation clarified that codification of the doctrine was not intended to affect certain alternative energy tax credit transactions.

The doctrine was codified by the Health Care and Education Reconciliation Act (P.L. 111-152), signed in March 2010. The law created new §7701(o).

The accounting firm noted that earlier in 2011, staff members from the IRS Office of Chief Counsel created potential uncertainty around these issues with comments on the limited application of a so-called ''partnership flip'' structure and concerns about creating new

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standards for economic substance in alternative energy transactions.

BY ALISON BENNETT

☐ *For a discussion of LB&I-4-0711-015, see the Tech section of this issue.*

IRS Administration

IRS Seeks Public Comment on Rules, Revenue Procedures, Notices, and Forms

The IRS is asking for public comment on regulations, revenue procedures, notices, and forms, according to notices in the July 20 *Federal Register*.

The specific items are:

- final rules (T.D. 9270) on reporting of gross proceeds payment to attorneys;
- final regulations (T.D. 8801, FI-28-96) on arbitrage restrictions on tax-exempt bonds;
- final and proposed regulations (T.D. 9004, REG-100276-97, REG-122450-98) on real estate mortgage investment conduits and financial asset securitization investment trusts;
- final regulations (T.D. 9082, REG-106876-00) on use of taxpayer identification numbers on submissions under §§897, 1445, and 6109;
- Rev. Proc. 2002-43 (T.D. 9255) on determining a substitute agent for a consolidated group;
- Notice 2002-27 on IRA required minimum distribution reporting;
- Notice 2005-41 on guidance regarding qualified intellectual property contributions;
- Form 8804-C, *Certificate of Partner-Level Items to Reduce Section 1446 Withholding*; and
- Form 5498-SA, *HSA, Archer MSA, or Medicare Advantage MSA Information*.

IRS said comments should address whether the collection of information has practical utility; the accuracy of the IRS's estimates of the paperwork burden on taxpayers; ways to enhance the quality, utility, and clarity of the information to be collected; ways to minimize the burden of the collection of information on respondents, including through the use of automated collection techniques or other forms of information technology; and estimates of capital or startup costs and costs of operation, maintenance, and purchase of services to provide information.

☐ *Comments are due by Sept. 19 and should be sent to Yvette Lawrence, IRS, Room 6129, 1111 Constitution Ave. N.W., Washington, D.C. 20224.*

Information Reporting

FinCEN Announces Taxpayers Can Report Foreign Financial Accounts Electronically

The Financial Crimes Enforcement Network (FinCEN) announced July 18 that taxpayers now can electronically file Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR).

The news comes at a time when many taxpayers have asked IRS to be able to file the form online as the government continues to press for reporting of foreign accounts.

FinCEN said at the present time, it can only accept FBAR filings where one signature is required. Therefore, spouses who jointly own accounts must file separate FBARs in order to file electronically, the agency said.

No Change in Who Must File. In a July 18 news release, FinCEN said the new ability to e-file the FBAR has no impact on who must file an FBAR, even in light of recent guidance on that issue.

It noted that a U.S. person who has a financial interest in or signature authority over foreign financial accounts must file an FBAR if the aggregate value of the accounts exceeds $10,000 at any time during the calendar year. These taxpayers are eligible for electronic filing, FinCEN said.

FinCEN acknowledged that the FBAR instructions state that a spouse included as a joint owner who does not file a separate FBAR must also sign the FBAR in item 44. However, the agency said, its current capability only allows for one digital signature, so separate FBARs are required for joint owners.

FinCEN said taxpayers will receive notifications that their electronic FBARs have been received. It added that paper filing will still be available until further notice.

☐ *A page with links to allow taxpayers to electronically file the FBAR is at http://bsaefiling.fincen.treas.gov/Enroll_Individual.html.*

Tax Court Litigation

IRS Designates Calendar Administrators For November, December Tax Court Trials

The IRS Office of Chief Counsel announced designations of calendar administrators on July 15 for U.S. Tax Court trial sessions scheduled for November and December.

The designations, dated July 13, provide the names, addresses, and telephone numbers of counsel responsible for scheduling each of the trial sessions scheduled by the Tax Court.

IRS noted that the calendar administrator is not the primary trial attorney for cases on a calendar. Petitioners and their representatives should continue to deal directly with the trial attorney or paralegal previously assigned to their cases, it said.

Calendar administrators oversee the trial calendar on behalf of the IRS Office of Chief Counsel and coordinate administrative and scheduling matters, IRS explained.

Health and Welfare Benefit Plans

DOL Rereleases Final Rule Announcing Delay In Compliance Deadlines for Disclosure Rules

A final rule delaying the applicability date of Department of Labor rules on investment fee disclosures was rereleased July 15 by DOL's Employee Benefits Security Administration, with minor changes from

a version posted on the IRS's website two days earlier.

The final rule delayed to April 1, 2012, the effective date for the department's interim final rule under §408(b)(2) of the Employee Retirement Income Security Act on fee disclosures by plan service providers to plan fiduciaries. The delay aligns the compliance deadline with a separate compliance deadline for a DOL final rule under ERISA §404 on investment fee disclosures to plan participants.

The rules apply to persons who ''reasonably expect to receive $1,000 or more in direct or indirect compensation'' for providing services to the plan, including investment consulting, accounting, auditing, and legal services. Failure to comply with the rules could result in an excise tax penalty.

At the top of the new document where the department describes the action it is taking, DOL changed the phrase ''extension of applicability dates'' to ''delay of applicability dates.'' The wording change was made to conform with stylistic rules used by the *Federal Register*, Phyllis C. Borzi, assistant secretary of labor for EBSA, said July 15 during an EBSA webchat.

In addition, the new version adds the *Federal Register* publication date: July 19.

DOL also made minor changes in the summary section to clarify that the document delays previously specified ''applicability and effective dates'' for the department's interim final rule on fiduciary-level fee disclosures and final rule on participant-level fee disclosures.

DOL also dropped a summary paragraph on the participant-level fee disclosure regulation that had appeared on page 2 of the earlier version of the final rule document.

IRS Administration

Tax Deadline Extended in Arkansas, Vermont Counties Declared as Federal Disaster Areas

Tax deadlines for Arkansas and Vermont victims of severe storms, tornadoes, and flooding have been extended as an extra measure of relief for the affected counties, the IRS said in website postings July 12.

Following May 24 storms, tornadoes, and flooding in Arkansas, President Obama declared Franklin and Johnson counties federal disaster areas, IRS said in a release (AR-2011-08). As a result, taxpayers who reside or have businesses in these areas have a July 25 deadline for second-quarter estimated tax payments, which normally fall due June 15, and other time-sensitive payments or filings that were due on or after May 24 and on or after July 25.

In addition, IRS is waiving the failure-to-deposit penalties for employment and excise tax deposits due on or after May 24 and on or before June 9, as long as the deposits were made by June 8.

Relief for Vermont Taxpayers. The Vermont counties of Caledonia and Washington, which experienced storms and flooding beginning May 26, also have been declared federal disaster areas (VT-2011-35).

Taxpayers that reside or have a business in any of these areas have a July 25 deadline for estimated tax payments and other time-sensitive filings or payments. The failure-to-deposit penalties for employment and excise tax deposits due on or after May 26 and on or before June 10 is waived, as long as the deposits were made by June 10, IRS said.

Tax Administration

IRS Must Improve IT for Ongoing Projects, Assign Management Roles, GAO Recommends

The IRS needs to improve information technology investments for implementing ongoing projects and assign responsibilities in the management process, the Government Accountability Office recommended in a report released July 20.

The GAO report, *IRS Has a Strong Oversight Process but Needs to Improve How It Continues Funding Ongoing Investments* (GAO-11-587), examined the results of IRS policies and procedures in managing its IT investments and associated methodology, focusing on the framework's stage relevant to building a foundation for investment management.

Alongside establishing a process for improving IT projects, the report said that IRS should assign responsibilities for implementing the investment management process to optimize decisionmaking and for defining and implementing a process for deciding whether to continue funding ongoing projects.

The report noted that IRS project selection is carried out by a team of two senior executives representing IRS's deputy commissioners, rather than a larger body comprised of representatives from both IT and business units. According to GAO, the perspective and expertise are not as broad as they would be with a larger board.

In response to the report, IRS concurred with GAO's recommendations.

Credits

CRS Report Addresses Home Buyer Credit Repayment After Involuntary Conversions

Constituents whose property has been affected by flooding recently can look to a Congressional Research Service report released July 15 answering questions on repayment of the First-Time Homebuyer Credit after destruction of the property or other involuntary conversion.

Further, the information can be applied to other sorts of involuntary conversions of property, CRS said.

One of the questions was as follows: If a principal residence is destroyed by flooding in 2011, or if the residence is not completely destroyed by flooding but is severely damaged, would the taxpayer have to repay the outstanding balance of the credit with the 2011 tax return?

CRS said no in both cases. The involuntary destruction of a home is an involuntary conversion, CRS said. Generally these conversions will not trigger acceleration of repayment in the tax year in which the conversion occurs, the report said.

Further, CRS said taxpayers do not abandon their principal residences due to temporary absences. There-

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fore, it is likely that a home buyer would not be considered to have ceased using a property as his or her principal residence even if the homeowner moved out.

Limitation on Repayment. Taxpayers who purchased a principal residence in 2008-2010, and in some cases 2011, may qualify for a tax credit under §36 of the Internal Revenue Code. Taxpayers claiming the credit based on a 2008 credit are required to repay it over a 15-year period beginning with the 2010 tax returns, although those who repurchased after 2008 generally are not required to repay it.

Involuntary conversions include either the partial or complete destruction of a home buyer's tax credit property due to casualty such as fire, flood, or tornado. Conversions can also apply to the loss of some or all of the property by theft or condemnation, including a sale under threat of condemnation, the report said.

Under the exception for involuntary conversions, taxpayers who have received the home buyer's tax credit have two years from the date of the conversion to replace the property and thereby avoid acceleration of repayment.

However, those who purchased in 2008 will need to continue repaying one-fifteenth of their credit annually in the interim. If the taxpayer does not replace the residence within the allowed two-year period, CRS said the outstanding credit balance generally would be included in the tax liability for the tax return for the year in which the two-year period expires. Repayment of the credit could be limited by the gain realized on the involuntary conversion.

If the taxpayer realized a loss on the involuntary conversion, there would be no obligation to repay the outstanding credit balance. If the taxpayer realized a gain, but the gain was less than the outstanding credit balance, CRS said the credit repayment would be limited to the amount of the gain. That lower amount would be added to the taxpayer's tax liability for the year in which the two-year period expired. In either case the taxpayer would have no obligation to repay any remaining credit balance in future years.

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In Brief

IRS Corrects Rules on Tax on Repatriated Profits

The IRS July 21 issued a technical correction to month-old final and temporary rules (T.D. 9530) aimed at preventing U.S. shareholders of controlled foreign corporations from avoiding income taxation in certain situations when the CFCs acquire U.S. property in an exchange.

The rules were released June 23. The correction noted that the name of Acting Assistant Treasury Secretary (Tax Policy) Emily McMahon was spelled incorrectly in the rules' signature block.

IRS Makes Correction to 2010 Schedule J

The IRS corrected the instructions for 2010 Schedule J (Form 1040), according to a July 20 web posting.

Taxpayers that downloaded the form, *Income Averaging for Farmers and Fishermen*, before June 13 should note that on line 9 of page J-9, 2008 Qualified Dividends and Capital Gain Tax Worksheet—Line 12, the text after the ''Yes'' box should read: ''Skip lines 9 and 10, go to line 11 and check the 'No' box.''

IRS Clarifies Redaction Rules for Public Files

Taxpayers' Social Security numbers should be redacted in all cases, the IRS said in a memo released July 15.

The Small Business/ Self-Employed Division memo (SBSE-05-0711-042) clarified instructions in Internal Revenue Manual 5.8.8.3(5) about redaction of information included in the public information files. Also, when redacting the taxpayer's address, only the street address with house number and street name should be redacted, in accordance with disclosure guidelines in the Disclosure/Privacy Act Quality Review Report released July 14.

The change was effective July 11, the date of the memorandum.

High-Low Substantiation for Per Diems Discontinued

The IRS plans to publish a revenue procedure in 2011 outlining the rules and procedures for substantiating lodging, meal, and incidental expenses for business travels that eliminates the high-low substantiation method, the IRS said in Announcement 2011-42 released July 19.

In Rev. Proc. 2010-39, IRS asked for comments on the continued use of the high-low substantiation method for such expenses, but received no comments, according to the announcement. Therefore, IRS will discontinue authorizing the high-low method.

In the future, the IRS said it will publish the special transportation rate in an annual notice; it may publish a revenue procedure to modify the substantiation rules and procedures. Announcement 2011-42 is scheduled to be published in I.R.B. 2011-32, dated August 8, 2011.

Tax Forms, Schedules Picked for 2010 SOI Programs

The IRS July 15 released the list of tax forms, schedules, and other information the Statistics of Income Division has chosen for its Tax Year 2010 programs.

According to the *Tax Stats Dispatch*, the forms and schedules in the program document are in three categories: Individual Statistics Branch studies (Form 1040 return series and data on sales of capital assets), Corporation Statistics Branch studies (data from the Form 1120 series and SOI's Partnership program), and Special Studies Branch programs (estate and gift taxes, tax-exempt organizations, tax-exempt bonds, and international filers).

IRS also released 2008 County Income Data, which reports addresses on individual income tax returns organized by county, for tax years 1989 through 2008 as well as the number of returns, the number of personal exemptions, adjusted gross income, wages and salaries, dividends before exclusion, and interest received.

IRS Says Manual Entry Required for Taxpayer IDs

The IRS July 15 said it will require the manual key entry of taxpayer identification numbers on Forms W-2 received from employers for taxpayers reporting wages, according to a posting on the IRS website.

IRS said no software package should utilize the auto-population feature regardless of the presence of an override feature to fill in the TIN on Form W-2 for individual taxpayer identification number filers. In reference to Rev. Proc. 2007-40, IRS said failure to comply with this requirement could result in a written reprimand, suspension, or expulsion from the e-file program.

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Focus

Subpart F: Here to Stay?

BY HEATHER HUDAK

Everybody is talking about U.S. tax reform, but opinions differ on when it will occur, and how drastic any reform will be; however, it appears likely that whatever model the U.S. tax system takes in the future, the controlled foreign corporation (CFC) rules will be at least a component of that system.

Many territorial countries use some form of CFC rules to eliminate a perceived incentive for taxpayers to shift passive or other types of income offshore. Even if the United States were to move to a territorial system (which would take time to implement), it seems Subpart F, in some form, is likely to continue.

This article addresses three aspects of Subpart F that deserve renewed attention given the changes that have occurred (new §960(c), for example) and the changes that might occur (expiration of §954(c)(6)).

Background

In general, the Subpart F rules (§§951-964) require U.S. shareholders with a 10% or greater interest in a CFC to include currently in income for U.S. tax purposes their pro rata share of certain income of the CFC (referred to as ''Subpart F income''), without regard to whether the income is actually distributed to the shareholders. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50% of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that own at least 10% of the corporation's voting stock.

Subpart F income consists of foreign base company income, insurance income, and certain income relating to international boycotts and other proscribed activities. The most common of these is foreign base company income, which consists of foreign personal holding company income (which includes passive income such as dividends, interest, rents, royalties, and annuities) and other categories of income from business operations, including foreign base company sales income and foreign base company services income.

Tax reform aside, taxpayers are likely to report more Subpart F income in the near future. Dividends and most interest, rents, and royalties currently escape Subpart F under the recently extended §954(c)(6)—which the Obama administration proposed to extend through 2012. However, to the extent interest, rents, and royalties reduce Subpart F income, they are ineligible for §954(c)(6). And if §954(c)(6) is not extended past 2011, taxpayers will need to be prepared to once again include these items as Subpart F income (as many companies did, at least for financial reporting purposes, during 2010 before the rule was extended retroactively to Jan. 1, 2010).

Perhaps more significantly, it appears foreign base company sales income (FBCSI) and foreign base company services income (FBCSvI) are here to stay. Congress and Treasury have made some recent changes to these rules that can be seen as taxpayer-friendly. For example, Notice 2007-13 changed the FBCSvI rules such that the ''substantial assistance'' provisions (more on those later) only apply to assistance from the United States, and not from another CFC. The contract manufacturing regulations issued in 2008 also provided much-needed clarity, however, at the cost of an increase in the number of ''branch rule'' issues that can create Subpart F. Still, the rules leave much to be desired.

The Subpart F rules were enacted in 1962, when just a handful of U.S. companies had the global presence that many have today. The notion of earning a margin in one foreign country on income from customers in another foreign country seemed to be nothing more than a way for large companies to avoid U.S. tax on their income, and for some, it probably was.

Both the House and Senate committee reports enacting §954 reference ''tax haven'' operations of foreign subsidiaries. The Senate committee report noted that the income they were targeting was income earned by a selling subsidiary ''which has been separated from manufacturing activities of a related corporation merely to obtain a lower rate of tax for the sales income.''[1] Of course, nothing in the legislation exempts income earned in separate subsidiaries as a result of business-driven decisions.

The Way Business Happens Today

As the economy slowly rebounds around the world—in many countries more quickly than here in the

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The author would like to thank Ernst & Young LLP Tax professionals Carl Grande and Brian Abbey for their insights and assistance with this article.

The views expressed in this article are those of the author and do not reflect the views of Ernst & Young LLP or any other member of Ernst & Young Global Limited.

[1] S. Rept. No. 1881, 87th Cong. 2d Sess. p. 84 (1962), 1962-3 C.B. 703, 790, 949.

United States—companies are beginning to enter new markets. With fewer domestic customers, U.S. companies must go where the customers are.

However, because of the tentative nature of the recovery, we are seeing smaller and more nimble investments in these markets. Instead of a large acquisition or investment in a full in-country operation, we are seeing a single contract as a first cautious foray into a new country. If this contract is entered into by a CFC, any income from the contract may give rise to Subpart F income.

Under §954(d), FBCSI includes income derived by a CFC in connection with the purchase of personal property from a related person and its sale to any person where:

- the property that is sold is manufactured outside the country under the laws of which the CFC is created or organized; and
- the property is sold for use, consumption, or disposition outside such foreign country.

Under §954(e), foreign base company services income includes income derived in connection with the performance of technical, managerial, engineering, and other services that:

- are performed for or on behalf of any related person; and
- are performed outside the country under the laws of which the CFC is created or organized.

For example, assume that a U.S. taxpayer has a CFC in Poland that is a distributor. The Polish CFC's employees provide general marketing and business development services in Central and Eastern Europe and travel throughout the region to identify and sell to new customers. If the Polish CFC purchases product from its U.S. parent and sells it to customers outside of Poland, because the CFC purchased product from a related party and sold some of that product for use outside its country of incorporation, the income earned by the Polish CFC on these sales would be considered FBCSI and subject to tax in the United States under Subpart F.

In another example, assume that a U.S. parent incorporates a subsidiary in Dubai to provide services across the Middle East. Because the senior management presence in the Dubai CFC is relatively light, the U.S. parent provides supervision, know-how, and other services and supplies. If this assistance rises to the level of ''substantial assistance'' as defined in Regs. §1.954-4(b)(1)(iv), this could result in FBCSvI and also be taxable under Subpart F.

To anyone who knows much about global business in 2011, neither of the above structures looks as if it was designed to avoid U.S. tax. It may make very good business sense to operate a Polish corporation as a ''master distributor'' for Central and Eastern Europe, or to centralize the Middle Eastern operations of a services company in Dubai. Whereas, just a few years ago, a company might have set up separate subsidiaries in each of the countries where it had customers, either to avoid triggering Subpart F or just as a matter of habit, many companies are operating a lean structure after the recent financial crisis. Such things as corporate registrations, local bank accounts, separate statutory financial statements, and local administrative personnel may now be expensive luxuries. As a result, more companies are operating in branch form between foreign countries, triggering U.S. tax on the income under Subpart F.

Limited Exceptions

In the past, the ''high tax exception'' of §954(b)(4) enabled companies operating in high-tax markets to escape the additional U.S. tax on this income. The regulations under §954 provide that, if a net item of income of a CFC was subjected to an effective rate of foreign tax at a rate that was greater than 90% of the applicable U.S. tax rate, then a taxpayer could elect to exclude that item of income from Subpart F income.

The logic was that the FBCSI rules were enacted to tax companies routing business profits through tax haven jurisdictions; therefore, if the income that would otherwise be FBCSI was taxed at a relatively high rate of foreign tax, it was unlikely that the use of the CFC was tax motivated.

However, with the U.S. rate stuck at 35%, the relevant income would need to be taxed at an effective rate of 31.5% to be excepted from Subpart F. Now that the average Organization for Economic Cooperation and Development rate is at about 25%, it can be difficult to meet the high tax exception without planning.

In addition to the high tax exception, the Subpart F rules also provide an ''out'' in the form of the de minimis rules of §954(b)(3). Under this exclusion, if the sum of a CFC's foreign base company income (before deductions) and gross insurance income for a year is less than the lesser of 5 percent of that CFC's gross income and $1 million, it is excluded from Subpart F income.

This is helpful for CFCs that report a small amount of, for example, bank interest every year. However, for a distributor CFC with more than $1 million in sales outside its country of incorporation, the de minimis exception is of no help. This is another example of the U.S. tax code not keeping up with global business—the $1 million threshold has not changed since 1986.

FTC Limitation Benefits

If the preceding section sounds dire, a transaction that gives rise to Subpart F income is not necessarily something to be avoided at all costs. In many cases, Subpart F income produces foreign source income (FSI) that can enhance a company's ability to use foreign tax credits (FTCs). If a company has expiring FTCs to utilize and reports Subpart F income, the Subpart F income could provide the vehicle to utilize FTC carryforwards.

This is especially helpful after the August 2010 passage of the Education Jobs and Medicaid Assistance Act (P.L. 111-226), which abolished provisions—such as the 80/20 company rules, the interest apportionment rules for affiliated companies, and the treaty resourcing provisions—that previously provided significant foreign source income benefits to many taxpayers.

For example, on sales of product manufactured in the United States, there can be an incremental benefit to FSI if the distributor's margin is earned in a CFC and treated as Subpart F income. Assume a company's managers might otherwise decide that a CFC should enter into a transaction in a new market. However, when it is realized the income will be taxed in the United States as Subpart F, they might determine that the U.S. company should enter into the transaction so that the income is only taxed once. But depending on the split of the margin between the manufacturer and the distributor, and the FTC profile of the taxpayer, Subpart F may be the

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better result. All of the margin earned by the CFC as Subpart F income is treated as foreign source, whereas typically only 50% of the margin on a U.S. export sale is treated as FSI under §863(b).

It should be noted that taxpayers should carefully consider transfer pricing rules to support the margin earned by the distributor CFC—even though the IRS may be less likely to focus on this transaction under §482 since both sides of the transaction will be subject to U.S. tax, the FSI benefit and the resulting gross-up will not go unnoticed. Further, there could be a risk under §367(d) if the return to the CFC is too high. In that case, depending on the facts, the taxpayer could have a §367 ''commensurate with income'' result that would be worse than a transfer pricing adjustment.[2]

Hopscotch Rule

A foreign tax credit is generally available for foreign income taxes paid by a CFC to the extent that the CFC's income is taxed to a U.S. shareholder under Subpart F, subject to the limitations set forth in §904. Section 902 allows U.S. taxpayers to treat taxes paid by certain foreign subsidiaries as if paid by the U.S. taxpayer directly. The amount of taxes deemed paid by a U.S. taxpayer with respect to a CFC is equal to the amount of any deemed or actual dividends paid to the U.S. taxpayer divided by the post-1986 accumulated earnings and profits, multiplied by the post-1986 accumulated tax pool of the CFC. (This is referred to as the ''the gross-up.'')

The deemed paid tax credit on an actual dividend distribution would be calculated by adding the deemed paid credit from the distributing entity to the tax pool of the upper-tier recipient, and then calculating a deemed paid credit on a further distribution to the United States. This can have the effect of diluting the tax pool of a CFC that would otherwise have a relatively high effective tax rate, if the intermediate company has a lower effective tax rate.

By contrast, §960 provides that §902 also applies to treat Subpart F, including §956 inclusions, as a dividend for purposes of the deemed paid credit. Under the rules in §960, the deemed dividend is considered to be paid directly from the CFC to the U.S. shareholder, so the taxes from the CFC's tax pool effectively ''hopscotch'' over any intermediate subsidiaries.

Under §956, a CFC's earnings may be currently taxed as gross income to its U.S. shareholders in the form of a deemed dividend if the CFC invests in U.S. property, which includes an obligation of a U.S. person. New §960(c), enacted in August 2010, requires that taxpayers calculate foreign tax credits on ''deemed inclusions'' in a manner that, in effect, will require a tiered pooling approach with respect to deemed paid taxes resulting from investments in U.S. property under §956. (Even worse, unresolved technical issues may result in no credit at all, for example in a situation where the top-tier entity has previously taxed income or a deficit in E&P.)

New §960(c) applies specifically to §956 deemed dividends; Subpart F still provides the ability to ''hopscotch'' foreign tax credits from a lower-tier subsidiary. With §954(c)(6) extended again, planning into affirmative use of the Subpart F hopscotch rule is limited with respect to FPHCI. FBCSI and FBCSvI, on the other hand, result from business operations and it is possible to make changes to a legal entity structure within the constructs of an existing Subpart F generating entity that will improve a taxpayer's ability to utilize FTCs.

For example, movement of legal entities can be fairly straightforward. If a taxpayer has a lower-tier subsidiary with a historically high effective tax rate, it may be possible to transfer a Subpart F-generating CFC to that entity and treat the second entity as disregarded for U.S. tax purposes. This could have the effect of bleeding in the higher tax pool as the Subpart F income is recognized, skipping over any lower rate intermediate subsidiaries. Of course, a tax director would have to model the numbers and should not enter into such a transaction without first considering economic substance, business purpose, and any other number of tax considerations.

Finally, the hopscotch rule may impact the taxpayer's choice of a contracting entity (if this decision is otherwise supportable from a business perspective). For example, if the business and legal considerations would be the same for a number of different foreign subsidiaries but one is a relatively high-taxed entity that is in a lower tier, the taxpayer may consider making this entity the contracting entity to be able to bring back higher effective rate FTCs if these would be useful.

Of course, locating a valuable contract in a high-taxed country would not be an obvious choice—but if that country has a territorial tax system that would not otherwise tax the income from the contract, and if that CFC has a large pool of high-taxed E&P that would not be too diluted by the addition of low- or zero-taxed contract income, the numbers may make sense. (Because the deemed paid credits are determined on a pooled basis, it does not matter that the Subpart F income itself may not be taxed by the local country.)

Other Considerations

Several other benefits may accompany a transaction giving rise to Subpart F income.

For example, take the hypothetical transaction above in which the U.S. parent manufactures product and sells to its Polish CFC, which distributes into Eastern Europe. The distribution margin earned by the Polish CFC, which otherwise would have been earned by the U.S. parent, is still subject to U.S. tax at 35% under Subpart F. However, if the margin were earned directly by the U.S. parent, it would also likely be subject to state and possibly local income tax. By contrast, most states either exempt Subpart F income or treat Subpart F as a dividend eligible for a full or partial dividends received deduction.

With some state income tax rates approaching 10%, this can represent a significant savings. As a company

[2] Further, the Obama administration's fiscal year 2012 revenue proposals include (as they did for fiscal year 2011) a proposal to tax currently ''excess'' returns with respect to a ''covered intangible,'' to the extent the CFC's income is subject to a ''low'' foreign effective tax rate. This rule would apply if a U.S. person transfers (directly or indirectly) that intangible to a CFC. The income would be taxed as a new category of Subpart F income and likely would not provide an incremental benefit for foreign tax credit purposes. The administration has provided little guidance with respect to what qualifies as low effective tax rate or an excess return. (However, the proposal does note that excess income would be determined by reference to a cost-plus level of income at the CFC.)

contemplates changes to its supply chain or a legal entity restructuring, potential Subpart F should not necessarily be an impediment. A structure that moves profit from the United States to a foreign jurisdiction can save taxes if the Subpart F income is exempt from state tax and can be sheltered by excess foreign tax credits.

In addition to U.S. corporate income taxes, there are of course non-U.S. taxes to consider. Again, a structure that results in Subpart F income but reduces local taxes paid—by locating income-producing functions in a low-tax foreign jurisdiction—can still result in a cash tax benefit if excess foreign tax credits are available to offset Subpart F income.

Further, while many tax directors have a good understanding of corporate income taxes in various jurisdictions, indirect taxes such as VAT and customs duties are not as obvious. While corporate tax directors might have once argued against moving to a regional sales model mainly due to the resulting Subpart F, such an approach may improve VAT cash flow or save indirect taxes. If nothing else, the local (non-U.S.) finance and business personnel may simply be more familiar with VAT and customs in a given region and administer the indirect tax compliance more efficiently. While this is not a ''benefit'' of Subpart F income, it is certainly worth remembering that a decision made to reduce Subpart F income may result in unexpected indirect tax consequences.

Finally, as many companies are now discovering, a regional model can result in many non-tax benefits, including speed to market helped by closer inventory stocks, supply chain benefits, and enhanced employee measurement and rewards. Companies should be careful not to let the specter of Subpart F deter them from considering a regional approach that could have substantial tax and non-tax benefits.

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Technical Developments

Court Decisions, Regulations, Announcements, Revenue Rulings and Procedures, Notices, Actions on Decisions, Technical Advice Memoranda, Generic Legal Advice Memoranda, Private Letter Rulings, Exemption Rulings, Service Center Advice Memoranda, Chief Counsel Advice, Field Attorneys Advice Memoranda, Program Manager Technical Advice Memoranda, Litigation Guideline Memoranda, Criminal Tax Bulletins, Information Letters, Exemption Denial and Revocation Letters

Full text of the material analyzed in this issue can be obtained for a fee from BNA PLUS. Call toll-free (800) 452-7773, or e-mail bnaplus@bna.com. Please specify the case, ruling, or document number.

SEC. 35—HEALTH INSURANCE COSTS OF ELIGIBLE INDIVIDUALS

Bankrupt Employer's Renegotiated Plan Coverage Is Qualified Health Insurance for Purposes of Credit

PLR 201128020: Coverage under plan that does not satisfy §4980B requirements is qualified health insurance for purposes of §35 credit with respect to retirees to whom employer or successor employer had obligation to make COBRA continuation coverage available in connection with employer's bankruptcy or in connection with retirement of an employee on date of assets' sale.

Discussion: An employer shut down in bankruptcy, and the employer and successor employer renegotiated retiree health benefits with its union, establishing a voluntary employees beneficiary association (VEBA) to fund the reduced benefits. Because the coverage is not the same as that provided to similarly situated non-COBRA beneficiaries, the terms of the plan did not satisfy the requirements for COBRA continuation coverage set forth in §4980B.

The IRS ruled that: (1) coverage under the plan is qualified health insurance for purposes of §35 with respect to retirees and family members of retirees to whom the employer or successor employer had the obligation to make continuation coverage available; (2) management of the VEBA trust by a board of trustees that is independent of the employer, successor employer, or any other entity will not affect the status of the health coverage as qualified health insurance under §35; and (3) election of the health coverage in advance of the applicable COBRA continuation period will not affect the health coverage's status as qualified health insurance under §35.

According to the IRS, the union negotiated the terms of the plan with the employer after the bankruptcy proceeding began, but before it had resulted in a loss of health coverage for the retirees (i.e., before a qualifying event had occurred), and the union's agreement to accept the plan in lieu of the coverage required under §4980B was an effective waiver of the retirees' COBRA continuation coverage rights. The IRS reasoned that, although the regulations do not acknowledge the possibility of a waiver before the right to elect COBRA continuation coverage arises, if a waiver is entered into shortly before and in anticipation of a qualifying event, with the waiving party being fully informed of the right to COBRA continuation coverage in connection with the anticipated qualifying event, then the waiver is not contrary to the policies reflected in §4980B.

In the limited circumstances in which an anticipatory waiver of COBRA continuation coverage is not contrary to public policy, the provisions in the regulations allowing revocation of the waiver until the end of the election period apply, the IRS stated. Thus, although an individual may effectively waive some or all of the individual's COBRA continuation coverage rights shortly before the occurrence of the qualifying event that gives rise to those rights, under the Code provisions and regulations relating to COBRA continuation coverage, the individual may revoke that waiver at any time before the end of the COBRA election period. However, the IRS noted that the law under Title 11 of the United States Code may affect the individual's right to revoke the waiver, preventing such a revocation from taking effect.

☐ *For a discussion of the health insurance costs credit, see 506 T.M., Tax Credits: Concepts and Calculation, V.J., pp. A-161-165.*

SEC. 45—ELECTRICITY PRODUCED FROM CERTAIN RENEWABLE RESOURCES, ETC.

Coal Production Process Determined To Result in Refined Coal

PLR 201128005: T's coal production process examined, results will constitute ''refined coal'' under §45(c)(7) if it is produced from feedstock coal of same source or rank as that tested and it satisfies §45(c)(7)(B)'s qualified emission reduction test; T may establish qualified emission reductions through testing at combustion research facility or similar pilot-scale combustion testing facility, regardless of normal fluctuations in operating conditions at the plant itself.

☐ *For a discussion of the characteristics of refined coal for purposes of the refined coal production credit, see 603 T.M., Mineral Properties Other Than Gas & Oil—Operation, XVIII.C.2.c.(1), pp. A-150-150(1).*

SEC. 61—GROSS INCOME DEFINED

Payments to be Loans, Not Income

Kaider v. Comr., T.C. Memo 2011-174 (7/20/11): Four personal checks taxpayer received from uncle were loans, not compensation for services.

Facts: Taxpayer (T) entered into an agreement with his uncle (U) to assist U with his personal affairs and his various businesses. From 2005 to 2006, T received 10 checks from U totaling $58,500. All checks were signed by U and drawn from U's personal checking account. The word ''loan'' was in the memo line of all 10 checks. T deposited each check into his personal bank account. Each of the 10 checks corresponds to a total of 10 loan agreements between T and U. Each loan agreement provided that U would lend T the amount stated at 6% annual interest and that the full amount plus interest would be due five years from the date of the agreement. Each agreement also provided that the debt could be paid partially or fully at any time without penalty, and that the agreement could be renewed at the discretion of U and T. All loan agreements bear T's signature, but only one contained both men's signatures.

U and T had a falling out and sometime thereafter a Form 1099-MISC was filed by one of U's businesses (B) claiming that B paid T $58,500 of nonemployee compensation in 2006. B also filed a Form 1120S for 2006, which did not claim any deductions for wages, officer compensation, or nonemployee compensation. T filed a Form 1040 for 2006 and did not report any income from U or B. The IRS issued a notice of deficiency for the tax year 2006 to T determining an income-tax deficiency of $16,529 and a §6662(a) accuracy-related penalty of $3,306. The IRS conceded that T's income-tax deficiency for 2006 should be reduced to $3,676 and that T is not liable for the §6662(a) penalty. The IRS's initial determination was based on the Form 1099-MISC. The parties now stipulate that T received only $21,500 of the $58,500 in 2006.

Holding: The Tax Court held that four of the checks T received from U, totaling $21,500, during 2006, were loans pursuant to written agreements and not compensation for services. The court considered various factors to determine whether T and U intended a bona fide loan and found that all factors weighed in favor of treating the $21,500 as loans rather than compensation: (1) although T has no money at the time, both T and U reasonably expected that some of U's startup enterprises would become profitable enabling T to repay his loans within five years; (2) T and U entered into written loan agreements and T testified credibly that T and U signed all of the agreements whereas U was not a credible witness; (3) the agreements showed an intent to establish bona fide loans, i.e., the checks were drawn from U's personal bank account and not deducted on B's tax return; (4) there is no evidence that the checks were disguised compensation for services; and (5) T testified that T and U intended the checks to be loans and T's testimony that the checks were loans is supported by objective evidence: the ability to repay, the checks with ''loan'' in the memo line, the loan agreements corresponding to the checks, the fixed interest rate, and the fixed repayment dates.

□ *For a discussion of the factors involved in determining the existence of a bona fide debt, see 538 T.M., Bad Debts, III.A.1., pp. A-5-6.*

SEC. 385—TREATMENT OF CERTAIN INTERESTS IN CORPORATIONS AS STOCK OR INDEBTEDNESS

Preferred Shares Treated as Equity of Funds for Tax Purposes

PLR 201128008: Preferred shares carrying variable dividend rate and liquidity facility treated as equity of funds for federal income tax purposes.

Discussion: Each fund in a group of several funds (Funds) is a closed-end management investment company and has elected and qualifies to be taxed as regulated investment company (RIC). Funds are ''eligible issuers,'' as defined in Notice 2008-55, 2008-27 I.R.B. 11. Funds each have two classes of stock: auction market preferred shares (the ''AMPS'') and common shares. Funds propose to replace all or a significant portion of the outstanding AMPS with Shares, a class of preferred stock that is eligible to be held by money-market funds. Shares will be supported by a liquidity facility under which an unrelated third-party bank or other financial institution agrees to buy Shares from investors in certain circumstances. Shares will have a variable dividend rate that is set through a remarketing process.

The IRS ruled that Shares of each Fund, as supported by the initial liquidity facility and any liquidity facility that renews, replaces or extends the initial liquidity facility, will be treated as equity of that Fund for federal income tax purposes.

□ *For a discussion of equity characterization of funds holding auction rate preferred stock, see 740 T.M., Taxation of Regulated Investment Companies, VI.D.2.c., pp. A-32-33.*

SEC. 446—GENERAL RULE FOR METHODS OF ACCOUNTING

Extension of Time to File Duplicate Form 3115 Granted

PLR 201128002: Extension of time granted for filing duplicate Form 3115, *Application for Change in Accounting Method*.

Discussion: Taxpayer (T), a limited liability company taxed as a partnership, timely filed its federal tax return for the taxable year ending Date 1 along with the original Form 3115, *Application for Change in Accounting Method*, to change its method of accounting under §446. However, T failed to file a signed duplicate copy of Form 3115 with the IRS National Office as required by §6.02(3)(a) of Rev. Proc. 2008-52, 2008-36 I.R.B. 587, which provides the procedures by which a taxpayer may obtain automatic consent to change certain methods of accounting.

Firm (F) advised T to attach the original Form 3115 to T's federal tax return and to file the federal return before Date 2, the due date of the return for the taxable year ending Date 1. F advised T either to send the duplicate copy of the Form 3115 back to F so that F could hand deliver the duplicate copy to the National Office before Date 2, or to mail the duplicate copy of the Form 3115 directly to the National Office at the address provided in Rev. Proc. 2008-52, via certified mail, postmarked no later than Date 2. Because of a miscommunication between T and F, T mailed the duplicate copy of the Form 3115 to F on Date 2 with the understanding

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that F would file the duplicate copy with the National Office. F received the duplicate copy on Date 3, which precluded it from filing the duplicate copy with the National Office on or before the date of T's timely filed tax return.

The IRS ruled that the requirements of Regs. §§301.9100-1 and -3 had been met and T was granted 60 calendar days to file the required duplicate copy of Form 3115 with the National Office for the taxable year ended Date 1. Under Regs. §§301.9100-1 and -3, a taxpayer may be granted a reasonable extension of time to make a regulatory election when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government.

☐ *For a discussion of the time for filing the duplicate copy of Form 3115, see 572 T.M., Accounting Methods—Adoption and Changes, V.D.2., p. A-34.*

SEC. 460—SPECIAL RULES FOR LONG-TERM CONTRACTS

Request to Revoke Election to Use SMIM To Calculate Look-Back Interest Granted

PLR 201128007: Consent granted for parent corporation to revoke election made on behalf of subsidiary to calculate look-back interest pursuant to simplified marginal impact method.

Discussion: Corporation (C) is the parent of an affiliated group of corporations that includes Corporation X (X) and files consolidated federal income tax returns on a calendar year. X uses the percentage-of-completion method (PCM) to account for long-term construction contracts that it enters into during the course of its business. C made a voluntary election under Regs. §1.460-6(d)(4)(ii)(B) to use the simplified marginal impact method (SMIM) to calculate the look-back interest on the amount of tax liability deferred or accelerated as the result of overestimating or underestimating total contract costs or total contract price. C has now filed a request on behalf of X for permission to revoke its election to calculate look-back interest under the SMIM.

The IRS ruled that the request to revoke the election under Regs. §1.460-6(d)(4)(ii)(B) to use the SMIM to calculate look-back interest is granted. Therefore, the IRS stated, X may begin computing its look-back interest using the actual method, rather than the SMIM, beginning in Year B.

☐ *For a discussion of application of the look-back rule in the year of completion, see 575 T.M., Accounting for Long-Term Contracts, VI.B.1., pp. A-22-24.*

SEC. 468A—SPECIAL RULES FOR NUCLEAR DECOMMISSIONING COSTS

Revised Schedules of Ruling Amounts for Nuclear Power Plant Funds Approved

PLR 201128003: Revised schedules of ruling amounts related to nuclear power plant decommissioning funds approved for purposes of taxpayer computations of deductions under §468A.

☐ *For a discussion of the tax treatment of nuclear decommissioning costs, see 512 T.M., Tax Incentives for Production and Conservation of Energy and Natural Resources, VII.C.2., p. A-148.*

SEC. 1001—DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS

IRS and Treasury Issue Regulations on Assignment of Derivative Contracts

T.D. 9538, 76 Fed. Reg. 43892 (7/22/11); **REG-109006-11**, 76 Fed. Reg. 43957 (7/22/11): IRS and Treasury issue regulations on assignment of derivative contracts.

Discussion: The IRS and Treasury issued final, temporary, and proposed regulations that address when a transfer or assignment of certain derivative contracts does not result in an exchange to the nonassigning counterparty for purposes of Regs. §1.1001-1(a).

The rules for the computation and recognition of gain or loss from a sale or other disposition of property are provided for in §1001, stated the IRS. The IRS explained that gain or loss is realized upon an exchange of property for other property differing materially either in kind or in extent. As a general matter, the assignment of a notional principal contract is treated as a taxable disposition to a nonassigning counterparty if the resulting contract differs materially either in kind or in extent, the IRS stated. Citing, *Cottage Savings Association v. Comr.*, 499 U.S. 554 (1991), the IRS explained that an exchange of property gives rise to a realization event so long as the exchanged properties are ''materially different,'' i.e, so long as they embody legally distinct entitlements. Under Regs. §1.1001-4(a), however, the substitution of a new party on a notional principal contract is not treated as a deemed exchange of the contract by the nonassigning party for purposes of Regs. §1.1001-1(a) if two conditions are satisfied: (i) the assignment is between dealers in notional principal contracts; and (ii) the terms of the contract permit the substitution, stated the IRS.

Many notional principal contracts permit assignment of the contract only with the consent of the nonassigning counterparty, and there has been some uncertainty as to whether a contract that requires the consent of the nonassigning counterparty as a condition to assignment will satisfy the second requirement of Regs. §1.1001-4(a), the IRS stated. In addition, commenters have suggested that the scope of Regs. §1.1001-4 is too narrow because it only applies to notional principal contracts. Also, the need to amend Regs. §1.1001-4 has been increased by the Dodd-Frank Wall Street Reform and Consumer Protection Act, P.L. 111-203, §1376, which in some cases will necessitate the movement of entire books of derivative contracts, the IRS explained. In particular, there is a concern that the assignment of derivative contracts may create a taxable event for the nonassigning counterparties to the assigned contracts, the IRS stated.

The IRS and the Treasury stated that Regs. §1.1001-4 should be amended and expanded to include derivative contracts other than notional principal contracts. The temporary regulations provide that there is no exchange to the nonassigning counterparty for purposes of Regs, §1.1001-1(a) solely because a dealer in securities or a clearinghouse transfers or assigns a derivative contract to another dealer in securities or clearinghouse, provided that the transfer or assignment is permitted by the terms of the contract, the IRS stated. The

derivative contracts to which the regulations apply are those described in §475(c)(2)(D), (E), or (F), stated the IRS. In addition, the IRS explained that the temporary regulations provide that transfers or assignments are permitted by the terms of the contract when consent of the nonassigning counterparty is required as well as those transfers or assignments that do not require consent.

If consideration passes between the assignor and assignee in connection with the transfer or assignment, the IRS explained that the consideration will not affect the treatment of the nonassigning counterparty for purposes of Regs. §1.1001-4. If any consideration is paid to or received by the nonassigning counterparty, however, the payment or receipt of the consideration is analyzed under the general principles of §1001 to determine its effect on the nonassigning counterparty, the IRS stated. In addition, the IRS stated that any changes to the terms of the contract are analyzed under the general principles of §1001 to determine whether there has been a sale or disposition of the contract by the parties.

☐ *For a discussion of assignments of derivative contracts, see 736 T.M., Hedge Funds, XI.A.4.c., pp. A-84-85.*

SEC. 4481—IMPOSITION OF TAX

Truckers Granted Three-Month Extension For Filing Federal Highway Use Tax Returns

T.D. 9537, 76 Fed. Reg. 43121 (7/20/11); **REG-122813-11**, 76 Fed. Reg. 43225 (7/20/11): Next federal highway use tax return, usually due August 31, will be due November 30, 2011.

Discussion: The IRS issued final and temporary regulations advising truckers and other owners of heavy highway vehicles that their next federal highway use tax return, usually due August 31, will instead be due November 30, 2011. Under the regulations, the November 30 filing deadline for Form 2290, *Heavy Highway Vehicle Use Tax Return*, for the tax period that begins on July 1, 2011, applies to vehicles used during July, as well as those first used during August or September. The regulations state that returns should not be filed and payments should not be made prior to November 1.

The regulations require states to accept as proof of payment the stamped Schedule 1 of the Form 2290 issued by the IRS for the prior tax year, ending on June 30, 2011. For those acquiring and registering a new or used vehicle during the July-to-November period, the regulations also require a state to register the vehicle, without proof that the highway use tax was paid, if the person registering the vehicle presents a copy of the bill of sale or similar document showing that the owner purchased the vehicle within the previous 150 days.

The regulations are effective on July 20, 2011. IRS asked for written and electronic comments and requests for a public hearing by October 18.

☐ *For a discussion of the federal highway use tax and Form 2290, see 607 T.M., Farm and Ranch Expenses and Credits, VI.C., p. A-122.*

SEC. 4942—TAXES ON FAILURE TO DISTRIBUTE INCOME

Set-Aside of Qualifying Distribution for Relocating and Expanding Services Approved

PLR 201128033: Set-aside of qualifying distribution to relocate and expand clinics approved; set-aside to purchase healthcare facility through repurchase provision of sales agreement not approved because failed suitability test.

Discussion: O is a tax-exempt private foundation formed to facilitate and support healthcare services and programs in City. O was funded by the sale of assets owned by a healthcare provider (Hospital 1) to a multiple facilities healthcare provider (Hospital 2). Both hospitals are §501(c)(3) organizations. The sales agreement guaranteed that Hospital 2 would continue to operate in City for five years, and gave O the option to repurchase the assets at fair market value if Hospital 2 wished to close the healthcare facility in City within 15 years of the sale date.

If the facility is not repurchased, O will relocate and expand medical clinics in City. Hospital 2 is involved in the funding of the clinics project, and the availability of O's fund for it will act as a catalyst for community financial support for the clinics project. O requested to set-aside amounts over a five-year period that would otherwise be subject to §4942 excise tax for failure to distribute income to fund the repurchase of the healthcare facility and to relocate and expand the clinics. The IRS requested a TAM setting forth the specific terms and conditions under which O's request could be approved.

In its TAM, which the IRS included as an attachment to PLR 201128033, the National Office advised that under §4942(g)(2)(B)(i), an amount set-aside for a specific project will be treated as a qualifying distribution if, at the time of the set-aside, the foundation meets the suitability test. The National Office explained that under Regs. §53.4942(a)-3(b)(2), the suitability test is satisfied if the amount set aside will be paid for the specific project within five years, and the specific project is one that can better be accomplished by the set-aside of income rather than by the immediate payment of funds.

The National Office advised that the proposal to repurchase the healthcare facility does not qualify as a set-aside because it fails the suitability test. The National Office reasoned that though the repurchase cannot be accomplished by immediate payment of funds, it is speculative whether the repurchase will occur within the five years required by §4942(g)(2)(B). The National Office advised that similar to the organizations in Rev. Ruls. 77-7, 1977-1 C.B. 354 and 74-450, 1974-2 C.B. 388, O's proposed clinics project is a charitable project that qualifies as a set-aside. The National Office reasoned that the relocation and improvement is better accomplished by a set-aside than by immediate payment of funds, and the amount of the set-aside will be paid for the relocation and improvement within five years unless some or all of such funds are first utilized for the repurchase of the healthcare facility.

☐ *For a discussion of set-asides of qualifying distributions, see 880 T.M., Private Foundations—Distributions (Section 4942), III.N., p. A-32-36.*

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SEC. 6323—VALIDITY AND PRIORITY AGAINST CERTAIN PERSONS

Investment Partnership's Security Interest Superior to Federal Tax Lien

Equity Investment Partners LP v. U.S., No. 0:09-cv-600002-ASG (S.D. Fla. 7/12/11): Perfected security interest and transfer of deed in lieu of foreclosure are superior to IRS tax lien.

Facts: In 1995, an investment partnership (E) was formed by individual (B), two other individuals, and an LLC. E participated in deals involving technology companies and manufacturing. In 2000, the three individuals withdrew as partners of E.

In 1999, a warranty deed had been issued to B for real property. B had been audited for 27 years consecutively by the IRS and he first knew that the IRS was going to make an assessment in 2004. E began lending money to B. In 2004, B and his spouse signed a closing agreement with the IRS for various tax years, and as of February 2010, the outstanding liability was $3.1 million. In October 2004, B and E entered into a mortgage and security agreement for $300,000 that covered the property. E already had a security interest based on an original loan and security agreement, but the mortgage was recorded so that E could perfect the security interest. B was eventually incarcerated from February 2005 to late 2007. E sued to foreclose in April 2008.

The IRS imposed a tax lien on the property. The IRS argued that the transfer was done to help B avoid the lien.

Holding: The district court held that the transfer of property made to E in lieu of foreclosure is superior to the IRS tax lien on the property. The court stated that the timing of the transfer, as well as other factors, met all four of the necessary conditions for the transfer of a security interest under state law. As a result, the mortgage constituted a security interest in the property and B's transfer of the property to E in lieu of a foreclosure did not extinguish E's interest in the property.

☐ *For a discussion of priority of holders of security interests, see 637 T.M., Federal Tax Collection Procedure — Liens, Levies, Suits and Third Party Liability, III.F.2.c., pp. A-29-30.*

SEC. 6330—NOTICE AND OPPORTUNITY FOR HEARING BEFORE LEVY

Tax Court Has Jurisdiction to Review IRS's Failure to Comply with Statutory Mandate

Zapara v. Comr., No. 08-74173 (9th Cir. 7/18/11): Tax Court has jurisdiction to review finding that IRS violated provision of Code by failing to sell taxpayers' stock within 60 days.

Facts: Following the taxpayers' guilty plea to criminal tax evasion and bank fraud charges, the IRS determined that the couple had unreported income and resulting tax liabilities for multiple years of approximately $500,000. The IRS provided the taxpayers with a notice of jeopardy levy pursuant to §6335, and served a notice of levy on the taxpayers' brokerage house with respect to certain nominee stock accounts held on their behalf. At the time of levy, the stock accounts had a fair market value of approximately $1 million.

The taxpayers requested, by letter, a §6330 Appeals hearing with respect to the jeopardy levy. The taxpayers indicated that they wished to sell the stock and apply the proceeds to their outstanding tax liabilities. The taxpayers' representative sent a fax to the Appeals officer asking her for a letter approving the release of the stock for sale. The Appeals officer informed the taxpayers' representative that he needed to submit information regarding the stock, such as the fair market value, in writing and that a revenue officer would make a determination regarding the sale. The taxpayers did not submit the required information regarding the fair market value of the stock, and the IRS neither sold the stock nor made a determination regarding the request.

The Appeals officer issued a notice of determination precluding the taxpayers from challenging their tax liabilities and refusing to withdraw the jeopardy levy. The taxpayers appealed to the Tax Court, which affirmed the notice of determination. However, the Tax Court held that the IRS violated §6335(f) by failing to sell the taxpayers' stock within sixty days. The IRS moved for reconsideration of the Tax Court's decision and the Tax Court denied the motion, concluding that the taxpayers appropriately requested a sale under §6335(f). The IRS appealed.

Holding: The Ninth Circuit held that the Tax Court has jurisdiction to review a finding that the IRS had violated a provision of Code by failing to sell the taxpayers' stock within sixty days. The court emphasized that the ''plain language of §6330 authorizes a taxpayer to raise any relevant issue in a [collection due process] CDP hearing as long as the issue concerns the imposed jeopardy levy.'' The court added that the ''Tax Court review is critical to the jeopardy levy process, which imposes the levy before providing the taxpayers a forum in which to challenge the action. Indeed, the entire purpose behind the creation of the CDP hearing was to provide taxpayers with greater due process to contest the IRS's levy and sale of their property.''

The Ninth Circuit concluded that the Tax Court properly exercised its authority in ordering the IRS to credit the value of the stock against the taxpayers' outstanding tax liabilities and added that the Tax Court correctly concluded that §7433, which provides ''the exclusive remedy for recovering damages'' resulting from Code violations, did not preempt the specific remedy imposed in the case.

☐ *For a discussion of Tax Court jurisdiction over a determination in a collection due process hearing, see 630 T.M., Tax Court Litigation, I.B.11., pp. A-5-6. For a discussion of the right to request sale of seized property within 60 days, see 637 T.M., Federal Tax Collection Procedure — Liens, Levies, Suits and Third Party Liability, IV.B.3., pp. A-57-59.*

SEC. 6503—SUSPENSION OF RUNNING OF PERIOD OF LIMITATION

Agents Should Consult on Partnership Location for Collection Statute

SBSE-05-0711-022 (7/15/11): Guidance provided concerning §6503(c) and its application to partnerships with addresses outside the United States.

Discussion: The IRS, in a memo dated July 12, stated that agents should consult with counsel and carefully check to see that a partnership is located outside the

United States before recalculating its ''collection statute expiration date'' (CSED). The IRS explained how agents can decide the location of a partnership in determining whether to suspend the period of limitations on collection under §§6502 and 6503. The IRS stated that the period of limitations will be suspended during the time that a taxpayer is outside the United States for a continuous period of at least six months.

If a partnership has a foreign address, the CSED may be suspended for balance due accounts on said partnership until the partnership should ''return'' to the United States. The IRS stated that agents could refer to Internal Revenue Manual 5.1.19.3.7.2, paragraph 1, for the reasons to recalculate the CSED. Agents should look at paragraph 2 of that section for guidance on how to confirm that a taxpayer has been outside of the United States when unable to communicate with the taxpayer or power of attorney, IRS said.

When planning to recalculate a partnership's CSED under §6503(c), agents should consult with counsel first to get advice on whether they have sufficient evidence to justify the determination, the IRS said. The IRS stated that this only applies to assessments made against the partnership entity. If a partnership has an address outside the United States, but one or more of the partners are in the United States, the CSED for the taxes assessed against the partnership is still suspended under §6503(c), IRS said. In the memo, the IRS stressed that if the partners owe individual taxes and they live in the United States, their individual taxes are not suspended under §6503(c).

☐ *For a discussion of the running of the collections limitations period where the taxpayer is outside the United States, see 627 T.M., Limitations Periods, Interest on Underpayments and Overpayments, and Mitigation, I.E.6., p. A-31, and 637 T.M., Federal Tax Collection Procedure — Liens, Levies, Suits and Third Party Liability, III.I., pp. A-52-54.*

SEC. 6662—IMPOSITION OF ACCURACY-RELATED PENALTY ON UNDERPAYMENTS

Examiner, Manager Guidance Provided on Codified Economic Substance Doctrine and Related Penalties

LB&I-4-0711-015 (7/15/11): Examiners and their managers instructed on how to determine when to seek approval to raise economic substance doctrine, inquiries examiner must make and factors it must analyze before seeking approval for application of economic substance doctrine set forth.

For a complete discussion of LB&I-4-0711-015, see §7701 below.

SEC. 6672—FAILURE TO COLLECT AND PAY OVER TAX, OR ATTEMPT TO EVADE OR DEFEAT TAX

Former Airline CEO Liable For $11.6 Million in Passenger Excise Taxes

Conway v. U.S., No. 10-40485 (5th Cir. 7/19/11): Former chief executive officer of airline liable for $11.6 million in excise taxes collected from passengers, but not paid over to government during time leading company.

Facts: Taxpayer (T) was the CEO, president, and chairman of the board for an airline. The airline was required to collect a transportation excise tax from its passengers and pay the collected taxes to the federal government. The airline filed for Chapter 11 bankruptcy after sending the IRS its quarterly excise tax return and a check. The airline closed its bank accounts to establish new accounts for reorganization. The check to the IRS was returned.

During bankruptcy, the airline regularly made biweekly payments of the excise taxes, but following the terrorist attacks on September 11, 2001, Congress passed the Air Transportation Safety & System Stabilization Act (P.L. 107-42) (Stabilization Act), which allowed airlines to defer paying over collected excise taxes until November 15, 2001. IRS then extended the deferral to January 15, 2002. Under the Stabilization Act, the airline received approximately $21 million from the government. The airline filed its excise tax return, but did not pay the collected taxes on January 15, 2002. Similarly, the airline sent in a tax return without payment on January 30, 2002.

The airline shut down all operations and the bankruptcy was converted to Chapter 7. The IRS made a request for payment of the unpaid excise taxes in the amount of $11,572, 151.91 and the government sent T a notice that it intended to seek to recover the unpaid excise taxes from him personally. T made a few small payments towards the excise taxes and filed for a refund of those amounts, which was denied.

T filed suit in the district court seeking a refund of the amounts paid and an abatement of the amounts owing. The IRS counterclaimed for the amount owing followed by a motion for summary judgment on T's liability for the unpaid excise taxes under §6672. The district court granted the motion and entered judgment for the IRS. T appealed.

Holding: The Fifth Circuit held that T was liable for $11.6 million in excise taxes collected from passengers, but not paid over to the government during his time leading the company. The court stated that each of the six factors considered in determining whether an individual is a responsible person weighed in favor of finding that T was responsible for the taxes at issue where T was the founder, CEO, president, and chairman of the board of the airline during the periods in question; he was one of the largest individual stockholders; he had the most individual authority; and he was authorized to sign checks on each of the airline's company accounts.

T argued that the court should not find him to be liable due to the extraordinary circumstances of the September 11, 2001, terrorist attacks and the subsequent Stabilization Act. The court stated that, ''[n]othing in the plain language of the Act evinces an intent to allow the airlines to use the excise taxes as working capital. By the plain terms of the Stabilization Act, its effect was to allow airlines to defer paying over the collected excise taxes until January 15, 2002, as authorized by the IRS. Because these taxes are collected from passengers, and were not intended to become the property of [the airline], more than a mere statutory deferral of payment would be required to evince an intent to allow the collected taxes to be used for operational purposes.''

☐ *For a discussion of the willfulness requirement for asserting the penalty under §6672 against a responsible person, see 639 T.M., Responsible Person*

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and Lender Liability for Trust Fund Taxes — §§6672 and 3505, II.F., pp. A-18-27.

SEC. 7206—FRAUD AND FALSE STATEMENTS

Tax Conviction Affirmed, Case Remanded For Recalculation of Tax Loss

U.S. v. McLain, No. 09-3292 (8th Cir. 7/21/11): Taxpayer's conviction affirmed on charges of failing to pay employment taxes, but calculation of loss to government vacated because improper deductions were never claimed.

Facts: Taxpayer (T) managed a temporary staffing agency for nurses that failed to file either a Form 941, *Employer's Quarterly Federal Tax Returns*, or pay employment taxes between 2002 and 2005. A district court convicted T of failing to account for and pay employment taxes, sentenced T to four years in prison, and T was fined $75,000. T appealed and contended that the district court miscalculated his sentence under the sentencing guidelines. T said the district court included the amount of tax deductions he gave as ''gifts'' to two other individuals in its calculation of a tax loss to the government. However, the district court did not find that either individual filed a return claiming the false deduction.

Holding: The Eighth Circuit affirmed T's conviction on charges of failing to pay employment taxes, but vacated the district court's calculation of loss to the government because the improper deductions T ''gifted'' to other individuals were never claimed. The court stated that §7206(2) cannot be violated if a false return is never prepared and discussed the three essential elements to a violation of §7206(2): (1) the defendant aided, assisted, procured, counseled, advised or caused the preparation and presentation of a return; (2) the return was fraudulent or false as to a material matter; and (3) the act of the defendant was willful. The court found that the second element was never proven where the district court had no evidence that a return was actually prepared.

The court also stated the district court acted properly by admitting evidence of T's compliance with state tax law. The Eighth Circuit held that the evidence was ''highly relevant to [T's] willfulness, a necessary element of the crime charged.''

☐ *For a discussion of determining tax loss to the government, see 636 T.M., Tax Crimes, VI.E.2.a.(1), pp. A-77-81.*

SEC. 7701—DEFINITIONS

Examiner, Manager Guidance Provided on Codified Economic Substance Doctrine and Related Penalties

LB&I-4-0711-015 (7/15/11): Examiners and their managers instructed on how to determine when to seek approval to raise economic substance doctrine, inquiries examiner must make and factors it must analyze before seeking approval for application of economic substance doctrine set forth.

Discussion: The IRS issued a directive for examiners to use in determining whether and when to seek high-level review in asserting the codified economic substance doctrine and its associated strict liability penalty. The guidance, which requires examiners to undertake a four-step inquiry before asking an IRS Director of Field Operations to assert the penalty, gives constructive answers to questions that taxpayers have been raising since Congress codified the doctrine in §7701(o). The directive outlined several specific sets of facts and circumstances under which it likely would or would not be appropriate for agents to assert the economic substance doctrine, as well as factors that could raise red flags.

According to the directive, the strict liability penalty should be asserted only in cases involving the economic substance doctrine and not other judicial doctrines, and if agents find another doctrine that is more appropriate to assert than economic substance, they should assert that other doctrine.

Practitioner Comments: Donald Korb, a former IRS chief counsel now with Sullivan & Cromwell LLP in Washington, D.C., said July 15 that the directive is ''a real positive development. It's good to have a methodology that examiners can use to decide whether to apply the economic substance doctrine in a way that will provide consistency across the country.''

Sullivan & Cromwell's Korb praised the stance taken by the guidance on when the new penalty will apply, noting that for now the strict liability penalty will only apply in cases where the economic substance doctrine comes into play and will not apply where IRS is using other judicial doctrines, such as the substance over form or step transaction doctrine.

Korb said the first two steps that examiners must take in evaluating transactions, one outlining facts and circumstances where application of the doctrine is likely not appropriate and the second outlining factors where the doctrine likely is appropriate, will generate a lot of discussion in the tax community about whether the list is complete.

The former chief counsel told BNA he believes IRS's clarification that generally all of the steps of a transaction will be considered together to determine its status is a positive development. He noted, however, that the guidance does provide some flexibility to disaggregate the steps in some cases, although examiners will have to seek guidance from their manager and consult with their local counsel before doing so.

Lawrence Hill of Dewey & LeBoeuf LLP in New York, told BNA July 15 that he too sees the directive as a very positive development. ''This is very constructive guidance which should mitigate against the inconsistent application of the strict liability penalty to transactions that the Service determines may lack economic substance,'' Hill said. ''Taxpayers have been given an extensive planning checklist to evaluate transactions for risk management purposes, prior to approval.''

Hill noted that before examiners engage in the four-step process prior to submitting cases to the Director of Field Operations for review of the penalty, taxpayers require notification in advance of this process that the examiner is considering whether to apply the doctrine.

''Most notably, the directive identifies 18 nonexclusive factors and four circumstances where application of the doctrine is likely not appropriate and 17 nonexclusive factors where application of the doctrine may be appropriate,'' Hill said.

☐ *For a discussion of the codified economic substance doctrine, see 508 T.M., The Economic Substance Doctrine, VIII., pp. A-89-90. For a discussion of the accuracy-related penalty for understatements*

attributable to a disallowance of claimed tax benefits by reason of a transaction lacking economic substance, see 634 T.M., Civil Tax Penalties, IV.L., p. A-48(4). For a discussion of tax shelters, see generally 798 T.M., Tax Shelters.

31 U.S.C.—CIRCULAR 230

Comments Requested on Continuing Education Requirements for Tax Preparers

Notice 2011-61, 2011-31 I.R.B. __ (8/1/11): Comments requested on requirements for approving continuing education provider for tax preparers.

Discussion: The IRS requests public comments regarding the process for individuals and entities to be approved by the IRS as continuing education providers. The IRS published final regulations (T.D. 9527, 76 Fed. Reg. 32286 (6/3/11); see 30 *Tax Mgmt. Wkly. Rpt.* 712 (6/6/11)), which required registered tax return preparers to complete continuing education offered by qualified continuing education providers. IRS said comments should address what information an applicant must submit to be approved as a continuing education provider under §10.9 of Circular 230; the criteria IRS should use to determine the requirements of Circular 230; and the criteria for a continuing education provider's programs to meet the standards for a continuing education program under Circular 230. The IRS also requests comments on what criteria it should use to determine which accrediting organizations have minimum education standards comparable to those set forth in Circular 230.

Comments are requested by August 17, 2011.

Practitioner Comments: National Society of Accountants Executive Vice President John Ams told BNA that, ''The new standards for continuing education will reflect the fact that preparing tax returns is now considered to be practice before IRS.''

Circular 230 requires preparers to complete 15 hours of continuing education offered by ''qualified education providers.'' The question is how to define that term, Ams said.

''What the IRS is wrestling with is how do we make sure that the people who are offering education are offering quality education?'' he said.

Continuing education providers will see a business opportunity in providing required continuing education to 712,000 newly registered tax preparers, Ams said, but the IRS will need to make sure its standards are tough enough to meet state accountancy requirements as well as to encompass tax preparers who have never before faced testing or continuing education.

☐ *For a discussion of qualifying continuing education programs for enrolled agents and registered tax return preparers, see 620 T.M., Practice Before the IRS; Attorney's Fees in Tax Proceedings, V.G.3., p. A-18.*

26 C.F.R. §601.105—EXAMINATION OF RETURNS AND CLAIMS FOR REFUND, CREDIT, OR ABATEMENT; DETERMINATION OF CORRECT TAX LIABILITY

Notice Issued on Permissible Communications Between Appeals and Other Parts of IRS

Notice 2011-62, 2011-32 I.R.B. __ (8/8/11): Notice issued seeking comment on proposed regulations on permissible communications between the Appeals office, other parts of IRS.

Discussion: The IRS issued proposed regulations on permissible communications between the Appeals office and other parts of the IRS that take place without the taxpayer or the taxpayer's representative being given an opportunity to participate in the communication. The IRS stated that the proposed regulations would update existing ex parte communication rules as set forth in Rev. Proc. 2000-43, 2000-2 C.B. 404, and that the updates are necessary (1) because of changes to some of the IRS's business practices since the existing rules were issued in 2000, and (2) to implement a provision in the IRS Restructuring and Reform Act of 1998, aimed at ensuring that the Appeals office remains an independent and flexible vehicle for settling audit and collection-related disputes.

The IRS stated that one major change from the existing rules is that Appeals would no longer participate on issue management teams (IMT), but can be briefed by IMTs, as long as the discussion remains generic rather than case specific. The IRS explained that IMTs include representatives from various IRS components, typically Compliance and Counsel, and the IMT meetings usually involve general discussions of how to handle technical issues or procedural matters.

Among other changes, the IRS continued, the proposed rules would: (1) add guiding principles to aid in understanding the overall approach to applying the ex parte communication rules; (2) add or clarify definitions for certain terms; (3) clarify transmittals and the permissible content of the administrative file; (4) address the application of the ex parte communication rules to collection due process (CDP) cases, including those CDP cases that are remanded by the Tax Court; (5) expand the discussion of Appeals' involvement in multifunctional meetings; (6) address the application of the ex parte communication rules in the context of alternative dispute resolution proceedings; (7) clarify the remedies available to taxpayers in the event of a breach of the ex parte communication rules; and (8) add a statement that the ex parte communication rules do not create substantive rights affecting a taxpayer's liability or the IRS' ability to determine, assess or collect that tax liability.

The IRS stated that the proposed rules, to be issued in a revenue procedure, will amplify, modify and supersede Rev. Proc. 2000-43.

Comments are due August 18, 2011.

☐ *For a discussion of the prohibition on ex parte communications between Appeals employees and other IRS employees, see 623 T.M., IRS Procedures: Examinations and Appeals, IV.G., pp. A-88-99.*

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Applicable Federal Rates

Applicable, Adjusted Federal Interest Rates for August 2011 Issued

This revenue ruling is scheduled to appear in I.R.B. 2011-32, dated August 8, 2011.

Part I

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Rev. Rul. 2011-16

This revenue ruling provides various prescribed rates for federal income tax purposes for August 2011 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(1) for buildings placed in service during the current month. However, under section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, and before December 31, 2013, shall not be less than 9%. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2011-16 TABLE 1

Applicable Federal Rates (AFR) for August 2011

	Period for Compounding			
	Annual	Semiannual	Quarterly	Monthly
		Short-term		
AFR	.32%	.32%	.32%	.32%
110% AFR	.35%	.35%	.35%	.35%
120% AFR	.38%	.38%	.38%	.38%
130% AFR	.42%	.42%	.42%	.42%
		Mid-term		
AFR	1.90%	1.89%	1.89%	1.88%
110% AFR	2.09%	2.08%	2.07%	2.07%
120% AFR	2.28%	2.27%	2.26%	2.26%
130% AFR	2.48%	2.46%	2.45%	2.45%
150% AFR	2.86%	2.84%	2.83%	2.82%
175% AFR	3.34%	3.31%	3.30%	3.29%
		Long-term		
AFR	3.86%	3.82%	3.80%	3.79%
110% AFR	4.24%	4.20%	4.18%	4.16%
120% AFR	4.63%	4.58%	4.55%	4.54%
130% AFR	5.03%	4.97%	4.94%	4.92%

REV. RUL. 2011-16 TABLE 2

Adjusted AFR for August 2011				
	Period for Compounding			
	Annual	Semiannual	Quarterly	Monthly
Short-term adjusted AFR	.44%	.44%	.44%	.44%
Mid-term adjusted AFR	1.62%	1.61%	1.61%	1.60%
Long-term adjusted AFR	3.82%	3.78%	3.76%	3.75%

REV. RUL. 2011-16 TABLE 3

Rates Under Section 382 for August 2011	
Adjusted federal long-term rate for the current month	3.82%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.17%

REV. RUL. 2011-16 TABLE 4

Appropriate Percentages Under Section 42(b)(1) for August 2011	
Note: Under Section 42(b)(2), the applicable percentage for non-federally subsidized new buildings placed in service after July 30, 2008, and before December 31, 2013, shall not be less than 9%.	
Appropriate percentage for the 70% present value low-income housing credit	7.66%
Appropriate percentage for the 30% present value low-income housing credit	3.28%

REV. RUL. 2011-16 TABLE 5

Rate Under Section 7520 for August 2011	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	2.2%

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Compliance Calendar

July, 2011

■ **July 27:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments on July 20-22.

■ **July 29:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments on July 23-26.

August, 2011

■ **August 1:** Employers - File Form 941 for the second quarter of 2011 and deposit any undeposited tax (employers that deposited the tax for the quarter in full and on time have until August 10, 2011); deposit FUTA tax owed through June 2011 if more than $500; certain small employers must deposit any undeposited FUTA tax if liability is $2,500 or more for 2011 but less than $2,500 for the second quarter; employers maintaining employee benefit plans must file Form 5500 or 5500-EZ for calendar year 2010.

■ **August 2:** Excise Taxes -File Form 720 for the second quarter of 2011. File Form 730 and pay tax on wagers accepted during June 2011. File Form 2290 and pay tax for vehicles first used during June 2011.

■ **August 3:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments on July 27-29.

■ **August 5:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments on July 30- August 2.

■ **August 10:** Employees - Employees who received tips of $20 or more during July must report them to employers on Form 4070.

■ **August 10:** Employers - File Form 941 for second quarter of 2011 if you deposited the tax for the quarter in full and on time.

■ **August 10:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments on August 3-5.

■ **August 12:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments on August 6-9.

■ **August 15:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments in July if the monthly deposit rule applies.

■ **August 15:** Employers - Nonpayroll withholding. If the monthly deposit rule applies, deposit the tax for payments in July.

■ **August 17:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments on August 10-12.

■ **August 19:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments on August 13-16.

■ **August 24:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments on August 17-19.

■ **August 26:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments on August 20-23.

■ **August 31:** Employers - Deposit the Social Security, Medicare, and withheld income taxes for payments on August 24-26.

■ **August 31:** Excise Taxes -File Form 730 and pay tax on wagers accepted during July 2011. File Form 2290 and pay tax for vehicles first used during July 2011.

Editor's Note: In IR-2011-77; T.D. 9537; REG-122813-11 (7/15/11), the IRS advised truckers and other owners of heavy highway vehicles that their next federal highway use tax return—Form 2290—usually due August 31, 2011, will instead be due on November 31, 2011, as the tax is scheduled to expire on September 30, 2011. According to the IRS, returns should not be filed and payments should not be made before November 1, 2011. The extension is designed to alleviate confusion if Congress reinstates or modifies the tax. For more information on T.D. 9537; REG-122813-11, see the *Tech* section of this issue.

For a discussion of the payroll deposit and reporting rules for employers, see 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation*. For the tax calendar for the preceding month, see the June 27, 2011 issue of the *Tax Management Weekly Report*.

Journal

July

New **How to Design, Explain, and Implement Dynasty Trusts and Asset Protection Trusts, and Maximize Benefits;** July 26; webinar; BNA; 800-372-1033, menu option 6, option 1; http://www.bna.com.

NABE Transfer Pricing Symposium; July 26-27; Arlington, Va.; National Association for Business Economics; (202) 463-6223; http://www.nabe.com.

Modern Real Estate Transactions; July 28-30; Boston; live video webcast; American Law Institute-American Bar Association; 800-CLE-NEWS; http://www.ali-aba.org.

August

2011 ABA Annual Meeting; Aug. 4-9; Toronto; American Bar Association Taxation Section; 800-285-2221; http://www.abanet.org.

IFRS Boot Camp Certification Program; Aug. 8-12; Atlantic City, N.J.; Center for Professional Education Inc.; 800-544-1114; http://www.cpeonline.com.

U.S. International Tax Planning - 2011; Aug. 15-17; San Francisco; BNA Tax and Accounting/CITE; (914) 328-5656; http://www.citeusa.org.

International Trust and Estate Planning; Aug. 18-19; San Francisco; live video webcast; American Law Institute-American Bar Association (ALI-ABA); 800-CLE-NEWS; http://www.ali-aba.org.

IFRS Boot Camp Certification Program; Aug. 22-26; Chicago; Center for Professional Education Inc.; 800-544-1114; http://www.cpeonline.com.

New **2011 Affordable Housing Tax Incentive Real Estate Conference;** Aug. 25; Atlanta; (404) 847-7740; http://www.reznickgroup.com.

September

Sophisticated Estate Planning Techniques; Sept. 8-9; Boston; live video webcast; American Law Institute-American Bar Association (ALI-ABA); 800-CLE-NEWS; http://www.ali-aba.org.

42nd Annual Estate Planning Institute; Sept. 12-13; New York City; New Brunswick, Pa. groupcast locations; live webcast; Practising Law Institute; 800-260-4PLI; http://www.pli.edu.

IFRS Boot Camp Certification Program; Sept. 12-16; Houston; Center for Professional Education Inc.; 800-544-1114; http://www.cpeonline.com.

18th Annual Affordable Housing Tax Credit Conferences; Sept. 15-16; San Francisco; Novogradac & Co.; (415) 356-7970;http://www.novoco.com/events/.

How to Handle a Tax Controversy at the IRS and in Court: From Administrative Audit Through Litigation; Sept. 15-16; Washington, D.C.; live video webcast; American Law Institute-American Bar Association (ALI-ABA); 800-CLE-NEWS; http://www.ali-aba.org.

Retirement, Deferred Compensation, and Welfare Plans of Tax-Exempt and Governmental Employers; Sept. 15-16; Washington, D.C.; live video webcast; American Law Institute-American Bar Association; 800-CLE-NEWS; http://www.ali-aba.org.

15th Annual Mexico Tax Update; Sept. 19-20; San Diego; BNA Tax and Accounting/CITE; (914) 328-5656; http://www.citeusa.org.

Introduction to U.S. International Tax; Sept. 19-20; Boston; BNA Tax and Accounting/CITE; (914) 328-5656; http://www.citeusa.org.

IFRS Boot Camp Certification Program; Sept. 19-23; Charlotte, N.C.; Center for Professional Education Inc.; 800-544-1114; http://www.cpeonline.com.

Intermediate U.S. International Tax Update; Sept. 21-23; Boston; BNA Tax and Accounting/CITE; (914) 328-5656; http://www.citeusa.org.

Property Compliance Workshop; Sept. 22-23; Washington, D.C.; Novogradac & Co.; (415) 356-7970; http://www.novoco.com/events/.

October

IFRS Boot Camp Certification Program; Oct. 10-14; Pittsburgh; Center for Professional Education Inc.; 800-544-1114; http://www.cpeonline.com.

Bond Attorneys' Workshop; Oct. 12-14; San Antonio; National Association of Bond Lawyers; (312) 648-9590; http://www.nabl.org.

Pension, Profit-Sharing, Welfare, and Other Compensation Plans; Oct. 12-14; Washington, D.C.; live video webcast; American Law Institute-American Bar Association; 800-CLE-NEWS; http://www.ali-aba.org.

U.S. Taxation of Intellectual Property; Oct. 17-18; Chicago; BNA Tax and Accounting/CITE; (914) 328-5656; http://www.citeusa.org.

IFRS Boot Camp Certification Program; Oct. 17-21; Las Vegas; Center for Professional Education Inc.; 800-544-1114; http://www.cpeonline.com.

23rd Annual Partnership Tax Institute; Oct. 19-21; Las Vegas; National Institute of Tax Professionals; (805) 520-3162; http://www.nitp.com.

Creative Tax Planning for Real Estate Transactions; Oct. 19-21; Chicago; live video webcast; American Law Institute-American Bar Association; 800-CLE-NEWS; http://www.ali-aba.org.

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IRB Highlights

The documents summarized herein were issued by the IRS in Internal Revenue Bulletin 2011-30, July 25, 2011. I.R.B. highlights are printed verbatim as received from the IRS. Tax Management is not responsible for grammatical or syntactical errors.

INCOME TAX

Rev. Rul. 2011-15

Life insurance gross income; original issue discount. This ruling concludes that the 1994 publication of regulations concerning original issue discount (OID) rendered obsolete Rev. Rul. 58-225, 1958-1 C.B. 258, which held that a life insurance company must include in taxable income the amount of interest collected in advance under policyholder loans. Rev. Rul. 58-225 obsoleted.

T.D. 9529

REG-101352-11

Temporary and proposed regulations under section 6038A of the Code remove the requirement that taxpayers required to file Form 5472 *(Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business)* must file a duplicate Form 5472 with the Philadelphia Service Center. Corresponding amendments are made to section 1.6038A-1(n)(2) with respect to the effective dates of sections 1.6038A-2(d) and 1.6038A-2(e).

Rev. Proc. 2011-38

This procedure addresses the tax treatment under sections 1035 and 72 of the Code of the partial exchange of an annuity contract. Specifically, the procedure provides that the direct transfer of a portion of the cash surrender value of an existing annuity contract for a second annuity contract will be treated as a tax-free exchange under section 1035 if no amount other than an amount received as an annuity for a period of 10 years or more, or during one or more lives, is received during the 180 days beginning on the date of the transfer. A subsequent direct transfer of all or a portion of either contract involved in an exchange is not taken into account if the subsequent transfer qualifies (or is intended to qualify) as a tax-free exchange. Other transactions will be characterized consistent with their substance. Prior to this procedure's effective date, Rev. Proc. 2008-24 will be applied with the clarification that the conditions described in section 4.01(b) of Rev. Proc. 2008-24 will be treated as satisfied if the condition was satisfied on the date of the withdrawal or surrender. Rev. Proc. 2008-24 modified and superseded.

Rev. Proc. 2011-39

Specifications are set forth for the private printing of paper and laser-printed substitutes for Form 941, *Employer's QUARTERLY Federal Tax Return*, Schedule B (Form 941), *Report of Tax Liability for Semiweekly Schedule Depositors*, and Schedule R (Form 941), *Allocation Schedule for Aggregate Form 941 Filers*. This procedure will be reproduced as the next revision of Publication 4436, *General Rules and Specifications for Substitute Form 941, Schedule B (Form 941), and Schedule R (Form 941)*. Rev. Proc. 2008-32 superseded.

EXEMPT ORGANIZATIONS

Notice 2011-52

This notice provides information and solicits further comments regarding the community health needs assessment requirements applicable to charitable hospitals under the Patient Protection and Affordable Care Act of 2010. Comments are requested by September 23, 2011.

EMPLOYMENT TAX

Rev. Proc. 2011-39

Specifications are set forth for the private printing of paper and laser-printed substitutes for Form 941, *Employer's QUARTERLY Federal Tax Return*, Schedule B (Form 941), *Report of Tax Liability for Semiweekly Schedule Depositors*, and Schedule R (Form 941), *Allocation Schedule for Aggregate Form 941 Filers*. This procedure will be reproduced as the next revision of Publication 4436, *General Rules and Specifications for Substitute Form 941, Schedule B (Form 941), and Schedule R (Form 941)*. Rev. Proc. 2008-32 superseded.

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Introduction to Net Operating Losses

TOPIC 1: OVERVIEW OF THE DEDUCTION

The NOL deduction overcomes this result by allowing the excess expenses from one year to be carried over to a future year or carried back to a previous year.

	Year 1	Year 2	Year 3	Year 4	Total
Income	$ 10,000	$ 9,000	$ 8,000	$ 9,000	$ 36,000
Expense	$ 7,000	$ 8,000	$ 9,000	$ 8,000	$ 32,000
Net	$ 3,000	$ 1,000	$ (1,000)	$ 1,000	$ 4,000

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