C Corporations as S Corporation Subsidiaries

An S corporation can elect to treat a 100% owned subsidiary as a qualified subchapter S subsidiary (QSub) (Sec. 1361(b)(3)). A QSub election causes the subsidiary to be disregarded for most federal tax purposes. Accordingly, the QSub's items of income, deduction, and credit, as well as its assets and liabilities, are normally treated as those of its parent. As a prerequisite for the election, the subsidiary must be a corporation that would be eligible to be an S corporation if the shareholders of its parent S corporation held its stock directly.

Observation: Before the creation of the QSub alternative, an individual who owned multiple activities conducted as S corporations was required to hold them in a "brother-sister" format (the individual owner holds the stock of several S corporations). Under this arrangement, the individual owner had to ensure that there was adequate stock basis to receive a pass-through loss from any S corporation that may have a loss year. Conversely, in QSub format, all income and losses are combined at the S level, and the owner's tax basis in stock needs to be monitored for only one entity.

As a practical matter, the biggest benefit of establishing one or more QSubs is to limit the parent company's legal liability (i.e., to prevent problems in one business or location from affecting other businesses or locations).

***Example 1*:** *E*, Inc., is an S corporation that operates a vegetarian restaurant. The owners are interested in expanding but are worried about the liability of opening new restaurants. To prevent problems in one restaurant from spilling over into other restaurants, *E* forms three new corporations, each operating a new restaurant in a different location, and elects to treat them as QSubs. The assets and liabilities of each restaurant are treated as if they are owned by *E*. Only one S corporation return is filed, the three subsidiaries are disregarded for federal tax purposes, and each provides limited liability protection for *E* and its shareholder(s).

Operating a Subsidiary as a C Corporation

S corporations are permitted to hold up to 100% of the stock of a corporation. Ownership of more than 50% of a corporation's stock gives the owner the right to control the subsidiary corporation. Ownership of 80% or more establishes an affiliated group relationship (Sec. 1504(a) (1)). However, the S corporation parent cannot be included as a member of the affiliated group for federal tax purposes (Sec. 1504(b)(8)). Thus, only the S corporation's subsidiary C corporations can be included in the group; the S corporation and its QSubs, if any, cannot be included.

Because S corporations cannot be included in an affiliated group, an S corporation cannot join in the filing of a consolidated return. However, a C corporation subsidiary can elect to join in the filing of a consolidated return with its affiliated C corporations.

Dividends received by an S corporation from a C corporation are not eligible for the dividends-received deduction (Secs. 1363(b) and 243). Thus, dividends received by an S corporation are fully taxable pass-through items of income.

The Sec. 1374 built-in gains (BIG) tax applies only to S corporations (Sec. 1374(a)). Thus, it does not apply to assets held by a subsidiary C corporation. (BIG tax does apply when the parent S corporation elects QSub status for a C corporation or an S corporation that is subject to the BIG tax.)

In general, there are no carry forwards and no carry backs between C and S tax years (Sec. 1371(b)). However, net operating losses, capital losses, business credits, and minimum tax credits carried over from C corporation tax years can be used to reduce the BIG tax (Sec. 1374(b) (2)). Therefore, it may be preferable to continue operating the subsidiary as a C corporation rather than making a QSub election when the subsidiary C corporation can use such carryovers.

Operating a Subsidiary as a QSub

A QSub is a subsidiary corporation that is 100% owned by an S corporation that has made a QSub election for that subsidiary (Sec. 1361(b)(3); Regs. Sec. 1.1361- 2(a)). (An S corporation can own 100% of the stock of two subsidiaries and make a QSub election for either, neither, or both of them.) A QSub is not treated as a separate corporation for federal tax purposes (although it is still treated as a separate corporation for other purposes).

A QSub's assets, liabilities, and items of income, deduction, and credit are treated as owned by the parent S corporation (Sec. 1361(b)(3)). Therefore, transactions between the S corporation parent and the QSub are not taken into account, and items of the subsidiary (including accumulated earnings and profits, passive investment income, built-in gains, and debt basis) are considered items of the parent. (See the committee report on Section 1308 of the Small Business Job Protection Act of 1996, P.L. 104-188, H.R. Conf. Rep't No. 104-737, 104th Cong., 2d Sess. 224 (1996).)

Example 2: *E*, Inc., is a calendar-year S corporation that plans to purchase 100% of the stock of *R* Corp., a C corporation. *R* Corp. can be operated as either a C corporation or a QSub. To operate the subsidiary as a QSub, it must be 100% owned by the parent S corporation, and the parent S corporation must make a QSub election. But making a QSub election for a subsidiary that was a C corporation can subject the S corporation to the BIG tax and the LIFO recapture tax (Secs. 1374 and 1375).

Changing Existing Subsidiary into a QSub

When a parent S corporation makes a QSub election for an existing corporation (whether or not its stock was acquired from another person or previously held by the S corporation), the subsidiary is generally deemed to have engaged in a tax-free liquidation under Secs. 332 and 337 immediately before the election is effective (Regs. Sec. 1.1361-4(a)(2)). Filing a QSub election is treated as the

adoption of a plan of liquidation for purposes of Sec. 332. If the deemed liquidation does not qualify under Secs. 332 and 337 as a tax-free parent/subsidiary liquidation, the subsidiary must recognize gain on the transaction. Losses are generally not recognized due to the loss limitation on transactions between related parties imposed by Sec. 267.

Under Sec. 337, the subsidiary corporation recognizes no gain or loss on the deemed liquidating distribution of its property (Sec. 337(a)). Under Sec. 332, the parent S corporation recognizes no gain or loss on the deemed receipt of the subsidiary's property (Sec. 332(a)). The parent S corporation takes a transferred basis in the subsidiary's property (Sec. 334(b)).

Example 3: Assume the same facts as Example 2, except *R* Corp. is an S corporation. An S corporation can own stock in another corporation; however, a corporation (other than a Sec. 501(c) (3) charitable organization) is not an eligible S shareholder. Thus, *R*'s S election will terminate on the day before *E* acquires its shares. *E* can then operate *R* as a subsidiary C corporation or as a QSub.

The tax treatment of the deemed liquidation (or of a larger transaction that includes the deemed liquidation) must be determined under the general principles of federal tax law, including the step transaction doctrine (Regs. Sec. 1.1361-4(a)(2)). According to that doctrine, the steps of a corporate reorganization, if related, will be treated as one transaction. Thus, the tax consequences of the transaction (e.g., whether the transferors are in control of the transferee) will be determined after all the steps are completed rather than at each step of the transaction.

Federal Tax Alert: IRS Rules on Reasonableness of C Corporation Sole Shareholder's Compensation

(Article No. ta-072010-0006, July 01, 2010)

Citations: Multi-Pak Corp., TC Memo 2010-139

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes

Forms Affected:

- **Form 1120, U.S. Corporation Income Tax Return**

The Tax Court has held that: (a) most of the compensation paid by a C corporation to its employee-owner was deductible compensation and not a dividend; and (b) no accuracy-related penalty applied on the portion of the compensation deduction that was excessive because the corporation reasonably relied on its CPA to determine the amount of the deductible compensation.

Related Resources:

Bittker & Lokken: Federal Taxation of Income, Estates & Gifts ¶ 64.2

Background. For compensation paid by an employer to be deductible, the amount must be reasonable. What's reasonable depends on the facts and circumstances of each case. Several factors are used to determine the reasonableness of compensation including the employee's role in the company and the character and condition of the company. The "independent investor" test may also be applied to determine whether compensation is reasonable. That test looks at what a hypothetical, independent investor would be willing to compensate the employee. (Elliotts, Inc., (CA 9 1983) 52 AFTR 2d 83-5976)

Facts. When Randal Unthank became the sole shareholder of Multi-Pak in '72, it was on the verge of bankruptcy, but he turned the enterprise around so that it became largely debt free and successful. He has been Multi-Pak's president, CEO, and COO for decades, controls all aspects of Multi-Pak's operations and designs the products that Multi-Pak sells.

For 2002 and 2003, total assets of Multi-Pak were $3.321 million and $3.134 million respectively, revenue was $9.484 million and $8.771 million, EBITDA (earnings before interest, taxes, depreciation and amortization) was $508,500 and ($120,500), net income was $140,700 and ($474,000), and total equity was $3.181 million and $2.994 million.

For 2002, Multi-Pak paid Unthank $2,020,000 ($150,000 salary and $1,870,000 bonus), and for 2003, it paid him $2,058,000 ($353,000 salary and $1,705,000 bonus). Unthank's policy was to decide in consultation with Multi-Pak's outside CPA the amount of bonus to pay himself at the end of every month, based on his performance and the company's profitability.

On audit, IRS determined that for 2002 and 2003, Multi-Pak could deduct only $655,000 and $660,000 of Unthank's compensation, respectively. And, IRS also assessed Multi-Pak with an accuracy-related penalty under IRC § 6662(a) .

Arguments. The taxpayer argued that Unthank was the driving force behind the company's success who was involved in every aspect of the company's operations from designing the products to making all important business decisions.

IRS argued that under the "independent investor test," the compensation was too high because Multi-Pak had only a 2.9% return on equity in the first year and a negative 15.8% return on equity in the second year.

Court's ruling. The Tax Court agreed with the taxpayer that Mr. Unthank was the driving force behind the taxpayer's success and stated that the compensation paid to Mr. Unthank in 2002 would not have been unreasonable to an independent owner. However, it found that a negative 15.8% return on equity in 2003 called into question the level of Unthank's compensation for that year. When compensation results in a negative return on shareholder equity, the Court said it couldn't conclude, in the absence of a mitigating circumstance, that an independent investor would be pleased. The Tax Court held that Multi-Pak could deduct only $1,284,104 (62.4%) of the $2,058,000 of the compensation it paid Unthank in 2003, an amount which would have resulted in a 10% return on equity in 2003.

The Tax Court also held that Multi-Pak wasn't liable for the IRC § 6662(a) accuracy related penalty for 2003 since it reasonably relied on the professional advice of its CPA as to the compensation it paid Unthank.

Background Information: Federal Tax Coordinator ¶ H-3706 ; United States Tax Reporter ¶ 1624.229 ; Tax Desk ¶ 276,027

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Federal Tax Alert: IRS Guidance Regarding Tax Issues Resulting From Spin-Off

(Article No. ta-062010-0079, June 18, 2010)

Citations: Chief Counsel Advice 201023056

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes

Forms Affected:

- **Form 1120, U.S. Corporation Income Tax Return**

Related Resources:

Bittker, Streng & Emory: Federal Income Taxation of Corporations & Shareholders: Forms ¶ 3.03

IRS has released Chief Counsel Advice (CCA) with respect to tax issues that resulted from a spinoff.

Background. *Deductibility of contingent liability by target corporation.* Under IRC § 351 , no gain or loss is recognized if property is transferred to a corporation solely in exchange for stock of that corporation, if, immediately after the transfer, the transferor or transferors are in control of the corporation.

If a transferee corporation's payments of assumed liabilities (including contingent liabilities) could have been deducted by the transferor corporation had they been made before a IRC § 351 exchange, the transferee is entitled to a deduction for the amount of the payments. (Rev Rul 80-198 , 1980-2 CB 113 , Rev Rul 95-74 , 1995-2 CB 36) This rule is subject to two limitations: (1) There must be a valid business purpose for the transfer of the liabilities, and (2) The liabilities must be transferred together with their related receivables, and

both must have arisen in the ordinary course of business and must not have been accelerated or prepaid for a tax-avoidance purpose.

Transfer of tax attributes. In order for tax attributes to be transferred to the transferee corporation (target corporation) where the target corporation was formed as a result of a divisive (i.e., not acquisitive) "D" reorganization, the target corporation must acquire substantially all of the transferor's assets under IRC § 354(b)(1) .

Claim of right doctrine. If a taxpayer must repay income received and reported in an earlier year, it may be allowed a deduction in the year of repayment for the amount repaid or it may claim a credit for the amount that that repayment would have reduced its income tax in the year that the income was reported. (IRC § 1341)

Facts. Parent had three subsidiaries that generated gross income from Activity X of Business B. These subs were merged into Parent, which continued to conduct Business B and other businesses. Parent later formed Target by transferring, among other things, the Business B assets to Target. In exchange, Target issued its stock to Parent and assumed the liabilities associated with Business B. Shortly thereafter, Parent spun off Target in a transaction qualifying as a tax-free reorganization under IRC § 368(a)(1)(D) (Type "D" reorganization) and IRC § 355 (dealing with a transfer of assets to controlled corporation followed by a distribution).

Just before the spin-off was completed, a class action lawsuit by litigants was filed against Parent concerning the conduct of Activity X of Business B. Under a court approved settlement of these claims, Parent agreed to pay the sum of $M. Parent and Target agreed that with respect to the settlement, Target was responsible for the liability but entitled to reimbursement of a certain percent from Parent. Target accrued and paid $N of the $M settlement.

CCA's favorable conclusion. The CCA concluded that, to the extent that the liabilities Target assumed were incurred in the ordinary course of business by Parent's subsidiaries and were associated with the Business B assets that Parent transferred to Target in a IRC § 368(a)(1)(D) and IRC § 351 transaction, Target can deduct as ordinary and necessary business expenses the $N amount it paid to extinguish these contingent liabilities to the extent such amounts would otherwise have been deductible by Parent if not assumed by Target.

In transactions qualifying as transfers under IRC § 351 and nonacquisitive IRC § 368(a)(1)(D) reorganizations, where the contingent liabilities of a transferor corporation are assumed by the acquiring corporation, the acquiring corporation is allowed to deduct the liabilities when they mature or are paid. The deduction is premised on the acquiring corporation being treated as having stepped into the shoes of the transferor with respect to the liabilities.

No transfer of tax attributes. The CCA determined that Target's transaction was a divisive "D" reorganization. Target acquired only the Business B assets from Parent and not substantially all of Parent's assets. Accordingly, the CCA found that Target couldn't carry over Parent's tax attributes under IRC § 381 and thus couldn't claim a credit under IRC § 1341 for the amount that the abovementioned reimbursement would have reduced Parent's prior year tax.

Background Information: Federal Tax Coordinator ¶ F-1509 ; Federal Tax Coordinator ¶ L-5403 ; United States Tax Reporter ¶ 3574 ; Tax Desk ¶ 231,502

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Federal Tax Alert: Prepaid Income Not Built-In Gain for Purposes of IRC 382 Loss Limitations

(Article No. ta-062010-0078, June 17, 2010)

Citations: TD 9487, 06/11/2010 ; Reg § 1.382-7

Effective date: See below

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes

Forms Affected:

- **Form 1120, U.S. Corporation Income Tax Return**

Related Resources:

Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders ¶ 14.44

IRS has issued final regs that provide that prepaid income is not recognized built-in gain for purposes of calculating IRC § 382 loss limitations on a change of ownership.

Background on loss limitation rules. IRC § 382 limits, after a more than 50% change in stock ownership (ownership change), the amount of a loss corporation's taxable income for any post-change year, that may be offset by pre-change losses. The amount of the limitation each year is equal to the product of the fair market value of all the stock of the loss corporation immediately before the ownership change multiplied by the applicable long-term tax-exempt rate (IRC § 382 limitation).

However, if a loss corporation has a net unrealized built-in gain (NUBIG) on the change date, the IRC § 382 limitation for any tax year ending within a 5-year recognition period is increased by recognized built-in gain (RBIG) for the tax year, subject to the NUBIG limitation. RBIG is any gain recognized during the 5-year period on the disposition of any asset to the extent the new loss corporation establishes that (i) the asset was held by the old loss corporation immediately before the change, and (ii) the gain does not exceed the unrecognized built-in gain on the asset on the change date. (IRC § 382(h))

IRC § 382(h)(6)(A) provides that any item of income that is properly taken into account during the 5-year recognition period but is attributable to periods before the change date is treated as RBIG for the tax year in which it is properly taken into account.

In Notice 2003-65 , 2003-2 CB 747 , IRS provided interim guidance for identifying built-in gains and losses under IRC § 382(h) . Under Notice 2003-65 , a loss corporation may use the IRC § 338 approach in determining its RBIG or recognized built-in loss (RBIL) for IRC § 382(h) purposes. This approach identifies items of RBIG and RBIL generally by comparing the loss corporation's actual items of income, gain, deduction, and loss with those that would have resulted if a IRC § 338 election had been made with respect to a hypothetical purchase of all of the outstanding stock of the loss corporation on the change date.

Background on prepaid income. Generally, a taxpayer, including an accrual method taxpayer that receives payments in advance of performance, must include the payments in gross income in the tax year of receipt without regard to whether the required performance has occurred. However, courts have allowed the deferral of prepaid income in limited circumstances.

Congress and IRS also have allowed deferral of prepaid income in certain circumstances. For example, IRC § 455 allows taxpayers that have prepaid subscription income for newspapers, magazines, and other periodicals to elect to defer such income to the tax years during which the liability to furnish or deliver the product exists. Reg § 1.451-5(b)(1)(ii) allows advance payments for the sale of goods to be deferred to the year the payments are included in gross receipts under the taxpayer's method of accounting for tax purposes (such as when the goods are shipped or delivered), unless the income is recorded earlier for purposes of the taxpayer's financial statements. Rev Proc 2004-34 , 2004-22 IRB 991 , allows a qualifying taxpayer to defer advance payments for services (and for certain non-services and combinations of services and non-services) to the tax year succeeding the tax year of receipt to the extent the taxpayer establishes that the advance payments are not recognized in revenues in the taxpayer's applicable financial statement in the tax year of receipt; or, if the taxpayer does not have an applicable financial statement, the payment is not earned in the tax year of receipt.

Perceived abuse. Certain taxpayers had taken the position that prepaid income received in the period before the change date (pre-change period) but included in gross income in the recognition period is RBIG. IRS believed that prepaid income is attributable to the period on or after the change date (post-change period) rather than the pre-change period. Thus, IRS said treating prepaid income as RBIG was inconsistent with the purposes of IRC § 382(h) . Accordingly, in 2007, IRS issued temporary and proposed regs that prevent taxpayers from doing this. (TD 9330, 06/13/2007) IRS has now finalized the regs without substantive change.

Final regs. Under the final regs, prepaid income is not recognized built-in gain. For this purpose, prepaid income is any amount received before the change date that is attributable to performance occurring on or after the change date. Examples include income received before the change date that is deferred under IRC § 455 , Reg § 1.451-5 , or Rev Proc 2004-34 (or any successor revenue procedure). (Reg § 1.382-7(a))

Effective date. The regs apply to loss corporations that have undergone an ownership change on or after June 11, 2010. (Reg § 1.382-7(b))

Background Information: Federal Tax Coordinator ¶ F-7200 et seq., Federal Tax Coordinator ¶ F-7341 et seq.; United States Tax Reporter ¶ 3824 et seq., United States Tax Reporter ¶ 3824.25 ; Tax Desk ¶ 240,300 et seq., Tax Desk ¶ 240,321

Federal Tax Planning: Simple Cafeteria Plans May Provide Tax-Free Benefits to Employee-Shareholders of Small C Corporations

(Article No. ta-042010-0110, May 20, 2010)

Citations:

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes

Forms Affected:

- **Form 1120, U.S. Corporation Income Tax Return**

Related Resources:

PPC's 1120 Deskbook (2009), Key Issue 16G ; PPC's 1120S Deskbook (2009), Key Issue 16A

This Alert discusses simple cafeteria plans and how those plans can provide tax-free benefits to employee-shareholders of small C corporations.

Cafeteria plan rules. *General.* Under a cafeteria plan, an employer may offer participating employees the opportunity to choose to receive certain nontaxable benefits in lieu of receiving taxable compensation. The value of the nontaxable benefits that a participant elects to receive is not includible in his income, notwithstanding the fact that a taxable benefit could have been chosen from the menu.

Participating employees may not be partners, more-than-2%-owners of S corporations or self-employed individuals. (Prop Reg § 1.125-1(g)(2))

RIA observation: C corporation shareholders who are employees may participate in such plans.

The following nontaxable fringe benefits are among the benefits that may be provided under a cafeteria plan:

(1) Accident and health insurance plans;

(2) Group-term life insurance coverage up to $50,000;

(3) Long-term disability coverage;

(4) Dependent care assistance;

(5) Flexible spending account (FSA) arrangements for medical or dependent care expenses;

(6) Adoption assistance benefits; and

(7) Contributions to a health savings account. (Prop Reg § 1.125-1(a)(3))

Nondiscrimination rules. In order for key employees to qualify for the above tax relief, nontaxable benefits provided under a cafeteria plan to those employees may not exceed 25% of the total nontaxable benefits provided to all employees under the cafeteria plan. (IRC § 125(b)(2)) Cafeteria plans may also not discriminate in favor of highly compensated participants with respect to eligibility to participate or contributions and benefits. (IRC § 125(b)(1))

Shareholders who hold more than 5% of their employer's stock and spouses or dependents of such shareholders are included in the definition of both key employees and highly compensated participants. (IRC § 416(i) ; IRC § 414(q)(1)(B))

Post-Dec. 31, 2010 exception to nondiscrimination rules for small employers. For tax years beginning after Dec. 31, 2010, the 2010 Health Care Act (Sec. 9022, PL 111-148, 03/28/2010) provides eligible small employers, i.e., employers who employed an average of 100 or fewer employees during the past two years, with a safe harbor from: (a) the nondiscrimination requirements for cafeteria plans (as described under "Nondiscrimination rules" above); and (b) the nondiscrimination requirements for specified qualified benefits, e.g., IRC § 129(d)(8) for dependent care benefits, that may be offered under cafeteria plans. (IRC § 125(j)(6))

A simple cafeteria plan will be treated as meeting applicable nondiscrimination requirements if it:

(1) is established and maintained by an eligible employer;

(2) meets prescribed contribution requirements; and

(3) meets prescribed eligibility and participation requirements. (IRC § 125(j)(2))

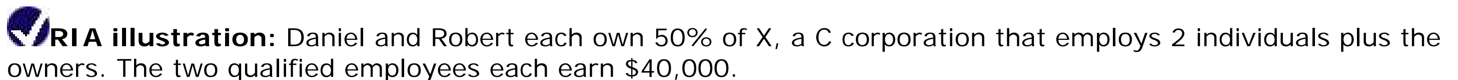
The prescribed contribution requirements provide that the employer must make a contribution to provide qualified benefits under the plan on behalf of each qualified employee, i.e., employees who are not highly compensated or key employees, in an amount equal to:

(i) a uniform percentage (not less than 2%) of the employee's compensation for the plan year, or

(ii) an amount which is not less than the lesser of (I) 6% of the employee's compensation for the plan year, or (II) twice the amount of the salary reduction contributions of each qualified employee. (IRC § 125(j)(3)(A)))

For more on simple cafeteria plans, see Article No. ta-032010-0132 .

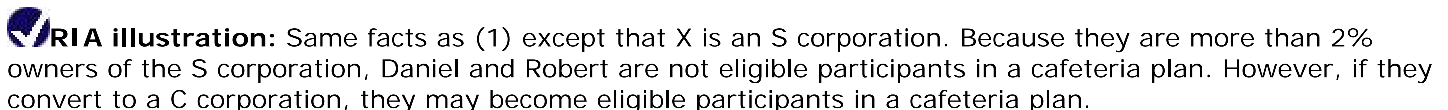
Strategies. *Strategy 1.* Existing C Corporations should consider establishing simple cafeteria plans.



RIA illustration: Daniel and Robert each own 50% of X, a C corporation that employs 2 individuals plus the owners. The two qualified employees each earn $40,000.

Assuming that both Daniel and Robert are in the 35% bracket, they can, for example, each save $3,500 by doing the following: a) establishing a simplified cafeteria plan; b) having the plan provide only those nontaxable benefits that are not subject to nondiscrimination rules under IRC § 125(j)(6) (see above); c) each having $10,000 of what would otherwise have been his salary contributed to the plan; d) having the plan pay for $10,000 of nontaxable benefits for each of them; and e) providing each of the qualified employees with at least $800 ($40,000 × 2%, i.e., the minimum contribution requirement) of cafeteria plan benefits.

Strategy 2. S corporations, sole proprietorships and partnerships may wish to convert to C corporations so that their owners can benefit from simple cafeteria plans.



RIA illustration: Same facts as (1) except that X is an S corporation. Because they are more than 2% owners of the S corporation, Daniel and Robert are not eligible participants in a cafeteria plan. However, if they convert to a C corporation, they may become eligible participants in a cafeteria plan.

Background Information: Federal Tax Coordinator ¶ D-1621

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Federal Tax Alert: IRS Releases Draft Form and Instructions to Report Uncertain Tax Positions

(Article No. ta-042010-0091, April 22, 2010)

Citations: Ann 2010-30, 2010-19 IRB ; Uncertain Tax Positions - Draft Schedule UTP, http://www.irs.gov/businesses/corporations/article/0,,id=221533,00.html

Effective date: Tax years beginning after Dec. 31, 2009

Taxing Authority: Federal

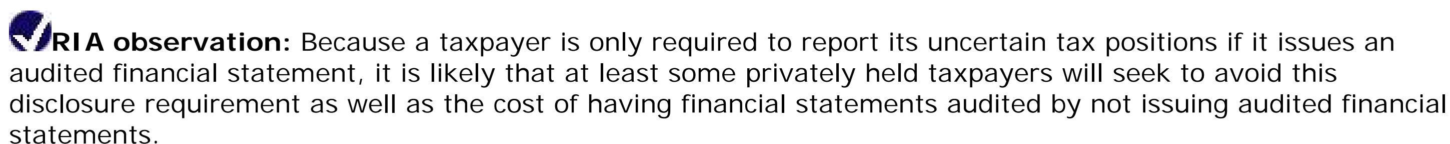
Topics: Corporate Income/Franchise Taxes

Forms Affected:

- **Form 1120, U.S. Corporation Income Tax Return**
- **Form 1120-L, U.S. Life Insurance Company Income Tax Return**
- **Form 1120-PC, U.S. Property and Casualty Insurance Company Income Tax Return**
- **Form 1120-F, U.S. Income Tax Return of a Foreign Corporation**
- **Form 1120, Schedule UTP-Uncertain Tax Position Statement**

IRS has released a draft schedule and instructions that taxpayers who issued audited financial statements will use to report uncertain tax positions.

Background. In Ann 2010-9, 2010-7 IRB , IRS announced that it was developing a schedule that would require certain filers to provide information about their uncertain tax positions that affect their income tax liability. For more on that announcement, see Article No. ta-012010-0031 .



RIA observation: Because a taxpayer is only required to report its uncertain tax positions if it issues an audited financial statement, it is likely that at least some privately held taxpayers will seek to avoid this disclosure requirement as well as the cost of having financial statements audited by not issuing audited financial statements.

Draft schedule and instructions. *Who must file Schedule UTP.* The draft schedule and instructions provide that, beginning with the 2010 tax year, the following taxpayers with both uncertain tax positions and assets equal to or exceeding $10 million will be required to file the new form, Schedule UTP, if they or a related party issued audited financial statements:

- Corporations required to file a Form 1120, U.S. Corporation Income Tax Return;
- Insurance companies required to file a Form 1120 L, U.S. Life Insurance Company Income Tax Return or Form 1120 PC, U.S. Property and Casualty Insurance Company Income Tax Return; and
- Foreign corporations required to file Form 1120 F, U.S. Income Tax Return of a Foreign Corporation.

For 2010 tax years, IRS won't require a Schedule UTP from Form 1120 series filers other than those identified above. IRS says it will determine the timing of the requirement to file Schedule UTP for these entities after comments have been received and considered.

Concern over duplicate reporting. IRS is reviewing the extent to which the proposed Schedule UTP duplicates other reporting requirements, such as Form 8275, Disclosure Statement; Form 8275-R, Regulation Disclosure Statement; Form 8886, Reportable Transaction Disclosure Statement; and the Schedule M-3, Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More. The draft instructions provide that a taxpayer will be treated as having filed a Form 8275 or Form 8275-R for tax positions that are properly reported on Schedule UTP. IRS is considering other circumstances under which a tax position reported on Schedule UTP need not be separately reported elsewhere on the tax return or another disclosure statement.

Tax positions to be reported. Schedule UTP requires the reporting of a corporation's federal income tax positions for which the corporation or a related party has recorded a reserve in an audited financial statement. It also requires the reporting of tax positions taken by the corporation in a tax return for which a reserve has not been recorded by the corporation or a related party based on an expectation to litigate or an IRS administrative practice.

A tax position must reported on a Schedule UTP attached to a particular tax year's return if (a) at least 60 days before filing the tax return a reserve has been recorded with respect to that tax position, or at least 60 days before filing the tax return a decision was made not to record a reserve based on an expectation to litigate or an IRS administrative practice, and (b) the tax position has been taken by the corporation in a tax return for the current tax year or a prior tax year.

A taxpayer will have to provide a concise description of each uncertain tax position reported for the current or a prior tax year.

A tax position must be reported regardless of whether the audited financial statement is prepared based on U.S. generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRS), or other country-specific accounting standards, including a modified version of any of the above (for example, modified GAAP) that requires a taxpayer to record a reserve for federal income tax positions.

A tax position taken in a tax return means a tax position that would result in an adjustment to a line item on that tax return if the position is not sustained. A line item on a tax return may be affected by multiple units of account, in which case each unit of account must be reported separately on Schedule UTP.

Recording a reserve. In general, a corporation or a related party records a reserve with respect to a tax position taken by the corporation when any of the following occurs in an audited financial statement of the corporation or a related party: (1) An increase in a liability for income taxes payable or a reduction of an income tax refund receivable with respect to the tax position, (2) A reduction in a deferred tax asset or an increase in a deferred tax liability with respect to the tax position, or (3) Both (1) and (2).

The initial recording of a reserve will trigger reporting of a tax position, but subsequent reserve increases or decreases with respect to a tax position taken in a tax return will not. This is shown in examples in the draft instructions.

How to calculate Maximum Tax Adjustment (MTA). Schedule UTP requires a taxpayer to specify the MTA for each uncertain tax position. The MTA for a tax position taken in a tax return is an estimate of the maximum amount of potential U.S. federal income tax liability associated with the tax year for which the tax position was taken. The MTA is determined on an annual basis. For tax positions that relate to items of income, gain, loss, and deduction, the taxpayer must estimate the total amount in dollars and multiply by 0.35 (35%). For items of credit, the taxpayer must estimate the total amount of credit in dollars. The taxpayer must combine the dollar estimates related to all applicable items of income, gain, loss, deduction, and credit to determine the MTA of that tax position. For example, the MTA for a tax position taken in a tax return claiming a $100 deduction is $100 x 0.35 or $35. The draft instructions provide additional details on calculating the MTA.

Other items. The draft instructions include detailed discussion of various other items pertaining to the new disclosure requirement. In addition, they include examples on specific points and also include several comprehensive examples.

How to Find Affected Returns:

- **[1120 (2009)]** Corporations with an amount reported greater than $10,000,000 on either Form 1120, Page 1, Box D or Form 1120S, Page 1, Box F. Note: This will identify corporate taxpayers with more than $10 million of assets who thus may be required to file the new form.
- **[1120 (2008)]** Corporations with an amount reported greater than $10,000,000 on either Form 1120, Page 1, Box D or Form 1120S, Page 1, Box F. Note: This will identify corporate taxpayers with more than $10 million of assets who thus may be required to file the new form.

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Federal Tax Alert: IRS Not Prevented From Challenging Removal of Costs from Inventory Under UNICAP Rules

(Article No. ta-042010-0039, April 09, 2010)

Citations: Chief Counsel Advice 201013035

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes; Individual Income Tax; Partnerships/S Corps/LLCs

Forms Affected:

- **Form 1040, U.S. Individual Income Tax Return**
- **Form 1120, U.S. Corporation Income Tax Return**
- **Form 1065, Return of Partnership Income**

Related Resources:

Bittker & Lokken: Federal Taxation of Income, Estates & Gifts ¶ 105A.2

Federal Income Taxation of Individuals ¶ 39.06

IRS has determined that the rules contained in an earlier IRS notice, that allowed taxpayers to use a simplified method to remove certain costs from inventory that didn't belong in inventory, do not prevent IRS from examining whether costs removed from inventory are required to be capitalized to inventory under the uniform capitalization (UNICAP) rules.

Background. Under the UNICAP rules, producers of real or tangible personal property and resellers of real or personal property must capitalize the direct costs and a proper share of the indirect costs of the property. While IRC § 263A requires capitalization of indirect costs, it generally does not set forth methods for allocating indirect costs. Instead, the regs generally provide that taxpayers must allocate indirect costs to property using detailed or specific cost allocation methods, including a specific identification method, the standard cost method, and methods using burden rates. Alternatively, taxpayers may use the simplified production method or simplified resale method (simplified methods), as applicable.

In general, the simplified methods determine aggregate amounts of additional IRC § 263A costs allocable to ending inventory. Additional IRC § 263A costs generally are those costs, other than interest, that were not capitalized under the taxpayer's method of accounting immediately before the effective date of IRC § 263A , but that are required to be capitalized under IRC § 263A . Under the simplified methods, additional IRC § 263A costs allocable to ending inventory are determined by multiplying IRC § 471 costs (generally, the costs other than interest the taxpayer capitalized under its method of accounting immediately before the effective date of IRC § 263A) remaining on hand at year's end by an absorption ratio consisting of a numerator of additional IRC § 263A costs incurred during the tax year over a denominator of IRC § 471 costs incurred during the tax year.

Notice 2007-29 was issued to address the controversy that arose regarding the means of removing costs from inventory that were not required to be capitalized to inventory under IRC § 263A , and specifically, the removal of these costs from inventory by including negative amounts as additional IRC § 263A costs in the numerator of the ratio of the simplified production method. Pending the issuance of additional published guidance, Notice 2007-29 provides that IRS will not challenge the inclusion of negative amounts in computing additional costs under IRC § 263A or the permissibility of aggregate negative additional IRC § 263A costs and that these issues will not be raised in any tax year ending on or before publication of the additional guidance, and that the issue will not be pursued by IRS, if already raised as an issue in examination or before Appeals or the Tax Court in a tax year ending on or before Mar. 12, 2007.

Notice 2007-29 provides examples of costs, such as the excess of book depreciation over tax depreciation, that aren't properly capitalized under IRC § 263A , and addresses the means by which a taxpayer may remove such costs from inventory. Notice 2007-29 does not change the rules under IRC § 263A and its regs as to which costs are required to be capitalized to inventory.

Facts. Taxpayer, which manufactures and wholesales Products, is under examination for Years X through Y. Taxpayer filed a Form 3115, Application for Change in Accounting Method, under Rev Proc 97-27 , 1997-1 CB 680 , in Year 1 seeking permission to discontinue capitalizing certain costs associated with Materials under IRC § 263A and to elect to use the simplified production method under Reg § 1.263A-2(b) to determine additional IRC § 263A costs allocable to its ending inventory. In Year 2, Taxpayer received consent to expense currently certain costs associated with Materials and use the simplified production method to allocate additional IRC § 263A costs to its ending inventory.

To currently expense certain costs associated with Materials, Taxpayer removed the costs from inventory by including negative amounts in the numerator of the ratio of the simplified production method. (Reg § 1.263A-2(b)) IRS is examining whether the removed costs from inventory were required to be capitalized and thus should not have been removed at all.

IRS's conclusion. In the CCA, IRS clarified that it wasn't challenging Taxpayer's means of removing costs from inventory—that is, the inclusion of negative amounts in the numerator of the ratio of the simplified production method. Instead, IRS was challenging whether or not the costs in question may be appropriately removed from inventory at all—that is, whether or not these costs were required to be capitalized to inventory under IRC § 263A . The CCA reasoned that if the costs were required to be capitalized to inventory, Notice 2007-29 doesn't transform such costs to currently deductible costs simply because Taxpayer is using negative amounts in the numerator of the ratio of the simplified production method as its means of removing the costs from inventory. Consequently, Notice 2007-29 doesn't preclude IRS from examining the issue of whether or not costs removed from inventory are required to be capitalized to inventory under IRC § 263A , nor does it preclude it from making adjustments if it determines that Taxpayer didn't capitalize costs to inventory which were required to be capitalized

The CCA noted that it had formed no opinion as to whether the specific costs at issue in Taxpayer's case were, in fact, required to be capitalized under IRC § 263A and its regs or if the costs may be properly removed from inventory and treated as currently deductible.

Background Information: Federal Tax Coordinator ¶ G-5450 et seq.; United States Tax Reporter ¶ 263A4.01 et seq.; Tax Desk ¶ 456,000 et seq.

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Federal Tax Alert: Corporation Gets Worthless Stock Deduction on Merger with Wholly-Owned Subsidiary

(Article No. ta-022010-0123, March 02, 2010)

Citations: PLR 201006003

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes

Forms Affected:

- **Form 1120, U.S. Corporation Income Tax Return**

Related Resources:

PPC's 1120 Deskbook (2009), Key Issue 31A

IIRS has ruled that a parent corporation could claim a worthless stock deduction resulting from a merger of its wholly-owned subsidiary into the parent.

Background. A taxpayer's loss from worthlessness of a security (including stock) issued by a subsidiary corporation which is affiliated with the taxpayer is an ordinary loss, even though the security would otherwise be treated as a capital asset. A sub is affiliated with the taxpayer for this purpose if both an ownership test and a gross receipts test are met. (IRC § 165(g)(3))

Under the ownership test, a sub is treated as affiliated with the parent if the parent owns directly stock in the subsidiary meeting the requirements of IRC § 1504(a)(2) (generally, ownership of at least 80% of the total voting power and value of the sub). (IRC § 165(g)(3)(A))

For a sub to meet the gross receipts test, more than 90% of the sub's aggregate gross receipts for all tax years during which the sub has been in existence must be from sources other than: royalties, rents (except rents derived from rental of properties to the corporation's employees in the ordinary course of its operating business), dividends, interest (except interest received on the deferred purchase price of operating assets sold), annuities, or gains from sales or exchanges of stock and securities. In computing gross receipts, gross receipts from the sales or exchanges of stocks and securities are taken into account only to the extent of the gains derived from these transactions. (IRC § 165(g)(3)(B))

Under Reg § 1.1502-80(c) , subsidiary stock is not treated as worthless under IRC § 165 until immediately before the earlier of the time: (1) the stock is worthless within the meaning of Reg § 1.1502-19(c)(1)(iii) or (2) the subsidiary for any reason ceases to be a member of the group.

Facts. Taxpayer is the common parent of an affiliated group that files a consolidated income tax return. Sub 1 is a currently wholly owned subsidiary of Taxpayer and was formed in Year 1. Before Year 2, Sub 1 was the common parent of an affiliated group that filed a consolidated income tax return (the "Old Sub 1 Group"). In Year 2, Predecessor owned all of the stock of Sub 1 and engaged in a transaction which resulted in the termination of the Old Sub 1 Group, and Sub 1 and its domestic subsidiaries joined the Taxpayer Group. Taxpayer represents that the transaction was not a "reverse acquisition" under Reg § 1.1502-75(d)(3) . Years 1 and 2 are years before '95.

Between Year 3 and Year 4, some of Sub 1's foreign and domestic subsidiaries (the "Transferor Subsidiaries") either merged with and into, or were liquidated into, Sub 1 in the "Subsidiary Transactions." Some of the Transferor Subsidiaries held subsidiaries (the "Second-Tier Transferor Subsidiaries") that either merged with and into, or were liquidated into, their immediate parent entity before that entity's merger or liquidation into Sub 1 in the "Second-Tier Subsidiary Transactions."

Sub 1 also owned, directly or indirectly, other domestic and foreign subsidiaries whose stock has been sold outside of the Taxpayer Group (the "Sold Subsidiaries"). Before Year 2, certain of the domestic Sold Subsidiaries made intercompany distributions to the Transferor Subsidiaries (the "Distributing Domestic Subsidiaries"), as described in former Reg. § 1.1502-14, which generally applies to transactions involving intercompany distributions with respect to the stock of members occurring in consolidated return tax years beginning before July 12, '95. In addition, before Year 2, certain of the domestic Sold Subsidiaries that were owned directly by the Distributing Domestic Subsidiaries made intercompany distributions to the Transferor Subsidiaries, as described in former Reg. § 1.1502-14 (the "Second-Tier Distributing Domestic Subsidiaries").

Proposed transaction. Sub 1 has liabilities that exceed the fair market value of its assets. They are owed solely to Taxpayer. There is no reasonable expectation of future business activity by Sub 1. Taxpayer proposes to cause Sub 1 to transfer all of its assets to Taxpayer in partial satisfaction of the liabilities (the "Proposed Transaction"). The Proposed Transaction will likely occur through a statutory merger of Sub 1 with and into Taxpayer under applicable state law. Taxpayer intends to claim a worthless stock deduction for its Sub 1 stock in an amount equal to its basis in the stock, to the extent permitted by Reg § 1.1502-36 .

Representations. Taxpayer made these representations:

- Sub 1 has a single class of stock outstanding, and Taxpayer owns directly 100% of it (thus, Taxpayer owns directly more than 80% of the voting power and value of Sub 1 within the meaning of IRC § 1504(a)(2));
- Sub 1 is currently, and will be, insolvent as of the date of the Proposed Transaction;
- Sub 1 has not made any distributions that caused it to become insolvent;
- On the date of the Proposed Transaction, Sub 1's stock will be worthless under IRC § 165(g) . If the stock was worthless under IRC § 165(g) at any time on or before Date 1, it wasn't worthless under Reg § 1.1502-80(c) because, before the date of the Proposed Transaction, Sub 1 will remain a member of the Taxpayer Group and will continue to own assets (beyond minimal capital);
- Each of the Subsidiary Transactions and the Second-Tier Subsidiary Transactions was tax-free under IRC § 332 (complete liquidation of subsidiary) or IRC § 368 (corporate reorganizations);
- Taxpayer has no excess loss account (ELA) in its Sub 1 stock; and,
- Taxpayer will claim a worthless stock loss with respect to the stock of Sub 1 only to the extent permitted by Reg § 1.1502-36 .

Rulings. IRS issued the following rulings:

- Assuming IRC § 165(g) requirements are otherwise satisfied, Taxpayer may claim a worthless stock deduction under Reg § 1.1502-80(c) upon the occurrence of the Proposed Transaction.
- For purposes of computing the "more than 90% gross receipts" test under IRC § 165(g)(3)(B) , Sub 1 will take into account the historic gross receipts of each of Transferor Subsidiary and Second-Tier

Transferor Subsidiary in the Subsidiary Transactions and Second-Tier Subsidiary Transactions provided, however, that (i) each Transferor Subsidiary will eliminate intercompany distributions received from a Second-Tier Subsidiary prior to such subsidiary's Second-Tier Subsidiary Transaction; and, (ii) Sub 1 will eliminate intercompany distributions received from any Transferor Subsidiary before such subsidiary's Subsidiary Transaction.

- For purposes of computing the "more than 90% gross receipts" test under IRC § 165(g)(3)(B) , Sub 1 must treat as a dividend the full amount of any intercompany distributions made out of earnings and profits, and received in a tax year beginning before July 12, '95, from a lower tier subsidiary (e.g., a Distributing Domestic Subsidiary or Second-Tier Distributing Domestic Subsidiary).

Background Information: Federal Tax Coordinator ¶ M-3310 ; United States Tax Reporter ¶ 1654.203 ; Tax Desk ¶ 372,021

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Federal Tax Alert: Payments Not Part of Spinoff Transaction Were Includible in Income

(Article No. ta-022010-0086, February 19, 2010)

Citations: LAFA 20100301F

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes

Forms Affected:

- **Form 1120, U.S. Corporation Income Tax Return**

Related Resources:

Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders ¶ 11.02

In a Legal Memorandum, IRS has concluded that a taxpayer that spun off a portion of its operations in a tax-free division under IRC § 355 , could not exclude from its gross income post-spinoff payments it received from the spun-off company that were not considered part of the spinoff transaction.

Facts. X was a global manufacturing company. Until Year 2, it had internal divisions that produced many of the components needed for its manufacturing operations. In Year 2, for business purposes, X spun off many of these parts operations into a separate company, Z. The spinoff qualified as a tax-free transaction under IRC § 355 .

Because X was subject to a Year 1 collective bargaining agreement ("CBA") covering all of its hourly employees at the time of the spinoff, X and Z agreed that Z would lease from X the hourly employees who had been working in the spun-off facilities as of the transfer date. X therefore assigned its hourly employees to Z but retained responsibility for the following with respect to the leased employees: (1) the payment of base hourly wages, (2) the provision of employee benefits, (3) the payment of all taxes required with respect to X's payment of wages and benefits, and (4) the liability for statutory benefits, such as workers' compensation. Z, as X's agent, had authority to exercise day-to-day supervision of the assigned employees, but X continued to provide payroll services. The assigned employees were covered under the same benefit plans as other X employees and could not participate in any Z employee benefit plans. The terms of the employee assignment agreement provided that it would terminate at the earlier of (a) the termination of employment of all covered X employees, or (b) when the parties otherwise agree to terminate the agreement.

Taxpayer arguments. X argued that it improperly included in income the payments it received from Z for: (1) the post-retirement benefits for the workers X had assigned to Z, and (2) a portion of the direct wage costs for X workers assigned to Z. X contended that these payments arose because of the tax-free spinoff transaction, and, therefore, were excludable from income.

X also argued that its position was supported by the Supreme Court's holding in Arrowsmith v. Com., (1952, S Ct) 42 AFTR 649 , 344 US 6. In that case, the taxpayers claimed that their payment of a judgment against their liquidated corporation was an ordinary loss because, although the corporate liquidation distributions were capital gains, the judgment occurred in a year that was later than the year of the liquidating distributions. The Supreme Court disagreed with the taxpayers, and concluded that the payment was a capital loss because it viewed the judgment as part of the original liquidation transaction, which was capital in nature.

IRS analysis and conclusions. IRS noted that, in order to prevail, X had to show that the payments were part of the spinoff transaction.

The Memo disagreed that *Arrowsmith* applied here. It noted that, in general, *Arrowsmith* governs cases where a subsequent, unknown or unexpected event occurs, and the proper tax treatment of that event can be determined only after reference to an earlier transaction. In contrast, in this case there was no subsequent event whose tax treatment was related to the integrated steps of the spin-off transaction.

In IRS's view, the *Arrowsmith* doctrine ultimately is premised on the idea that, if the transactions are sufficiently related, the tax consequences should be the same as if the prior and the subsequent transactions had occurred at the same time. The question of what is related to a tax-free spinoff is not addressed by the Code, apart from the specific rules in IRC § 351 , IRC § 355 , and IRC § 368 , which state, in essence, that the actual distribution of stock to shareholders in this type of spinoff is tax-free. (IRC § 368(a)(1)(D)) IRS said it was not aware of any cases, rulings, or other published advice in which a court or IRS has ruled that these types of post-spinoff payments relate back to the tax-free transaction.

IRS concluded that the payments X received from Z were not sufficiently related to the tax-free spinoff so as to be excluded from X's income. The mere contemporaneous execution of the spinoff transaction and employee assignment agreement was not enough to make the two integrally related for tax purposes. The purpose of the employee assignment agreement appeared to be more closely tied to obtaining the union's approval for the spinoff, rather than integrally related to the spinoff transaction itself. Here, X and Z were not required, by IRC § 351 , IRC § 355 , or IRC § 368 , to enter into the employee assignment agreement in order to effectuate the spinoff, and, in any event, none of those provisions (or related provisions) would grant nonrecognition treatment to payments received by X under the agreement. X and Z entered into the employee assignment agreement in large part because the CBA required it. The employee assignment agreement was merely an executory agreement about the parties' future dealings regarding employees. Therefore, because X failed to show that the payments were part and parcel of the tax-free spinoff of Z, X was required to include the payments in income when received.

Background Information: Federal Tax Coordinator ¶ F-4600 ; United States Tax Reporter ¶ 3554 ; Tax Desk ¶ 237,000

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Federal Tax Alert: No Waiver for Parent Corporation That Wanted to Reconsolidate

(Article No. ta-022010-0006, February 03, 2010)

Citations: PLR 201002002

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes

Forms Affected:

- **Form 1120, U.S. Corporation Income Tax Return**

Related Resources:

PPC's 1120 Deskbook (2009),

Key Issue 27C

Hennessey, Yates, Banks & Pellervo: The Consolidated Tax Return ¶ 3.04

IRS has denied a waiver under IRC § 1504(a)(3)(B) for a parent corporation, whose S election had terminated its former consolidated group, to be included in a new consolidated group before the expiration of the five-year waiting period.

Background. Generally, unless a special waiver is obtained, a corporation that ceases to be a member of an affiliated group may not be included in any later consolidated return filed by that group or by another group with the same common parent or a successor to that parent before the 61st month beginning after the corporation's first tax year in which it ceases to be a member. (IRC § 1504(a)(3)(A)) IRS may waive this five-year reconsolidation waiting period for any corporation for any period. (IRC § 1504(a)(3)(B))

IRS has issued a procedure under which taxpayers may obtain a waiver or exemption from the five-year waiting period. Under this procedure, taxpayers who meet certain conditions are automatically exempt from the five-year waiting period without having to request a waiver, while others must file a statement to obtain an automatic waiver. A taxpayer that doesn't qualify for an automatic exemption or an automatic waiver may be able to obtain a waiver from the five-year waiting period by means of a letter ruling request. (Rev Proc 2002-32)

Under IRC § 1504(b)(8) , an S corporation may not join in the filing of a consolidated return. A qualified subchapter S subsidiary ("a QSub") isn't treated as a corporation separate from its parent S corporation, and its assets, liabilities and items of income, deduction and credit are treated as those of the parent S corporation. (IRC § 1361(b)(3)(A)(ii)) Generally, if a QSub loses its qualification, the subsidiary is treated as a new corporation that acquired all of its assets and assumed all of its liabilities from the S corporation in exchange for its stock immediately before it lost its qualification. (IRC § 1361(b)(3)(C)(i))

Facts. Before Date 1, Parent was the common parent of an affiliated group of corporations that filed a consolidated federal income tax return on a calendar year basis (the "Old Group"). Effective Date 1, Parent elected to be taxed as an S corporation under IRC § 1361 and made QSub elections for most, but not all, of its subsidiaries. Parent's S corporation election terminated the Old Group for federal income tax purposes, effective at the end of the day on Date 2. Effective Date 3, Parent revoked its S corporation election. As a result of Parent's revocation of its S corporation election, each QSub election terminated as of the end of the day on Date 4. As a result of the termination of the QSub elections, Parent was treated for federal income tax purposes as transferring the assets of its QSubs to newly formed corporations. Immediately before the deemed asset transfer, the aggregate fair market value of Parent's assets (including the assets legally owned in the QSubs) exceeded their aggregate tax basis. As a result of Parent's revocation of its S corporation election, Parent, each of the former QSubs, and the other subsidiaries for which no QSub election had been made, became members of an affiliated group with Parent as its common parent (collectively, the "New Group"). Parent requested a ruling for a waiver under IRC § 1504(a)(3)(B) permitting Parent and each other member of the New Group to be included in the New Group's consolidated federal income tax return for the short tax period Date 3 through Date 5.

Ruling. IRS denied a waiver under IRC § 1504(a)(3)(B) to allow Parent to be included in the New Group's consolidated federal income tax return for the short tax period Date 3 through Date 5. Thus, IRS ruled that the New Group could not file a consolidated return with Parent as the common parent until the expiration of the five year waiting period. The New Group could begin filing a consolidated federal income tax return for the tax year beginning Date 6, if Parent and each other member of the New Group properly elected to file a consolidated return.

Background Information: Federal Tax Coordinator ¶ E-7654 ; United States Tax Reporter ¶ 15,024.17 ; Tax Desk ¶ 603,317

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Federal Tax Alert: IRS Requires Passive Activity Loss Groupings and Regroupings To Be Reported

(Article No. ta-012010-0067, January 19, 2010)

Citations: Rev Proc 2010-13 , 2010-4 IRB

Effective date: Tax years beginning after Jan. 24, 2010

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes; Partnerships/S Corps/LLCs

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Forms Affected:

- **Form 1120, U.S. Corporation Income Tax Return**
- **Form 1120S, U.S. Income Tax Return for an S Corporation**
- **Form 1065, U.S. Return of Partnership Income**

Related Resources:

Hennessey, Yates, Banks & Pellervo: The Consolidated Tax Return ¶ 11.08

In a new revenue procedure, IRS has finalized rules that require taxpayers to report their groupings and regroupings of activities for purposes of the passive activity loss rules under IRC § 469 and Reg § 1.469-4 .

Background. IRC § 469 generally provides that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), may not offset other income. Under IRC § 469(b) , disallowed losses and credits are treated as deductions and credits allocable to the activity in the next tax year.

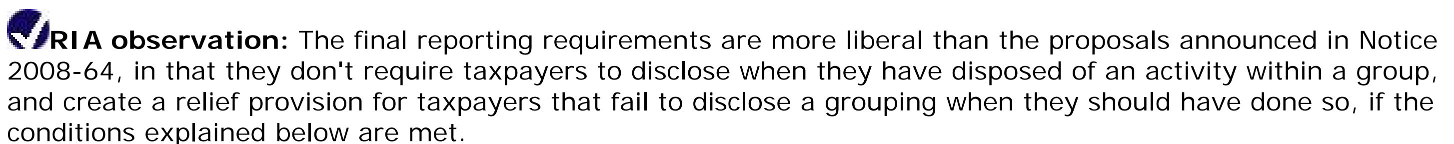
IRC § 469(g)(1)(A) generally provides that if during the tax year a taxpayer disposes of his entire interest in any passive activity (or former passive activity), and all gain or loss realized on the disposition is recognized, the excess of (i) any loss from the activity for the tax year (determined after the application of IRC § 469(b)), over (ii) any net income or gain for the tax year from all other passive activities (determined after the application of IRC § 469(b)), is treated as a loss which is not from a passive activity.

Reg § 1.469-4 sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules. Under Reg § 1.469-4(d)(5) , a section 469 entity (C corporation subject to IRC § 469 , an S corporation, or a partnership) must group its activities under the rules of Reg § 1.469-4 . Once the section 469 entity groups its activities, a shareholder or partner may group those activities with each other, with the activities conducted directly by the shareholder or partner, and with activities conducted through other section 469 entities, in accordance with the rules of Reg § 1.469-4 . The shareholder or partner can't treat activities grouped together by a section 469 entity as separate activities.

In general, once a taxpayer has grouped its activities, it can't regroup them in subsequent tax years. However, if IRS determines that a taxpayer's original grouping was clearly inappropriate, or if a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities and must comply with disclosure requirements that IRS may prescribe. (Reg § 1.469-4(e)(1) , Reg § 1.469-4(e)(2))

In Notice 2008-64 , 2008-31 IRB 268 , IRS announced proposals to require taxpayers to report to IRS their groupings and regroupings of activities and the addition and disposition of specific activities within their existing groupings of activities for purposes of IRC § 469 and Reg § 1.469-4 .

Rev Proc. The reporting requirements apply to all persons or entities to whom the rules in Reg § 1.469-4 apply. However, they don't apply to the rental real estate activities of persons or entities who have made the election in Reg § 1.469-9(g) , relating to real estate professionals. (Rev Proc 2010-13 , Sec. 3)



RIA observation: The final reporting requirements are more liberal than the proposals announced in Notice 2008-64, in that they don't require taxpayers to disclose when they have disposed of an activity within a group, and create a relief provision for taxpayers that fail to disclose a grouping when they should have done so, if the conditions explained below are met.

The new rules require a statement to be filed with respect to these events:

- *New groupings.* A taxpayer must file a written statement with his original return for the first tax year in which two or more trade or business activities or rental activities are originally grouped as a single activity or as separate activities.

- *Addition of new activities to existing groupings.* When a taxpayer adds a new trade or business activity or a rental activity to an existing grouping within a tax year, he must file a written statement with his original return for that tax year. Besides other required information, the statement must contain a declaration that the activities constitute an appropriate economic unit for the measurement of gain or loss for IRC § 469 purposes.

- *Regroupings.* Under Reg § 1.469-4(e)(2) , if IRS determines that the taxpayer's original grouping was clearly inappropriate or a material change in the facts and circumstances has occurred that makes the original grouping clearly inappropriate, the taxpayer must regroup the activities and file a written statement with his original return for the tax year in which the regrouping occurs. The rev proc lists specific requirements for activities that are regrouped into a single activity. (Rev Proc 2010-13 , Sec. 4)

Where no reporting is required. Reporting isn't required for:

- Partnerships and S corporations, which must instead comply with the disclosure instructions for grouping activities provided for on Form 1065 and Form 1120S, respectively. Generally, compliance with the applicable form requires disclosing the entity's groupings to the partner or shareholder by separately stating the amounts of income and loss for each grouping conducted by the entity on attachments to the entity's annual Schedule K-1.

- Preexisting groupings, namely groupings of trade or business activities and rental activities that were made before Jan. 25, 2010. (But reporting will be required if the taxpayer makes a change to the grouping.)

Failure to report. In general, if a taxpayer fails to report a grouping, then each trade or business activity or rental activity is treated as having been grouped as a separate activity for purposes of applying the passive activity loss and credit limitation rules. However, a timely disclosure is deemed to have been made by a taxpayer who has filed all affected income tax returns consistent with the claimed grouping of activities and makes the required disclosure on the income tax return for the year in which the failure to disclose is first discovered by the taxpayer. If the failure to disclose is first discovered by IRS, however, the taxpayer must also have reasonable cause for not making the required disclosures. (Rev Proc 2010-13 , Sec. 4.07)

Background Information: Federal Tax Coordinator ¶ M-4601 ; United States Tax Reporter ¶ 4694 ; Tax Desk ¶ 411,000

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IRS explains when a business must capitalize incentive payments made to customers

PLR 201032025

Businesses sometimes make up-front incentive payments to customers in order to get them to enter into agreements to buy products. In a recent private letter ruling, IRS concluded that incentive payments made by a manufacturer must be capitalized under Code Sec. 263(a) if made in connection with an agreement requiring the customer to buy a minimum number of products. However, on the facts, incentive payments that didn't lock customers into minimum purchases didn't have to be capitalized under Code Sec. 263(a) .

Background. Deductions for capital expenditures generally are prohibited by Code Sec. 263(a) . Among the payments that must be capitalized under Reg. § 1.263(a)-4 , are amounts paid to: acquire an intangible; create an intangible; or facilitate the acquisition or creation of an intangible.

Facts. Manufacturing Inc. has stand-by agreements with customers for the supply of one of its products. Manufacturing must supply designated products on an as-needed basis as customers demand them, and customers generally must buy 100% of their requirements for the designated products from Manufacturing. The price of the product is adjusted periodically based on raw materials costs.

The supply agreements fall into one of three categories:

(1) Category One agreements don't contain a minimum purchase requirement and don't require customers to retain Manufacturing as the supplier for products not specifically designated in the supply agreement. Customers are not obligated to use Manufacturing as their supplier if they: (1) replace the product designated in the supply agreement with another type of product or with a product that incorporates new technologies, (2) acquire a new business line that uses products offered by Manufacturing, or (3) sell or otherwise discontinue business lines for which Manufacturing supplies products.

(2) Category Two supply agreements are similar to the first but do require customers to retain Manufacturing as the supplier for products not specifically designated (should such products arise) in the supply agreement. For example, customers may be under obligation to use Manufacturing as their supplier if they replace the product designated in the supply agreement with another type of product or with a product that incorporates new technologies. With respect to one particular Category Two supply agreement, Manufacturing may recover a portion of its investment in manufacturing technologies during the course of the agreement if the contract is terminated early. The recovery, however, is limited to the extent of Manufacturing's investment in machinery and equipment purchased from third parties, the costs of which are capitalized and depreciated. It does not involve manufacture of equipment by Manufacturing, nor does it involve any research and experimentation activities.

(3) Category Three agreements contain a minimum purchase requirement.

Manufacturing may offer an incentive payment or signing bonus to customers to entice them to enter into one of the three categories of supply agreements or to extend the term of a supply agreement. These payments are one-time, up-front, non-refundable payments to customers made within a short period of time following the execution of the supply agreement. Incentive payment amounts vary by customer and are usually based on the volume of products Manufacturing expects to be purchased by the customer.

Manufacturing asked IRS to rule on whether incentive payments made in connection with any of the three categories of supply agreements had to be capitalized under Code Sec. 263(a) .

Only one type of incentive payment must be capitalized. IRS ruled that only the incentive payments made in connection with Category Three agreements had to be capitalized under Code Sec. 263(a) .

On the facts, IRS concluded that none of the incentive payments were amounts paid to: acquire an intangible under Reg. § 1.263(a)-4(b)(1) ; create an intangible under Reg. § 1.263(a)-4(d)(2) ; or to facilitate acquisition or creation of an intangible under Reg. § 1.263(a)-4(b)(1)(v) .

The sticking point was Reg. § 1.263(a)-4(d)(6) , under which a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party certain enumerated agreements or covenants. Included is an agreement giving the taxpayer the right to: (1) provide or to receive services; or (2) be compensated for services regardless of whether the taxpayer provides such services. An agreement does not provide the taxpayer right to provide services if it merely provides that the taxpayer will stand ready to provide services if requested, but places no obligation on another person to request or pay for the taxpayer's services.

IRS said the amounts Manufacturing may recover from its customer for investment in machinery and equipment under a Category Two supply agreement do not relate to a right to provide or receive services or the right to be compensated for services. Thus, incentive payments made under Category One and Category Two agreements do not provide Manufacturing with either (1) the right to provide or to receive services or (2) the right to be compensated for services regardless of whether it provides such services. Those payments are not otherwise described in Reg. § 1.263(a)-4(d)(6) .

By contrast, however, IRS concluded that in the case of Category Three supply agreements, customers must buy a minimum amount of product, and, therefore, incentive payments made with respect to Category Three supply agreements are described in described in Reg. § 1.263(a)-4(d)(6) and must be capitalized under Code Sec. 263(a) .

References: For expenditures to acquire or create intangible assets or benefits see, FTC 2d/FIN ¶ L-5750 ; United States Tax Reporter ¶ 2634.20 ; TaxDesk ¶ 256,300 ; TG ¶ 16071 .

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Federal Tax Alert: Reporting Requirements for Payment Card and Third-Party Payment Transactions Established in Final Regs

(Article No. ta-082010-0075, August 24, 2010)

Citations: TD 9496, 08/13/2010 ; Reg § 1.6041-1 ; Reg § 1.6050W-1 ; Reg § 1.6050W-2 ; Reg § 31.3406(a)-2 ; Reg § 31.3406(b)(3)-5 ; Reg § 31.3406(d)-1 ; ; Reg § 31.6051-4 ; Reg § 301.6721-1 ; Reg § 301.6722-1

Effective date: See the first paragraph under "final regs" below

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes; Financial Institutions/Insurance Cos

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Forms Affected:

- **Form 1099-K, Merchant Card and Third-Party Payments**

Related Resources:

Rook: Federal Income Taxation of Banks & Financial Institutions ¶ 14.06[9]

IRS has established the information reporting requirements, information reporting penalties, and backup withholding requirements for payment card and third party network transactions in newly issued final regs.

Background. For tax years beginning after Dec. 31, 2010, IRC § 6050W generally requires banks to file an information return with IRS reporting the gross amount of credit and debit card payments a merchant receives during the year, along with the merchant's name, address, and TIN. Similar reporting is also required for third party network transactions (e.g., those facilitating online sales).

Specifically, under IRC § 6050W , any payment settlement entity making payment to a participating payee in settlement of reportable payment transactions (any payment card transaction and any third party network transaction) must file a return for each calendar year with IRS, and furnish a statement to the participating payee, setting out the gross amount of the reportable payment transactions, as well as the name, address, and taxpayer identification number (TIN) of the participating payees. A payment settlement entity is a merchant acquiring entity in the case of a payment card transaction and a third party settlement organization in the case of a third party network transaction. (IRC § 6050W(d))

A payment card transaction is any transaction in which a payment card is accepted as payment. A payment card is defined as any card that is issued pursuant to an agreement or arrangement that provides for: (a) one or more issuers of the cards; (b) a network of persons unrelated to each other, and to the issuer, who agree to accept such cards as payment; and (c) standards and mechanisms for settling the transactions between the merchant acquiring entities and the persons who agree to accept the cards as payment. (IRC § 6050W(b) , IRC § 6050W(c) , IRC § 6050W(d))

A third party network transaction is any transaction that is settled through a third party payment network—i.e., generally an agreement or arrangement that involves the establishment of accounts with a central organization by a substantial number of persons who are unrelated to the organization, provide goods or services, and have agreed to settle transactions for the provision of the goods or services under the agreement or arrangement (IRC § 6050W(c) , IRC § 6050W(d))

Reportable payment transactions subject to information reporting generally are subject to backup withholding requirements (IRC § 3406(b)(3)) and failure to file penalties apply for noncompliance. (IRC § 6724(d)) Backup withholding for amounts reportable under IRC § 6050W applies to amounts paid after Dec. 31, 2011.

In November of 2009, IRS issued proposed regs on IRC § 6050W . IRS has now finalized those regs.

Final regs. The final regs provide guidance on implementing IRC § 6050W , amend the existing IRC § 6041 and IRC § 6041A regs to provide relief from duplicate reporting, and amend the existing IRC § 6721 and IRC § 6722 regs to expand these penalty provisions to apply to failures to file the information returns and furnish the payee statements required by IRC § 6050W . These regs apply for calendar years beginning after Dec. 31, 2010. The final regs also amend the existing IRC § 3406 regs to provide that amounts reportable under IRC § 6050W are subject to backup withholding. These regs apply to amounts paid after Dec. 31, 2011.

Because IRC § 6050W requires reporting of the gross amount of reportable payment "transactions," the final regs provide that the dollar amount of each reportable payment transaction is determined on the date of the transaction and not the settlement date, the date that payment is made, the posting date or some other date. (Reg § 1.6050W-1(a)(6))

If two or more persons qualify as payment settlement entities for a reportable payment transaction, then only the payment settlement entity that in fact makes payment in settlement of the reportable payment transaction is obligated to report the payment. (Reg § 1.6050W-1(a)(4))

Payment card transactions. Private label cards that can only be used at one merchant or within a group of related merchants do not meet the IRC § 6050W definition of payment card because they aren't accepted as payment by a network of unrelated persons. No reporting is required for any transaction in which the card is accepted as payment by a related merchant or other payee, as might be the case in certain campus card or mall card transactions. (Reg § 1.6050W-1(b)(5)(iii))

The use of a payment card to obtain a loan or cash advance doesn't fall within the statutory definition of "payment card transaction" because the card isn't being accepted by a merchant as payment. (Reg § 1.6050W-1(b)(5))

Electronic payment facilitator. A payment settlement entity (or an electronic payment facilitator acting on behalf of a payment settlement entity) makes a payment in settlement of a reportable payment transaction if the payment settlement entity (or its facilitator) submits the instruction to transfer funds to the account of the participating payee to settle the reportable payment transaction. In cases involving a processor, the processor need not have any agreement or arrangement with the payee to qualify as an electronic payment facilitator. The payment need not come from the processor's account. If a processor merely prepares payment instructions for the payment settlement entity, which in turn submits these instructions to initiate the transfer of funds, then the processor isn't an electronic payment facilitator, and the payment settlement entity retains the reporting obligation. (Reg § 1.6050W-1(d)(2))

Participating payee; foreign address exclusion. Under IRC § 6050W(d)(1)(B) , except as provided in regs or other guidance, a participating payee (i.e., any person who accepts a payment card as payment) doesn't include any person with a foreign address (the address rule). For payments made pursuant to contractual obligations entered into before Jan. 1, 2011, a payment settlement entity that is a U.S. payor or middleman may rely on a foreign address as long as the U.S. payor or middleman neither knows nor has reason to know that the payee is a U.S. person. For this limited purpose, the renewal of a contractual obligation won't result in a new contractual obligation unless there is a material modification. (Reg § 1.6050W-1(a)(5)(ii))

There is a presumption under which a payment settlement entity that is a U.S. payor or middleman making a payment outside the U.S. to an offshore account need not report payments to a participating payee with only a foreign address if the name of the participating payee indicates that it is a foreign *per se corporation* listed in Reg § 301.7701-2(b)(8)(i) and the payment settlement entity neither knows nor has reason to know that the participating payee is a U. S. person. There is also a grace period after account opening to collect documentation by applying the grace period rules of Reg § 1.6049-5(d)(2)(ii) if the participating payee has only a foreign address. (Reg § 1.6050W-1(a)(5)(ii))

If the participating payee has any U.S. address, the non-U.S. payment settlement entity may treat the participating payee as a foreign person only if the non-U.S. payment settlement entity has in its files documentation upon which the payment settlement entity may rely to treat the payment as made to a foreign person in accordance with Reg § 1.1441-1(e)(1)(ii) . (Reg § 1.6050W-1(a)(5)(ii))

Duplicate reporting of the same transaction. There is relief provided from duplicate reporting by having payment card and third party network transactions that otherwise would be reportable under both IRC § 6050W and either IRC § 6041 or IRC § 6041A , reportable only under IRC § 6050W . Solely for purposes of determining whether a payor is eligible for relief from reporting under IRC § 6041 , the de minimis threshold for third party network transactions in Reg § 1.6050W-1(c)(4) is disregarded because the IRC § 6041 payor will be unable to determine whether the de minimis threshold applies. (Reg § 1.6041-1(a)(1)(iv) , Reg § 1.6041A-1(d)(4))

Electronic consent procedures. Reg § 1.6050W-2 provides that a recipient consents to receive the statement required under IRC § 6050W in an electronic format either by making an affirmative consent or alternatively by previously having consented to receive from the furnisher other federal tax statements in an electronic format. The consent may be made electronically in any manner that reasonably demonstrates that the recipient can access the statement in the electronic format in which it will be furnished to the recipient. Alternatively, the consent may be made in a paper document if it is confirmed electronically. The procedures for meeting the consent requirements are set out in Reg § 1.6050W-2 .

Backup withholding. The amount reportable under IRC § 6050W is the gross amount of the transaction on the date of the transaction, which may differ from the amount and date of the payment (potentially a net amount paid on a later date). The obligation to withhold arises on the date of the transaction. A payor isn't required to satisfy its withholding liability until the time that payment is made. (Reg § 31.3406(b)(3)-5(c))

Backup withholding is allowed from an alternate source maintained by the payor for the payee if the payee's account has insufficient funds. If the payor can't locate such an alternative source of cash from which to backup withhold, the payor may defer its obligation to backup withhold until the earlier of the date on which the payee's account has sufficient funds or the close of the fourth calendar year after the obligation arose. If at that point the payor hasn't located an alternate source, and the account has insufficient funds, the backup withholding obligation will cease to exist. (Reg § 31.3406(b)(3)-5(d))

In the case of payments made in settlement of third party network transactions, the amount subject to withholding under IRC § 3406 is determined without regard to the exception for de minimis payments by third party settlement organizations in IRC § 6050W(e) and the IRC § 6050W final regs. (Reg § 31.3406(b)(3)-5(b))

Background Information: Federal Tax Coordinator ¶ J-9000 et seq., Federal Tax Coordinator ¶ S-3699.18 ; United States Tax Reporter ¶ 34,064 , United States Tax Reporter ¶ 60,50W4 ; Tax Desk ¶ 554,500 et seq.

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Federal Tax Alert: IRS Analyzes Sales-Leaseback Transactions Involving Retailer's Newly Constructed Stores

(Article No. ta-072010-0064, July 15, 2010)

Citations: PLR 201027045

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes; Individual Income Tax; Partnerships/S Corps/LLCs

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Forms Affected:

- **Form 4562, Depreciation and Amortization**
- **Form 1040, U.S. Individual Income Tax Return**
- **Form 1065, Return of Partnership Income**
- **Form 1120, U.S. Corporation Income Tax Return**
- **Form 1120S, U.S. Income Tax Return for an S Corporation**

Related Resources:

Bittker & Lokken: Federal Taxation of Income, Estates & Gifts ¶ 4.4.3

IRS has issued a Technical Advisory Memorandum that analyzes issues that arose from a major retailer's sale-leaseback transactions with respect to its newly constructed stores.

Facts. A company we'll call Good Buy operates retail stores throughout the U.S. The majority of Good Buy's retail stores are self-constructed in either a "Ground Owned" or "Ground Leased" transaction.

In a Ground Owned transaction, Good Buy owns the land on which it constructs a building. Following construction and an appraisal, Good Buy transfers title to the land and the building to an institutional investor

for cash and then leases back the property, generally for a term of 22 years, with two 10-year renewal periods at Good Buy's option. Rent for the renewal terms is predetermined and substantial.

Ground Owned transactions. *Sale versus financing issue.* IRS's Examination Department's (Examination) position was that the sale-leaseback transactions are in substance financings, not sales, because the term of the leaseback to Good Buy exceeds the useful life of the property. In the case of the Ground Owned transactions, the TAM concludes that the facts did not support the position that the leaseback term exceeds the useful life of the leasehold improvements. The sale-leaseback transactions involve both land and leasehold improvements, and land does not have a finite useful life. Further, the lease agreements generally provide for two 10-year renewal terms (with terms that are predetermined but substantial) following an initial 22-year term. If Good Buy does not exercise its renewal rights, the leasehold improvements revert to the landlord, who has certain remarketing rights. Accordingly, the TAM concludes that the Ground Owned transactions are sales for Federal income tax purposes.

RIA observation: Had the TAM agreed with Examination's position, both Good Buy and the purchasers/lessors would have been required to treat the transactions as loans.

Tax character of the sale. The TAM concluded that Good Buy's sale of land and building in a Ground Owned transaction yielded ordinary, not capital, gain or loss. In arriving at this conclusion, the TAM said that the controlling factor was the purpose for which the stores were held, determined as of the time of sale, based on Good Buy's method of operation and the standards customary in its line of business. The construction details of Good Buy's stores (and their locations) were critical to its primary business of retailing electronics. To meet these needs, Good Buy adopted the business model of selecting a location, building a store, and then selling the store and leasing it back. In Good Buy's judgment, this business model kept capital free to continue to select locations and build stores, rather than having capital tied up in existing stores. Based on all the facts and circumstances, the TAM concludes that the sale-leaseback of Ground-Owned stores was a necessary incident to the conduct of Good Buy's business and that the stores were held primarily for sale to customers, i.e., the purchasers/lessors, in the ordinary course of Good Buy's business. As a result, the gains or losses on these sales were ordinary, not capital.

Ground Leased transactions. In a Ground Leased transaction, Good Buy leases land from a landlord (typically a shopping center developer) and puts up a building to be used as a retail store (the "the leasehold improvement" or "retail building"). When the leasehold improvement is finished, the landlord must pay Good Buy a Tenant Improvement Allowance (TIA). After the leasehold improvements are completed, the landlord leases the land and leasehold improvements to Good Buy for a term substantially similar to those in the Ground Owned scenario.

The TIA amount is negotiated before the leasehold improvement is built and reflects the relative bargaining strengths of Good Buy and its landlord, with the projected cost of leasehold improvements providing a starting point for negotiation. The TIA generally is paid to Good Buy after the leasehold improvements are built, title to the improvements is transferred to the landlord, and Good Buy provides proof that all contractors have been paid. If a landlord fails to pay any portion of the TIA, the lease agreement permits Good Buy to withhold or reduce rent until the full TIA is paid. Generally, the amount of the TIA in Ground Leased transactions is less than what it cost Good Buy to build the leasehold improvements.

Good Buy took the position that it could deduct as a loss under IRC § 165 the difference between what it spent on leasehold improvements in the Ground Leased scenario and the TIA it received from the landlord. *Reasoning:* it sold the leasehold improvements to developers in exchange for the TIAs, and the leasehold improvements had a basis equal to the total cost of the improvements (including both costs reimbursed through the TIA and Good Buy's unreimbursed costs). Examinations rejected Good Buy's position and said that it could only depreciate its unreimbursed leasehold improvement costs over the specified recovery period of the improvements.

The TAM agreed with Examinations and ruled that Good Buy could not claim the above-described loss because there was no sale; i.e., Good Buy continued to have an interest in the leasehold improvements as a lessee in an amount equal to the difference between Good Buy's costs and the amount of the TIA.

Background Information: Federal Tax Coordinator ¶ L-6201 , Federal Tax Coordinator ¶ L-9106 ; United States Tax Reporter ¶ 1684.02 , United States Tax Reporter ¶ 614.086 ; Tax Desk ¶ 267,503 , Tax Desk ¶ 681,009

How to Find Affected Returns:

- **Criteria cannot be determined.**

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Federal Tax Alert: IRS Rules on Reasonableness of C Corporation Sole Shareholder's Compensation

(Article No. ta-072010-0006, July 01, 2010)

Citations: Multi-Pak Corp., TC Memo 2010-139

Taxing Authority: Federal

Topics: Corporate Income/Franchise Taxes

Forms Affected:

- **Form 1120, U.S. Corporation Income Tax Return**

Related Resources:

Bittker & Lokken: Federal Taxation of Income, Estates & Gifts ¶ 64.2

The Tax Court has held that: (a) most of the compensation paid by a C corporation to its employee-owner was deductible compensation and not a dividend; and (b) no accuracy-related penalty applied on the portion of the compensation deduction that was excessive because the corporation reasonably relied on its CPA to determine the amount of the deductible compensation.

Background. For compensation paid by an employer to be deductible, the amount must be reasonable. What's reasonable depends on the facts and circumstances of each case. Several factors are used to determine the reasonableness of compensation including the employee's role in the company and the character and condition of the company. The "independent investor" test may also be applied to determine whether compensation is reasonable. That test looks at what a hypothetical, independent investor would be willing to compensate the employee. (Elliotts, Inc., (CA 9 1983) 52 AFTR 2d 83-5976)

Facts. When Randal Unthank became the sole shareholder of Multi-Pak in '72, it was on the verge of bankruptcy, but he turned the enterprise around so that it became largely debt free and successful. He has been Multi-Pak's president, CEO, and COO for decades, controls all aspects of Multi-Pak's operations and designs the products that Multi-Pak sells.

For 2002 and 2003, total assets of Multi-Pak were $3.321 million and $3.134 million respectively, revenue was $9.484 million and $8.771 million, EBITDA (earnings before interest, taxes, depreciation and amortization) was $508,500 and ($120,500), net income was $140,700 and ($474,000), and total equity was $3.181 million and $2.994 million.

For 2002, Multi-Pak paid Unthank $2,020,000 ($150,000 salary and $1,870,000 bonus), and for 2003, it paid him $2,058,000 ($353,000 salary and $1,705,000 bonus). Unthank's policy was to decide in consultation with Multi-Pak's outside CPA the amount of bonus to pay himself at the end of every month, based on his performance and the company's profitability.

On audit, IRS determined that for 2002 and 2003, Multi-Pak could deduct only $655,000 and $660,000 of Unthank's compensation, respectively. And, IRS also assessed Multi-Pak with an accuracy-related penalty under IRC § 6662(a) .

Arguments. The taxpayer argued that Unthank was the driving force behind the company's success who was involved in every aspect of the company's operations from designing the products to making all important business decisions.

IRS argued that under the "independent investor test," the compensation was too high because Multi-Pak had only a 2.9% return on equity in the first year and a negative 15.8% return on equity in the second year.

Court's ruling. The Tax Court agreed with the taxpayer that Mr. Unthank was the driving force behind the taxpayer's success and stated that the compensation paid to Mr. Unthank in 2002 would not have been

unreasonable to an independent owner. However, it found that a negative 15.8% return on equity in 2003 called into question the level of Unthank's compensation for that year. When compensation results in a negative return on shareholder equity, the Court said it couldn't conclude, in the absence of a mitigating circumstance, that an independent investor would be pleased. The Tax Court held that Multi-Pak could deduct only $1,284,104 (62.4%) of the $2,058,000 of the compensation it paid Unthank in 2003, an amount which would have resulted in a 10% return on equity in 2003.

The Tax Court also held that Multi-Pak wasn't liable for the IRC § 6662(a) accuracy related penalty for 2003 since it reasonably relied on the professional advice of its CPA as to the compensation it paid Unthank.

Background Information: Federal Tax Coordinator ¶ H-3706 ; United States Tax Reporter ¶ 1624.229 ; Tax Desk ¶ 276,027

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