

# Tax News and Developments

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## IRS Relaxes Section 956 Rules to Provide Liquidity in Current Financial Crisis

In order to provide an additional source of liquidity for US corporations in the current financial crisis, the IRS, in Notice 2008-91, 2008-43 I.R.B., substantially relaxed the terms under which a controlled foreign corporation ("CFC") can loan earnings back to its US parent without triggering a current inclusion to the parent. Under Code Sections 951 and 956, the US parent must currently include in income the lesser of (a) the average of the CFC's bases in "US property" held at the end of each quarter of its taxable year over (b) the CFC's earnings that have not been subject to US tax. Although an obligation of a related US person is generally "US property" for such purposes, under Notice 88-108, 1988-2 C.B. 445, as adapted to current law by the legislative history of the Omnibus Reconciliation Act of 1993, an obligation of a related US person collected within 30 days from the time it is incurred would not constitute "US property" and would not trigger an inclusion, even if held at the end of a quarter, provided that the CFC held obligations of related US persons for less than 60 calendar days during its taxable year. Thus, if a calendar year CFC lent funds to its parent on March 25, and those were repaid 25 days later, on April 19, the parent would not have an inclusion with respect to the investment provided that the CFC did not have outstanding loans to the parent on more than 34 other calendar days during the taxable year. In determining whether loans were outstanding on more than 34 other calendar days, it would not matter whether those other days were quarter-end days. If, for example, the CFC made a 35-day loan made on May 1, and this loan was repaid on June 4, the May 1 loan would cause the CFC's basis in the March 25 loan to be included in the average under (a) above.

Notice 2008-91 allows the US parent to avoid an inclusion with respect to loans to related US persons collected within 60 (rather than 30) days, provided that the CFC holds obligations of related US persons for less than 180 (rather than 60) days in the year. Thus, the CFC could loan to the US parent for as many as two 60-day and one 59-day periods straddling calendar quarters. Again, if the CFC loaned for only two 60-day periods straddling calendar quarters, another loan outstanding for 60 days, whether or not straddling a calendar quarter, would cause the bases in the loans straddling calendar quarters to be included in the averaging computation.

This Notice applies only for the first two taxable years of a CFC ending after October 3, 2008. Thus, if a foreign corporation has a calendar tax year, the Notice applies for the CFC's taxable years ending December 31, 2008 and December 31, 2009. After those two taxable years, the CFC would (in the absence of an extension of the Notice or other change in law) presumably be relegated to reliance on Notice 88-108.

**Upcoming Tax Events:****Doing Business Globally:  
Navigating the Future of Corporate  
and Tax Risk Management**

New York, NY  
October 22, 2008

**Asia Pacific Tax Conference**

Kuala Lumpur, Malaysia  
November 13-14, 2008

**North American Tax Conference  
Seminar**

Dallas, TX  
January 15, 2009

The Notice states that a CFC can choose to apply Notice 2008-91 or Notice 88-108, but not both. (How the choice is to be made is not specified.) Apparently the intent of this provision was to prevent CFCs from claiming the term allowances in both of the notices (by, for example, making a loan for 30 plus 60 or 90 days straddling a calendar quarter). Although the Notice allows a CFC to elect to apply Notice 88-108 instead of Notice 2008-91, it is difficult to see under what circumstances a taxpayer would choose to do that, since there does not appear to be any respect in which Notice 88-108 is more generous to taxpayers.

There is considerable authority (*see* Rev. Rul. 87-89, 1987-2 C.B. 195, and *Jacobs Engineering v. United States*, 168 F.3d 499 (9th Cir. 1999)) for the IRS to collapse two or more loans, each of which is collected within 60 days, into a single loan that has a longer term. If, for example, a calendar year CFC loaned \$100x to the US parent on August 15, was repaid on September 30, loaned \$100x again on October 1 and was repaid on October 31, the IRS might well rely on these authorities to argue successfully that the taxpayer had made a single loan on August 15 that was repaid on October 31. According to that view, the basis in that loan, not collected within 60 days and outstanding at the September 30 quarter-end, would be included in the averaging computation. Based on the plain language of the Notice and confirmation by US Treasury Department officials, Notice 2008-91 does not affect the applicability of the principles articulated in these “rollover” authorities.

*By Peter M. Daub, Washington, DC*

## Newly Enacted Code Section 457A Applies to “Nonqualified Deferred Compensation from Certain Tax Indifferent Parties”

In addition to the highly publicized executive compensation provisions included in the Emergency Economic Stabilization Act of 2008 (“EESA”), a less known new tax provision, new Code Section 457A, was slipped in as section 801 of the Division C “Tax Extenders and Alternative Minimum Tax Relief” portion of the EESA. Section 457A is essentially an extension of section 409A, in that it subjects to income tax, as well as an additional 20% income tax and interest factor tax, deferred compensation (including stock appreciation rights, or “SARs,” and possibly stock options) provided by certain foreign partnerships and corporations as soon as the compensation is no longer conditioned on the future performance of services.

Section 457A applies to any compensation which is deferred under a nonqualified deferred compensation plan of a “nonqualified entity,” also called “tax indifferent parties.” Generally, this includes a foreign corporation, unless substantially all of its income is effectively connected with the conduct of a trade or business in the United States or subject to a comprehensive foreign income tax, and a foreign partnership unless substantially all of its income is allocated to persons subject to a comprehensive foreign income tax. The legislative history of prior proposed versions of this bill clarifies that the provision was intended to apply to “service providers” (employees, independent contractors, Board members, etc.), but it is not clear whether this includes only those providing services directly to the nonqualified entity or also to others within the controlled group of the nonqualified entity.

Of particular concern is that section 457A applies not only to deferred compensation subject to section 409A (bonus and cash deferrals, pension plans, severance, taxable fringe benefits, etc.) but *also* to items *exempt* from section 409A - namely any plan that

provides “a right to compensation based on the appreciation in value of a specified number of equity units” of the employer or related party. This includes SARs, and possibly options and partnership profits interests.

Baker & McKenzie is preparing and will distribute shortly a Client Alert examining this new provision in detail. Within 120 days, Treasury and IRS will provide further guidance on how to bring arrangements attributable to services on or before December 31, 2008 into compliance. We note here, however, that section 457A applies to compensation attributable to services performed after December 31, 2008. If the compensation is distributed within 12 months after the end of the calendar year in which the compensation is no longer conditioned on future performance of services, it will not be subject to section 457A. *Affected entities and persons apparently only have until the end of 2008 to modify arrangements to fall under this exemption.*

*By Veena K. Murthy, Washington, DC*

## IRS Addresses Loss Limitations Amidst Financial Crisis

In a series of recently issued notices, the IRS has addressed the application of the loss limitations of Code Section 382 in light of governmental and private sector actions necessitated by the financial turmoil gripping the US and world economies. In one notice, the IRS modified the definition of the term “testing date” under section 382 to exclude any date on or after which the United States (or any agency or instrumentality thereof) acquires stock in the Federal National Mortgage Association (“Fannie Mae”) or the Federal Home Loan Mortgage Corporation (“Freddie Mac”) under the housing act passed earlier this year. In another notice, the IRS modified the definition of the term “testing date” under section 382 to exclude dates on which the United States (or any agency or instrumentality thereof) owns, directly or indirectly, a more-than-50% interest in a loss corporation. In still another notice, the IRS stated that any deduction properly allowed after an “ownership change” to a bank with respect to losses on loans or bad debts (including any deduction for reasonable additions to bad debt reserves) will not be treated as a built-in loss or a deduction that is attributable to periods before the ownership change date. In a final notice, the IRS significantly limited the circumstances under which capital contributions made to a loss corporation will be presumed or considered to be part of a plan to avoid or increase the loss limitation under section 382. In each of the foregoing notices, the IRS has limited the additional damage which might be done to distressed financial institutions and other corporations if significant section 382 limitations were placed on their ability to utilize the significant losses they have or will incur for US federal income tax purposes merely because they seek to shore up their capital base or have been taken over by the US government.

To understand the impact of the foregoing notices, it is necessary to understand the basic mechanics underlying the application of section 382.

In general, section 382(a) imposes a limit on the amount of taxable income of a “loss corporation” which has undergone an “ownership change” that may be offset by the “pre-change losses” of such corporation. The term “loss corporation” refers to a corporation that is entitled to use a net operating loss carryover or that has a net operating loss for the year in which an ownership change occurs. Such term generally includes any corporation with a “net unrealized built-in loss” (a “NUBIL”) which, in turn, is defined as the amount by which the aggregate adjusted basis of a corporation’s assets immediately before an ownership change exceeds the fair market value of those assets. The term “pre-change loss” refers to the net operating loss carryforwards of the loss corporation to the taxable

year in which an ownership change occurs and any net operating loss for the current year to the extent allocable, on a ratable basis, to periods before the ownership change. In addition, to the extent the loss corporation has a NUBIL, any “recognized built-in loss” (an “RBIL”) of the loss corporation in a taxable year that includes any portion of the five-year period beginning on the date of the ownership change (the “recognition period”) is treated in the same manner as a pre-change loss. An RBIL is any loss recognized during the recognition period on the disposition of any asset if the loss corporation held the asset on the date of an ownership change and the loss does not exceed the loss inherent in the asset on the date of the ownership change (including depreciation, amortization, or depletion allowable within the recognition period to the extent attributable to such inherent loss). Under section 382(h)(6)(B), an RBIL also includes any deduction allowable during the recognition period to the extent attributable to periods before the ownership change date.

An ownership change occurs with respect to a corporation if it is a loss corporation on a “testing date” and, immediately after the close of such testing date, the percentage of stock of the loss corporation owned by one or more “5-percent shareholders” has increased by more than 50% over the lowest percentage of stock of such corporation owned at any time during the “testing period” by such shareholder(s). For purposes of section 382, except to the extent provided in regulations, stock is not taken into account if it is non-voting preferred stock which has redemption and liquidation rights that do not exceed its issue price and is not convertible into another class of stock – in other words, it is described in section 1504(a)(4). The term “5-percent shareholder” refers to any person holding five percent or more of the stock of the corporation at any time during the testing period. While there is no precedent directly on point, it is possible that the United States, or an agency or instrumentality thereof, could be classified as a “person” under section 7701(a)(1) for purposes of applying section 382. See *State of Ohio v. Helvering*, 292 U.S. 360 (1934) (whether the word “person” or “corporation” includes a state or the United States depends upon the context in which the word is used); see also *Wycoff, Est. of v. Commissioner*, 506 F.2d 1144, (10<sup>th</sup> Cir. 1974) (whether the term “person” includes a state or the United States depends on the legislative context) and *Fairfax County Economic Development Authority v. Commissioner*, 77 T.C. 546 (1981) (definition of “person” in section 7701(a)(1) does not explicitly include the government or an agency of the government but does not exclude them either).

The term “testing date” refers to each date on which a loss corporation is required to make a determination of whether an ownership change has occurred. A loss corporation is generally required to make such a determination immediately after any change in the ownership of stock in the loss corporation which affects the percentage ownership of any 5-percent shareholder. It is also required to make such a determination immediately after the issuance or transfer of an option that is treated as exercised under the constructive ownership rules applicable to section 382 because the issuance, transfer or structuring of such option has as a principal purpose the avoidance or amelioration of the impact of an ownership change of the loss corporation and certain other ownership, control or income tests are satisfied. The term “option” includes a contingent purchase, warrant, convertible debt, put, stock subject to a risk of forfeiture, contract to acquire stock, or similar interest. Finally, the “testing period” is generally defined as the three-year period ending on the day of any owner shift.

If there has been an ownership change with respect to a loss corporation, the amount of taxable income of the loss corporation that annually may be offset with pre-change losses is limited to the “value” of the loss corporation multiplied by the “long-term tax-exempt rate.” The “value” of the loss corporation is the value of its stock (including any stock which is otherwise not taken into account in determining whether an ownership change has occurred) immediately before the ownership change. The “long-term tax-exempt rate” is the highest adjusted Federal long-term rate in effect for any of the three months

preceding and including the date of the ownership change (e.g., 4.65% if the ownership change occurred in September 2008). Section 382(l)(1)(A) provides that any capital contribution received by a loss corporation as part of a plan a principal purpose of which is to avoid or increase any section 382 limitation is not taken into account in determining the value of a corporation's stock for purposes of section 382. Under section 382(l)(1)(B), any capital contribution made during the two-year period ending on the date of an ownership change is presumed to be treated as part of such a plan except to the extent provided in regulations.

### Notice 2008-76

On July 30, 2008, President Bush signed into law the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 (2008) (the "Act"). The Act provides the Secretary of the Treasury with the authority to purchase any obligations and other securities issued by Fannie Mae and Freddie Mac on such terms and conditions and in such amounts as the Secretary may determine. On September 7, 2008, the Federal Housing Finance Agency (the "FHFA"), established pursuant to section 1101 of the Act, placed Fannie Mae and Freddie Mac in conservatorship pursuant to the authority granted to it under section 1145 of the Act. Concurrently with the FHFA's action, pursuant to section 1117(a) and (b) of the Act, the Treasury Department entered into preferred stock purchase agreements (the "Agreements") with each entity pursuant to which it became obligated to purchase non-voting variable liquidation preference senior preferred stock (the "Senior Preferred Stock") up to a maximum amount of \$100 billion per entity and, in consideration therefor, became entitled (for no additional consideration) to receive on the effective date of the Agreement (or as soon as possible thereafter) \$1 billion of Senior Preferred Stock and warrants for the purchase of common stock of each entity representing 79.9% of its common stock on a fully-diluted basis at a nominal price. Each Agreement provides that neither the entity nor the conservator will take a position for any tax, accounting or any other purpose that is inconsistent with Notice 2008-76, 2008-39 I.R.B. 1 (or the regulations to be issued pursuant thereto).

Fannie Mae and Freddie Mac had deferred tax assets of \$20.6 billion and \$18 billion, respectively, as of June 30, 2008, much of which related to the recognition for book purposes that their assets have declined substantially in value even though losses have not yet been recognized for US federal income tax purposes. Each is likely to be a loss corporation for purposes of section 382 because each is likely to have a substantial NUBIL. However, neither entity had recorded a valuation allowance with respect to these tax assets because each believed it is more likely than not that they will generate sufficient taxable income for US federal income tax purposes to absorb these losses. Therefore, an ownership change under section 382 that resulted in substantial limitations being placed on the ability of either entity to utilize these NUBILs when they are recognized for US federal income tax purposes after an ownership change would likely result in a further deterioration of the book value of their assets as they record valuation allowances with respect to their deferred tax assets.

In order to avoid a potential ownership change with respect to Fannie Mae and Freddie Mac, in Notice 2008-76 the IRS, utilizing its regulatory authority under section 382(m), indicated that it will issue regulations modifying the term "testing date" under section 382 to exclude any date on or after which the United States (or any agency or instrumentality thereof) acquires stock, including stock described in section 1504(a)(4), or options in Fannie Mae or Freddie Mac pursuant to section 1117(a) and (b) of the Act. Notice 2008-76 indicates that the regulations to be issued will apply on or after September 7, 2008 and will apply unless and until there is further guidance. As described above, an acquisition by Treasury described in Notice 2008-76 occurred on September 7, 2008 and, therefore, no date on or after September 7, 2008 can constitute a testing date for Fannie Mae and Freddie Mac. Because no testing date can occur on or after September 7, 2008, there

cannot be an ownership change with respect to Fannie Mae or Freddie Mac because a testing date is a prerequisite to determining whether such an ownership change has occurred. Interestingly, this rule, by its terms, would seem to apply even if the Treasury disposes of its Senior Preferred Stock and warrants in these entities unless and until there is additional guidance from the IRS.

### Notice 2008-84

In Notice 2008-84, 2008-41 I.R.B. 1, the IRS utilized an approach similar to the one that it applied in Notice 2008-76 to expand the range of corporations that are protected from an ownership change under section 382 as a result of US government action. Specifically, the IRS, utilizing its regulatory authority under section 382(m), indicated that it will issue regulations modifying the term “testing date” under section 382 to exclude any date as of the close of which the United States (or any agency or instrumentality thereof) owns, directly or indirectly, a “more-than-50% interest” in a loss corporation even if there are changes in the corporation’s stock ownership. For this purpose, a “more-than-50% interest” refers to stock of a loss corporation possessing more than 50% of the total value of shares of all classes of stock (excluding stock described in section 1504(a)(4)) or more than 50% of the total combined voting power of all classes of stock entitled to vote, or an option to acquire such stock. The regulations described in Notice 2008-84 will apply for any taxable year ending on or after September 26, 2008, and will apply unless and until there is additional guidance.

On September 22, 2008, American International Group, Inc. (“AIG”) executed a definitive agreement with the Federal Reserve Bank of New York for a two-year, \$85 billion revolving credit facility (the “Credit Agreement”). The Credit Agreement provides that AIG will issue to the AIG Credit Facility Trust (the “Trust”), a new trust established for the benefit of the Treasury, 100,000 shares of Convertible Participating Serial Preferred Stock (the “Preferred Stock”) in exchange for \$500,000 plus the lending commitment described in the Credit Agreement. The Preferred Stock will be convertible into a number of shares of common stock equal to 79.9% of the common stock of AIG. Prior to conversion, the Preferred Stock will: 1) be entitled to participate in any dividends paid on the common stock, with the payments attributable to the Preferred Stock being approximately, but not in excess of, 79.9% of the aggregate dividends paid; and 2) vote with the common stock on all matters, and will hold approximately, but not in excess of, 79.9% of the aggregate voting power.

If AIG was a loss corporation on September 22, 2008 (which seems likely), the Credit Agreement providing for the issuance of Preferred Stock would likely be viewed as conferring on the Trust, and thus the Treasury, ownership of a “more-than-50% interest” in AIG within the meaning of Notice 2008-84 as of such date (even if the Preferred Stock is not issued immediately) because the Credit Agreement would likely be viewed as a contract to acquire stock that is treated as an option under section 382 (whether or not deemed exercised). Consequently, pursuant to Notice 2008-84, neither September 22, 2008 nor any date thereafter as of the close of which the Treasury owns a more-than-50% interest in AIG can constitute a “testing date” with respect to AIG assuming it is a loss corporation. Because no testing date can occur on or after September 22, 2008 until such date as the Trust, and thus the Treasury, disposes of the Preferred Stock, there cannot be an ownership change with respect to AIG because a testing date is a prerequisite to determining whether such an ownership change has occurred. The scope of Notice 2008-84 is not, of course, limited to AIG and, consequently, other corporations that undergo a government takeover may also benefit from its provisions.

## Notice 2008-83

During the course of the current economic crisis, many banks have been forced to substantially write down the value of their assets, such as loans and mortgage-backed or other asset-backed securities, for book purposes under the fair value accounting method described in Statement Number 157 of the Financial Accounting Standards Board (“FASB”) even though they have not recognized the losses inherent in these assets under the differing standards applicable for US federal income tax purposes. According to Bloomberg.com’s latest index of write-downs and capital infusions, banks and securities firms have taken almost \$591 billion of these write-downs since the beginning of 2007 though this figure is likely to go much higher. Onaran and Pierson, *Banks' Subprime-Related Losses Surge to \$591 Billion*, Bloomberg.com (September 29, 2008), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aSIW.imTKzY8>. Banks which have taken such write-downs are likely to have a NUBIL. If they were to undergo an ownership change, their ability to deduct recognized built-in losses on the disposition of these assets after the ownership change would have been limited to an amount equal to a small percentage of their market capitalization, which is also likely to be severely depressed, on the date of the ownership change.

In Notice 2008-83, 2008-42 I.R.B. 1, the IRS stated that it is studying the proper treatment under section 382(h) of certain items of deduction or loss allowed after an ownership change in a corporation that is a bank, as defined in section 581, both immediately before and after the date of such ownership change. Under section 581, the term “bank” is generally interpreted to include a national bank, a state bank, a cooperative bank that does not have capital stock represented by shares, a mutual savings bank, and a domestic building and loan association. Langbein, *Federal Income Taxation of Banks & Financial Institutions*, ¶ 1.03[1][a]. Thus, while an investment bank would not appear to be within the literal scope of Notice 2008-83, it could be provided it becomes a bank (and remains a bank) both before and after an ownership change. According to Notice 2008-83, unless and until there is further guidance from the IRS, for purposes of section 382(h), any deduction properly allowed after an ownership change to a bank with respect to losses on loans or bad debts (including any deduction for reasonable additions to bad debt reserves) will not be treated as a built-in loss or a deduction, as described in section 382(h)(6)(B), attributable to periods before the ownership change. In effect, Notice 2003-83 turns off the NUBIL and RBIL rules of section 382 with respect to losses on loans or bad debts, including presumably mortgage-backed and other asset-backed securities, attributable to periods before the ownership change.

The potential importance of Notice 2008-83, which was released by the IRS on Tuesday, September 30, 2008, cannot be understated, and its effect is apparently being felt almost immediately in the midst of the current economic crisis. For example, it has been widely reported in the financial press that the release of Notice 2008-83 helped persuade Wells Fargo & Company to pursue its \$15 billion acquisition of Wachovia Corporation, despite the latter’s previously-announced deal with Citigroup, because an ownership change would not affect the ability of Wachovia (or, depending on the facts and circumstances, Wells Fargo) to deduct almost \$72 billion in Wachovia’s book losses for US federal income tax purposes and potentially produce, over time, almost \$25 billion in US federal income tax savings. See, e.g., Dash and White, *Wells Fargo Swoops In*, NYTimes.com, <http://www.nytimes.com/2008/10/04/business/04bank.html?scp=2&sq=wells&st=cse>. It is expected that Notice 2008-83 will allow banks to replenish their capital base or engage in a merger or acquisition without endangering the deductibility of the losses they may eventually recognize for US federal income tax purposes. However, US Senator Charles Grassley appeared to criticize the issuance of the Notice without consulting Congress and noted that the, “extraordinary action \* \* \* likely will add billions of dollars to the deficit.”

## Notice 2008-78

As noted above, banks and securities firms have sought record amounts of capital infusions to shore up their capital base during the current financial crisis, as have corporations outside of the financial sector. If a bank, securities firm or other corporation constitutes a loss corporation at the time of such capital contribution, and such loss corporation undergoes an ownership change as a result of the issuance of new stock or as a result of other foreseen or unforeseen events such as a merger or acquisition, its losses would be subject to limitation under section 382. Prior to the issuance of Notice 2008-78, 2008-41 I.R.B. 1, a capital contribution, particularly if it was made in the two-year period ending on the date of an ownership change, could be disregarded in calculating the value of the loss corporation under section 382(l)(1) unless the taxpayer obtained a private letter ruling (a "PLR") from the IRS confirming that the capital contribution was not part of a plan a principal purpose of which was to avoid or increase the limitation under section 382 or could otherwise demonstrate that the capital contribution was not part of such a plan. *See, e.g.*, PLR 200814004 (January 2, 2008), PLR 200730003 (April 27, 2007), and PLR 9541019 (July 10, 1995). In Notice 2008-78, the IRS has provided general guidance regarding the application of section 382(l)(1) upon which taxpayers may rely with respect to any taxable year ending on or after September 26, 2008 pending the issuance of regulations.

The Notice provides that, notwithstanding section 382(l)(1)(B), a capital contribution will not be presumed to be part of a plan a principal purpose of which is to avoid or increase a section 382 limitation solely as a result of having been made during the two-year period ending on the change date. Thus, the IRS has used the regulatory authority granted to it under section 382(l)(1)(B) not to simply modify the presumption which effectively existed therein but rather to nullify it in its entirety. Instead, a capital contribution, whether or not it occurs within the two-year period ending on the date of the ownership change, will be disregarded under section 382(l)(1)(A) only if, based on the facts and circumstances, it is part of a plan a principal purpose of which was to avoid or increase the limitation under section 382 (a "Plan"). While Notice 2008-78 generally prescribes a facts and circumstances approach to the determination of whether a Plan motivated a particular capital contribution, importantly, it also describes certain "safe harbors" pursuant to which a capital contribution will not be considered a Plan. In formulating these safe harbors, the IRS borrowed, both conceptually and for definitional purposes, from the safe harbors contained in Treas. Reg. § 1.355-7 precluding the application of section 355(e) to cause the recognition of corporate-level gain in a transaction that would otherwise qualify as a tax-free distribution under section 355.

The first two safe harbors focus on the identity of the contributor, the amount of stock issued, the possibility of a transaction that would result in an ownership change at the time of the contribution, and the amount of time that passes after the contribution before the ownership change takes place. Under the first safe harbor, a capital contribution will not be considered part of a Plan if: i) the contribution is made by a person who is neither a controlling shareholder (determined immediately before the contribution) nor a related party; ii) no more than 20% of the total value of the loss corporation's outstanding stock is issued in connection with the contribution; iii) there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and iv) the ownership change occurs more than six months after the contribution. Under the second safe harbor, a capital contribution will not be considered part of a Plan if: i) the contribution is made by a related party but no more than 10% of the total value of the loss corporation's stock is issued in connection with the contribution, or the contribution is made by a person other than a related party; ii) in either case there was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and iii) the ownership change occurs more than one year after the

contribution. While both safe harbors appear broad in scope, it remains to be seen how useful they will be given the current economic crisis in which events, such as capital contributions, may be followed quickly by an acquisition or merger that results in an ownership change.

Under Treas. Reg. § 1.355-7(h)(3), a controlling shareholder of a corporation the stock of which is listed on an established market is defined as a five-percent shareholder that actively participates in the management or operation of the corporation (including by way of being a director). Furthermore, a controlling shareholder of a corporation the stock of which is not listed on an established market is any person that owns stock possessing voting power representing a meaningful voice in the governance of the corporation.

Under Treas. Reg. § 1.355-7(h)(1), whether an agreement, understanding, or arrangement exists depends on the facts and circumstances. The parties do not necessarily have to have entered into a binding contract or have reached agreement on all significant economic terms; however, an agreement, understanding, or arrangement clearly exists if a binding contract to acquire stock exists. Under Treas. Reg. § 1.355-7(h)(1), substantial negotiations generally requires the discussion of significant economic terms.

The third and fourth safe harbors are more narrowly focused than the first two. Under the third safe harbor, a capital contribution will not be considered part of a plan if the contribution is made in exchange for stock issued in connection with the performance of services, or for stock acquired by a retirement plan (under the terms and conditions of Treas. Reg. § 1.355-7(d)(8) or (9), respectively). Under the fourth safe harbor, a capital contribution will not be considered part of a plan if: i) the contribution is received on the formation of a loss corporation (not accompanied by the incorporation of assets embodying a NUBIL); or ii) it is received before the first year from which there is a carry forward of a net operating loss, capital loss, excess credit, or excess foreign taxes (or in which a NUBIL arose).

*By Thomas R. May, Washington, DC*

## The Wait is Over: Relief Has Arrived for Taxpayers Owing AMT Arising from the Exercise of ISOs

Long-awaited help is here for taxpayers who incurred substantial amounts of alternative minimum tax ("AMT") in prior years due to exercises of incentive stock options ("ISOs"). Many of these taxpayers were hit with a double whammy when the stock they received from these exercises later became worthless or decreased significantly in value when the dot com bubble burst in 2001 and 2002.

On October 2, 2008, President Bush signed into law H.R. 1424, otherwise known as the Economic Stimulus Relief Bill (the "Bill"). The Bill contains three separate divisions: the Emergency Economic Stabilization Act of 2008; the Energy Improvement and Extension Act of 2008; and the Tax Extenders and Alternative Minimum Tax Relief Act of 2008. H.R. 1424 was passed by the Senate on October 1 by a vote of 74 to 25, and by the House on October 3 by a vote of 203 to 171. H.R. 1424 provides authority to the Federal Government to purchase and insure certain types of assets in an effort to bail-out a failing economy, and to incentivize energy production and conservation. The Bill also, as part of the Alternative Minimum Tax Relief Act of 2008 (the "Act"), provides much needed relief for taxpayers owing taxes resulting from the exercise of ISOs. That relief, as well as the overall AMT "patch", is the focus of this article.

In anticipation of this legislation, IRS Commissioner Shulman indicated in an August 26 letter to Senator Chuck Grassley that the IRS would not undertake any collection enforcement actions on cases involving AMT liability arising from the exercise of ISOs. This moratorium, extended through September 30, was intended to give Congress an opportunity to enact relief legislation.

## What is the AMT?

The AMT is the excess, if any, of a taxpayer's tentative minimum tax for the year over his regular tax for the year. To calculate the tentative minimum tax, the taxpayer's taxable income is modified for certain adjustments, and is then reduced by an exemption amount. The result is the taxpayer's alternative minimum taxable income ("AMTI"), and this is taxed at an AMT rate of 26% or 28%.

***How is the AMT implicated upon the exercise of an ISO?*** With respect to the regular tax, Code Section 421 provides that, if certain requirements are met, a taxpayer does not recognize income either upon the granting or upon the exercise of an ISO. The recognition of income is delayed until the subsequent disposition of the stock. At that time the taxpayer recognizes a long-term capital gain or loss, determined using the amount paid for the stock as the cost basis.

For AMT purposes, however, ISOs are subject to Code Section 83. Under section 83, if the stock is substantially vested on exercise, the taxpayer takes into account as ordinary income the excess of the fair market value of the stock at the date of exercise over the amount paid for the stock.

***How does the Act help taxpayers owing tax from the exercise of ISOs?*** Of particular importance for many taxpayers is that the Act abates any underpayment of tax that is outstanding on the date of enactment that is attributable to the exercise of ISOs, including any related penalties and interest. This provision would eliminate some significant outstanding tax liabilities for taxpayers who exercised ISOs when the optional stock peaked in value and then later became worthless.

Other benefits of this legislation include an accelerated time frame for claiming any unused minimum tax credit, an elimination of the phase-out of the AMT Credit (described below), an increase in the AMT Credit, an increase of the AMT exemption amounts, and a greater number of credits that may be used to offset both the AMT and the regular tax.

## MTC and AMT Credits

As discussed above, upon the exercise of an ISO, a taxpayer recognizes ordinary income equal to the amount by which the fair market value of the stock exceeds the amount paid for the stock on the date of exercise. This ordinary income creates what is commonly referred to as a 'deferral adjustment'. The deferral adjustment generates a minimum tax credit (the "MTC"). The taxpayer may apply the MTC to reduce his regular tax to the extent his regular tax, as reduced by certain non-refundable credits, exceeds his tentative minimum tax in a future tax year. As previously described, the taxpayer's tentative minimum tax is the taxpayer's taxable income, as modified for certain adjustments and reduced by an exemption amount. The MTC is non-refundable, and any unused MTC may be carried forward indefinitely.

For persons with long-term unused MTCs, generally outstanding four years or more, Code Section 53(e) provides what is known as the AMT Credit. The AMT Credit is a refundable credit and, prior to the Act, was subject to a phase-out based on the amount of a person's adjusted gross income. The AMT Credit is often referred to as the 'refundable portion' of the MTC.

The AMT Credit is calculated as an amount, not in excess of the taxpayer's long-term unused MTC, equal to the greater of (a) 50% of the taxpayer's unused MTC for the year (up from 20% prior to the Act), or (b) the taxpayer's AMT Credit for the previous tax year. In addition, for each of the first two tax years beginning after December 31, 2007, the Act increases each of the MTC and the AMT Credit by half of the amount of any interest and penalties paid prior to the enactment of the this legislation, resulting from the exercise of ISOs. These interest and penalties are amounts that would have been abated by the Act, but for their payment prior to the Act.

## Exemption Amounts

Subject to phase-out, the AMT exemption amounts prior to the new legislation for 2008 were \$45,000 for married individuals filing jointly and surviving spouses; \$33,750 for unmarried individuals; and \$22,500 for married individuals filing separately. Under the Act, these amounts are increased to \$69,950 for married individuals filing jointly and surviving spouses; \$46,200 for unmarried individuals; and \$34,975 for married individuals filing separately. It is important to note that this is a temporary fix only for the year 2008. Absent further Congressional action, the exemption amounts for 2009 drop as follows: \$33,750 for unmarried persons; \$45,000 for married filing jointly and surviving spouses; and \$22,500 for married persons filing separately.

While this legislation increased AMT exemption amounts, it did not modify the phase-out rules. Therefore, for 2008, the phase-out rules are as follows:

- married filing jointly and surviving spouses, \$69,950, less 25% of AMTI in excess of \$150,000 (no exemption when AMTI reaches \$429,800);
- unmarried, \$46,200, less 25% of AMTI in excess of \$112,500 (no exemption when AMTI reaches \$297,300); and
- married filing separately, \$34,975, less 25% of AMTI exceeding \$75,000 (zero exemption when AMTI reaches \$214,900), but AMTI of married individuals filing separately is increased by the lesser of \$34,975 or 25% of the excess of AMTI (without regard to the exemption reduction) over \$214,900.

## Personal non-refundable credits

This legislation will also increase the number of personal non-refundable credits that can be used to offset the AMT and the regular tax. Prior to the Act, only the adoption credit, the low income saver's credit, and the child credit are permitted to offset both the regular tax and the AMT. However, under the Act, all of the following credits are eligible to offset the AMT and the regular tax: the dependant care credit, the credit for the elderly and permanently and totally disabled, the adoption credit, the child tax credit, the mortgage credit, the Hope and Lifetime Learning credits, the lower income saver's credit, the nonbusiness energy property credit for energy-efficient improvements to a principal residence, the residential energy efficient property credit for solar electric, solar hot water, and fuel cell property added to a residence, and the first time home buyer credit for the District of Columbia. As with the exemption amounts discussed above, this provision also applies for 2008, but only for 2008.

*By Shelly Boehler, Dallas*

## Proposed Regulations for Outbound Transfers Under Code Sections 367, 1248, and 6038B

On August 20, 2008, the Treasury Department and the IRS issued proposed regulations under Code Sections 367, 1248, and 6038B (the "Proposed Regulations"). The Proposed Regulations address domestic corporations transferring property to foreign corporations or distributing stock of foreign corporations in certain transactions.

The following summarizes the main provisions of the Proposed Regulations:

- Confirmation of the general section 367(a)(5) rule that an exchange of property described in section 361(a) or (b) (a "section 361 exchange") is fully taxable;
- Elective exception to section 367(a)(5), under certain conditions;
- Clarification that section 367(a) property transferred by a US person to a foreign corporation ("section 367(a) property") in a section 361 exchange includes both appreciated and depreciated property;
- An anti-stuffing rule, excluding from the regulatory exception any section 367(a) property acquired in connection with the section 361 exchange for the principal purpose of altering a determination made under the Proposed Regulations;
- Preservation of inside gain for future taxation on the stock received in a section 361 exchange, or current taxation, to the extent that gain cannot be preserved;
- Exception to existing section 367(b) regulations for certain distributions of stock of a foreign acquired corporation by a domestic corporation in a section 361 exchange;
- Elective exception to section 1248(f) rule requiring a domestic distributing corporation to include section 1248 amounts in income as a dividend;
- Imposition of section 6038B reporting requirements for certain section 361 exchanges;
- Modification of coordination rule, which provides that the rules of section 367 first apply to a direct asset transfer and then to an indirect stock transfer; and
- Suspension of section 1248(e) when capital gains are taxed at a rate that equals or exceeds the tax rate on ordinary dividends.

The Proposed Regulations do not address section 361 exchange tax attributes of the transferring domestic corporation (e.g., net operating losses and foreign tax credits) other than the bases and allocable liabilities of the transferred property. The Treasury Department and the IRS have requested comments on the Proposed Regulations and other potential regulations for similar transactions.

***Elective Exception to Section 367(a)(5).*** The Proposed Regulations confirm the general rule that a domestic corporation must recognize gain with respect to appreciated property transferred to a foreign corporation in a section 361 exchange; but also provide an elective exception to full gain recognition. To qualify for the exception, the following conditions must be satisfied:

- (i) the domestic corporation must be controlled (i.e., 80% of voting shares and 80% of total shares), by five or fewer, but at least one, domestic corporation;
- (ii) the domestic corporation must recognize gain equal to the aggregate inside gain allocable to non-control group members and to the extent any control group member cannot preserve its allocable share of inside gain in the stock received;

- (iii) each control group member's basis must be reduced to the extent necessary to preserve its share of inside gain; and
- (iv) the domestic corporation must include a statement with its tax return agreeing to recognize the amount of gain that would have been recognized without the election, if the foreign acquiring corporation disposes of the property in one or more transactions entered into with the principal purpose of avoiding US tax.

Additional conditions apply if the section 361 exchange is part of a divisive D reorganization and the US transferor distributes stock of the foreign acquiring corporation in a section 355 distribution. However, assuming all the conditions and requirements are satisfied, the proposed regulations allow an electing domestic corporation to qualify for the section 367(a) exceptions, otherwise precluded by the harsh rule in section 367(a)(5) -- i.e., the section 367(a)(2) exception for transfers of stock or securities of a foreign corporation that is party to the exchange or reorganization and the section 367(a)(3) active business exception.

***Current Taxation if Gain Not Preserved.*** As noted above, even if an election is made for one of the section 367(a) exceptions to apply, the domestic corporation nonetheless must recognize gain in two situations. First, a portion of the total built in gain in the transferred property must be recognized by the domestic corporation in proportion to the ownership interest (by value) of non-control group members. Second, the domestic corporation must recognize gain to the extent that a control group member's share of inside gain exceeds the fair market value of the stock received in the exchange. These rules apply to tax built in gain in the transferred property which will not be preserved for future taxation.

***Rules Governing Application of Regulations.*** The Proposed Regulations include rules for determining inside gain, including an anti-stuffing rule and rules for determining deductible liabilities, if any, taken into account. The Proposed Regulations also treat section 367(d) intangible property as section 367(a) property in certain transactions, pursuant to the exception to the Treas. Reg. § 1.367(a)-3(d)(2)(vi)(A) coordination rule.

***Section 1248 Amount Not Recognized after Section 361 Exchange, if Income Preserved.*** The general rule in the 2000 final regulations requires recognition of section 1248 amounts in certain outbound section 361 exchanges and triangular section 361 exchanges. In 2006, final regulations were issued to provide an exception to the general rule in the 2000 final regulations for certain triangular reorganizations. This exception, however, did not apply to a domestic corporation receiving stock of another domestic corporation that controlled (i.e., corporation owning 80% of voting shares and 80% of total shares) the foreign acquiring corporation in a section 361 exchange. After further review, the Treasury Department and the IRS determined that including the section 1248 amount in income in a section 361 exchange may not always be necessary to preserve the section 1248 amount for future taxation. Accordingly, the Proposed Regulations include additional exceptions from the general rule in the 2000 final regulations. Specifically, the Proposed Regulations provide that a domestic corporation transferring stock of a foreign acquired corporation to a foreign acquiring corporation, in a section 361 exchange, need not recognize gain currently if:

- (i) the controlling corporation is foreign and immediately after the exchange, the foreign controlling corporation, the foreign acquiring and the foreign acquired corporation are all CFCs with respect to which the domestic corporation is a section 1248 shareholder; or
- (ii) the controlling corporation is domestic and immediately after the exchange, the foreign acquired corporation is a CFC with respect to which the domestic controlling corporation is a section 1248 shareholder.

In both cases, the controlling corporation must make adjustments to the foreign acquiring corporation stock basis, under Treas. Reg. § 1.367(b)-13, to preserve the pre-exchange section 1248 amount.

**Rules to Ensure Section 1248 Amount Preserved.** Additionally, the Proposed Regulations include regulations under section 1248(f), to ensure that the section 1248 amount is preserved following subsequent distribution(s) of the stock of the foreign acquiring or controlling corporation by the domestic corporation to its shareholders. These proposed regulations require a domestic corporation to include in income the section 1248 amount attributable to the stock distributed in a section 337 or section 355 distribution. If the stock distributed was received in a section 361 exchange, the Proposed Regulations require the domestic distributing corporation to include in income an amount equal to the amount that would be included in income as a dividend by the foreign distributed corporation under section 964(e), as if the foreign distributed corporation sold the stock of each foreign corporation received in the section 361 exchange (the “section 1248(f) amount”). However, The Proposed Regulations affirm the statutory exception in section 1248(f)(2) and also provide an elective exception for section 355 distributions and section 361 distributions which generally fall outside section 1248(f)(2). Pursuant to this election, the holding period and bases in the stock received may be reduced in the hands of the domestic corporation’s shareholders under the Proposed Regulations. Once the election is jointly made by (i) the domestic corporation and (ii) the shareholders who are section 1248 shareholders immediately after the distribution, the election is irrevocable.

**Effective Date.** The Proposed Regulations would generally apply to transfers occurring on or after the date that is 30 days after the regulations are published as final, with an earlier effective date for specified provisions.

*By Angela J. Walitt, Washington, DC and Caryn L. Smith, Miami*

## Proposed Regulations Under Section 336(e) Expand Universe of Elective Deemed Asset Sales

In enacting the *General Utilities* repeal in 1986, Congress recognized that a taxable transfer of appreciated corporate stock without a corresponding step-up in the basis of the corporation’s assets may result in multiple taxation at the corporate level of the same economic gain, and that Code Section 338(h)(10) provided relief in limited circumstances. Congress decided that “principles similar to section 338(h)(10)” should be allowed to apply to taxable sales or distributions of controlled corporation stock. H.R. Conf. Rep. No. 841, 99<sup>th</sup> Cong., 2d Sess., Vol. II, 198, 204 (1986). Specifically, Code Section 336(e), enacted as part of the Tax Reform Act of 1986, provides that “under regulations prescribed by [Treasury],” where a corporate seller meeting the requirements of section 1504(a)(2) with respect to its ownership of stock in a target corporation sells, exchanges, or distributes “all of such stock,” an election may be made to treat such sale, exchange or distribution as a disposition of all of the target’s assets. On Aug. 25, 2008, the IRS at long last issued proposed regulations implementing section 336(e).

### General Rules

The proposed regulations generally provide that a section 336(e) election is available if a domestic corporation (“seller”) makes a “qualified stock disposition” of the stock of another domestic corporation (“target”). A qualified stock disposition can be made by any combination of taxable sale, exchange or distribution of target stock within a 12-

month period. The language of section 336(e) is unclear as to whether the phrase “all of such stock” requires that the seller dispose of all of the stock it owns. The proposed regulations resolve this ambiguity on the side of flexibility (and consistency with section 338(h)(10)) by permitting the seller to retain some target stock provided that it disposes of stock meeting the requirements of section 1504(a)(2), or 80%, by vote or value, of the target stock.

In keeping with the legislative history, the proposed regulations make liberal use of the mechanics and principles of section 338(h)(10). Other than in the case of distributions falling under section 355(d) or (e) as discussed below, a qualified stock disposition for which a section 336(e) election is made is not treated as a sale or exchange of target stock. Instead, it is treated as if the target corporation (old target) sold all of its assets to an unrelated corporation (new target) in exchange for an “aggregate deemed asset disposition price” (or “ADADP”) and liquidated into the seller. These events are deemed to occur at the close of the first date (the “disposition date”) on which a qualified stock disposition occurs. Subject to loss disallowance in the case of certain distributions as described below, old target recognizes both gain and loss on the asset disposition. Old target’s ADADP and new target’s “adjusted grossed up basis” (or “AGUB”) are allocated among the assets in accordance with the allocation rules of Treas. Reg. § 1.338-6. Tax consequences to shareholders of old target other than the seller generally are not affected by a section 336(e) election; a minority shareholder’s disposition or retention of stock is taxed in accordance with its form. Section 336(e) elections may be made “down the chain” where the target’s assets include stock of a subsidiary. However, other than in that context (*i.e.*, deemed disposition of stock of a subsidiary pursuant to a section 336(e) election), where a qualified stock disposition also constitutes a qualified stock purchase as defined under section 338, the transaction is treated only as a qualified stock purchase.

Further, to the extent not otherwise addressed and not inconsistent with section 336(e), the principles of section 338 and the regulations there under apply for purposes of the proposed regulations. The proposed regulations provide, for example, that the asset and stock consistency rules of Treas. Reg. § 1.338-8 and the application of the section 453 installment method provided under Treas. Reg. § 1.338(h)(10)-1(d)(8) may apply with respect to a section 336(e) election.

Unlike section 338(h)(10), the section 336(e) election is made solely by the seller, by attaching a statement to its timely filed federal income tax return for the taxable year which includes the disposition date. Further, there may be more than one buyer (or distributee) in the qualified stock disposition; and the buyer need not be a corporation. As with section 338(h)(10), the proposed regulations make the section 336(e) election inapplicable to transactions with related persons or transactions involving foreign sellers and/or foreign targets. However, the preamble to the proposed regulations acknowledges that the authority provided under section 336(e) is broad and requests comments regarding the potential for applying the election to such transactions and others beyond the scope of the proposed regulations.

### Application to Distributions Not Governed by Section 355

Under the proposed regulations, to the extent that a qualified stock disposition consists of a distribution of target stock that is not described in section 355, an additional step is deemed to occur immediately following the deemed asset sale to new target and liquidation of old target. The seller (*i.e.*, distributor) is deemed to purchase from new target the amount of stock distributed in the qualified stock disposition and to have distributed such new target stock to its shareholders. The seller recognizes no gain or loss on the deemed distribution of new target stock to its shareholders. To be consistent with section 311(a), the proposed regulations disallow the recognition of loss on the deemed asset sale to the extent of the portion of the qualified stock disposition which

constitutes an actual distribution. The tax consequences to the distributee shareholder(s) may be affected by the deemed asset sale. For example, any increase in earnings and profits of the seller following old target's asset sale and liquidation may increase the amount of dividend income resulting from the distribution. Further, as with a sale or exchange, new target would not inherit old target's tax attributes.

### Application to Distributions Taxable Under Section 355(d) or (e)

If a section 336(e) election is made for a qualified stock disposition which consists, in whole or in part, of a distribution described in section 355(d)(2) or (e)(2) (*i.e.*, disqualified distributions taxable to the distributing corporation under section 355(d) or "Morris trust"-type distributions taxable under section 355(e)), a different set of consequences is prescribed by the proposed regulations. As under the general rule, old target is deemed to sell all of its assets to an unrelated person in a single transaction at the close of the disposition date. However, old target is not deemed to liquidate, and immediately following the deemed asset disposition, old target is treated as acquiring all of its assets from an unrelated person in a single, separate transaction at the close of the disposition date in exchange for an amount equal to the AGUB. Immediately thereafter, the seller is treated as distributing the stock of old target actually distributed to its shareholders. The seller does not recognize gain or loss on the distribution of old target stock to its shareholders.

Because old target is not deemed to liquidate, old target (*i.e.*, the controlled corporation in the section 355 transaction) will retain its tax attributes following the distribution. According to the preamble to the proposed regulations, this treatment is intended to preserve the consequences of section 355 distributions. For example, Treasury and the IRS were concerned that if the controlled corporation's pre-distribution earnings and profits were eliminated upon a deemed asset sale to new target, its shareholders could receive distributions of assets from the controlled corporation without recognizing dividend income.

Given that taxpayers generally attempt to avoid the application of section 355(d) or (e), a section 336(e) election in the context of a section 355 transaction may be somewhat rare. However, the proposed regulations expressly provide for the possibility of making protective section 336(e) elections, and section 355 distributions that may be subject to corporate level taxation under section 355(d) or (e) would be a situation in which a protective section 336(e) election is worthy of consideration. As in the case of transactions not governed by section 355, loss is recognized on the deemed asset sale only to the extent of the portion of the qualified stock disposition consisting of a sale or exchange (but not a distribution) of stock.

### International Provisions

As indicated above, the proposed regulations do not apply to transactions in which either the seller or the target is a foreign corporation. However, where a target corporation has foreign operations (directly or through subsidiaries), a deemed sale of the target's assets would potentially provide a materially different result (in terms of source of income and section 904(d) basket) than a sale of the target's stock. The proposed regulations provide that the principles of section 338(h)(16) apply to section 336(e) elections for target corporations with foreign operations "to ensure that the source and foreign tax credit limitations are properly determined." Thus, under the proposed regulations, income and gain recognized in a qualified stock disposition generally will be US-source income from the sale of stock (*i.e.*, no look-through) since both the seller and the target corporation must be domestic. Where gain from an asset sale would be treated as foreign-source income but resourced as US source due to an overall foreign loss ("OFL") under section 904(f), query whether section 338(h)(16) would be turned off to that extent to reduce or

eliminate the OFL. *See* FSA 1999-648 (Nov. 10, 1993) (concluding, based on legislative history, that this is the proper result in the context of a section 338(h)(10) election made by a target in an OFL position).

As in the case of an election under section 338, the proposed regulations provide that if a section 336(e) election is made and the target's taxable year under foreign law does not close at the end of the disposition date, foreign income taxes attributable to income earned by the target during such taxable year are allocated to old target and new target under the principles of Treas. Reg. § 1.1502-76(b).

The IRS and Treasury have requested comments regarding how the proposed regulations should be modified to take into account the policies of the international tax provisions if the proposed regulations were extended to apply to foreign sellers and/or foreign targets, including comments regarding: (1) how the principles of section 338(h)(16) should apply; (2) how the foreign tax allocation rule of Treas. Reg. § 1.338-9(d) should apply; (3) the characterization of the gain recognized on the deemed asset disposition for purposes of section 954(c)(1)(B); (4) whether special earnings and profits rules are necessary; and (5) how the withholding tax provisions of section 1445 should apply to the deemed asset disposition (if relevant).

The proposed regulations under section 336(e) provide a different, more flexible, path pursuant to which the effects of an election under section 338(h)(10) can be achieved with respect to a transaction in which a section 338(h)(10) election may not be available (e.g., because the stock of the target is distributed rather than sold or because the purchaser is not a corporation). However, it could be argued that the disallowance of losses generated on a deemed sale of the target's assets to the extent attributable to an actual distribution, while possibly consistent with section 311(a), is clearly inconsistent with the deemed asset sale treatment prescribed by section 336(e) as well as the principles of section 338 (and is inequitable at least to the extent such losses do not exceed gains recognized on the deemed asset sale). Furthermore, other than any potential complications involved in applying section 336(e) where either the seller or target is foreign, there does not seem to be any particular policy reason why an election under section 336(e) should not be available in the international context. Hopefully, these points will be addressed in the final regulations under section 336(e). Though some argue that section 336(e) is a self-executing provision that is effective without the issuance of regulations, the proposed regulations provide that, once finalized, they will be effective only for qualified stock dispositions the disposition date of which occurs on or after the date the final regulations are issued.

*By Hoon Lee, New York and Thomas R. May, Washington, DC*

## **PLR 200803004: The IRS Issues Guidance on the Treatment of the Series LLC**

In 1996, Delaware became the first state to create a statute allowing for the creation of the series LLC. Since then, states such as Iowa, Nevada, Oklahoma, Tennessee, Illinois, and Utah have followed suit. Under the Delaware LLC act (the "Act"), each series essentially acts as a separate limited liability company entity. Each distinct series may own its own assets, may have its own business or investment objective, and may be operated by its own managers. Moreover, each series may have a distinct set of members with a separate allocation of profits and losses. Series LLCs have proven to be useful in businesses such as hedge funds, venture capital funds, oil and gas investments, real estate, and fractional share arrangements. Moreover, the series LLC eliminates the administrative burden and expense of forming multiple LLCs.

One of the major benefits of the series LLC is that creditors of one series may not seek judgment against the assets of another series. However, there are a few potential downsides. The series LLC is a relatively new vehicle and the creditor protection has not yet been adequately tested in the courts. Furthermore, the IRS has not officially commented on whether the series LLC should be treated as a single entity or whether each series should be treated as a distinct taxpayer.

Due to the IRS' silence on the issue, many commentators have analogized the treatment of the series LLC to that of a statutory trust series. Statutory trust series have been treated as separate taxpayers in a number of Private Letter Rulings ("PLRs") issued by the IRS, which generally cite two sources – the *National Securities Series—Industrial Stock Series v. Commissioner* case and Revenue Ruling 55-416. In *National Securities*, a single trust agreement created open-ended investment funds. Each fund had separate shareholders that were entitled at any time, at their option, to surrender their shares for redemption and receive the proportionate share of the underlying trust assets and net earnings to the date of surrender. The issue before the court was whether the distribution of the trust assets was a preferential dividend or a redemption payment. The court determined that there was no simultaneous pro rata distribution to all other shareholders of the series that did not redeem and, thus, the distribution was not a preferential dividend. In so holding, the court determined each series was a separate entity. In Revenue Ruling 55-416, the IRS subsequently acquiesced in this decision.

The PLRs that treat a statutory trust series as a distinct taxpayer generally cite to the separateness of the assets and liabilities of each trust series. In arrangements where creditors of one series may not reach the assets of a separate trust series, the PLRs have concluded that each series be treated as a distinct taxpayer. The concept of separateness of assets and liabilities from series to series is common in both the series LLC and the statutory trust. The analogy between the two types of entities indicates that a series of a series LLC should also be treated as a separate distinct taxpayer.

Additionally, two states – Massachusetts and California – have issued rulings concluding that each series of a series LLC is treated as a distinct taxpayer. Massachusetts Letter Ruling 08-2 determined that a Delaware series should be classified as a disregarded entity or partnership, depending upon the number of owners of a particular series. The ruling cited three principal authorities, including the *National Securities* case, Revenue Ruling 55-416, and numerous PLRs regarding the tax classification of trust series.

The California Franchise Tax Board (the "FTB"), in its online update to "California Forms and Instructions 568—2005 Limited Liability Company Tax Booklet," states that each series LLC must file and pay separate LLC annual taxes and fees. The FTB has taken the position that each series within the Series LLC is a separate business entity and each has a filing requirement if it is registered or doing business in California. Each series in a Delaware Series LLC is considered a separate LLC and must file its own California Form 568 Limited Liability Company Return of Income and pay its own separate LLC annual tax and fee. This decision in California is not surprising because it increases the state of California's tax income.

In January 2008, the IRS finally provided some guidance on the treatment of series LLCs in PLR 200803004. In the PLR, a statutory trust (similar to the one at issue in *National Securities*) that was separated into four series proposed a conversion into a series LLC with each trust series being converted into a separate series LLC. Some series would elect to be treated as a corporation, some series had multiple members and other series would have only one member. The taxpayer sought guidance from the IRS as to the treatment of each series after the reorganization.

The IRS issued the PLR with no significant analysis. The PLR concluded that each series should be treated as a distinct taxpayer. Thus, a single member series was treated as a

disregarded entity and a series with more than one member was treated as a partnership. Furthermore, the IRS noted that each series may make an election on Form 8832 to be treated as a corporation regardless of the number of members.

Similar to the statutory trust series rulings and cases, the facts of the PLR represented that each series of the LLC would be separate from the other series. Accordingly, the taxpayers represented the following facts that demonstrate the separate characteristics of each series:

- allocations of taxable income, gain, loss, deduction, and credit of each separate series will be made separately and in accordance with Sections 704(b) and 704(c);
- each LLC Portfolio will consist of a separate pool of assets, liabilities and stream of earnings;
- the members of a series may share in the income only of that series;
- the ownership interest of the members of a series will be limited to the assets of that series upon redemption, liquidation, or termination of such series;
- the payment of the expenses, charges and liabilities of a series will be limited to that series' assets;
- the creditors of a series are limited to the assets of that series for recovery of expenses, charges, and liabilities; and
- each series will have its own investment objectives, policies and restrictions.

As a practical matter, taxpayers seeking to minimize the possibility that a series LLC may be challenged by the IRS as a single entity should attempt to establish each series as a separate entity. Incorporating facts similar to those represented in the series LLC operating agreements should provide a good level of comfort in achieving that goal.

*By Steven Hadjiligiou, Miami*

## The Unified Loss Rule: Loss Disallowance, Just in Time for the Credit Crunch

Companies with troubled subsidiaries, and their potential buyers, have a new iteration of loss disallowance rules to navigate in the consolidated return regulations.

In broad terms, the rules limit a parent company's ability to recognize losses on transfers of the stock of its consolidated subsidiaries. In some cases the rules also reduce or eliminate a subsidiary's favorable tax attributes, such as loss carryforwards and asset basis. The rules generally apply whenever loss shares -- shares of a consolidated subsidiary with a basis in excess of value -- are transferred by a member. A transfer is broadly defined for this purpose to include, among other things, a sale of shares, a deconsolidation, or worthlessness under Code Section 165.

The new rules were issued as final regulations (the "Final Regulations") in early September and apply to share transfers on or after September 17, 2008, subject to an exception for transfers made pursuant to a prior binding commitment. Treas. Reg. § 1.1502-36(j). The Final Regulations include, with some notable exceptions, most of the features of the earlier proposed regulations issued in January of 2007. Although the Final Regulations are lengthy and relatively complex, their basic construct is described here along with a few of the more notable aspects of the rules and potential traps for the unwary.

The stated purpose of the Final Regulations is to prevent the consolidated return regulations from reducing a group's income through the creation and recognition of "noneconomic losses." The Final Regulations also attempt to prevent members and former members of a group from collectively benefiting more than one time from a single economic loss.

The Final Regulations try to serve these purposes through three distinct rules that are collectively referred to as the "Unified Loss Rule." The first of these is a basis spreading provision which reallocates investment adjustments among shares that have disparate bases. This rule may have the effect of delaying loss recognition in cases where, for example, the shares of a consolidated subsidiary do not have a uniform basis and some of the shares are sold to a nonmember. The rule does not apply in cases where all of the subsidiary's shares are transferred in a single, wholly taxable, transaction. As a result, this basis spreading rule, though complex in its application, may not be of much relevance in cases where all of the stock of a subsidiary is sold or if all of the stock of the subsidiary becomes worthless.

If a share remains a loss share after taking into account the basis spreading rule, the second, and generally more significant, basis reduction (*i.e.*, loss disallowance) rule applies. In this case the basis of the loss share is reduced, but not below fair market value, by the *lesser* of two amounts: (i) the net positive adjustment ("NPA") and (ii) the basis disconformity amount (the "Disconformity Amount").

The NPA equals the sum of all investment adjustments made with respect to the share under the consolidated return basis adjustment rules. The formula allows taxpayers to net their negative investment adjustments against positive adjustments, but not below zero, for purposes of determining the NPA and, as a result, the potential amount of basis reduction.

The Disconformity Amount generally operates as a limit on the amount of basis reduction that would otherwise occur if the NPA was the sole point of reference for the calculation. The Disconformity Amount equals the excess, if any, of the basis of the loss share over the share's allocable portion of the subsidiary's net inside attribute amount. The net inside attribute amount equals the sum of (i) the subsidiary's inside asset basis, (ii) loss carryforwards and (iii) deferred deductions, *less* any liabilities of the subsidiary.

At a very high level, the Disconformity Amount makes it less likely that the basis reduction rule will apply to subsidiaries which have been a member of the consolidated group since formation, because such companies are more likely to have matching inside attributes and outside stock basis. Purchased subsidiaries, in contrast, may enter the group with a disparity between their stock basis and inside attributes and thus are more likely to have a positive Disconformity Amount.

It is, however, difficult to generalize in this area because the Disconformity Amount formula has some interesting features. For example, taxpayers are allowed to include loss carryforwards in the net attribute amount but cannot include tax credits. There is no credit for credits. Also, the Disconformity Amount and other provisions of the Final Regulations generally operate without regard to section 382. As a result loss carryforwards are counted in full even in cases where, as a practical matter, they may have little or no economic value because of a section 382 limitation. In addition, the subsidiary's "liabilities", which essentially count against taxpayers in this rule, are determined by reference to section 461(h). It appears that contingent liabilities are not included for this purpose. In contrast, intercompany obligations generally are included even if, apparently, the debt is owed to a lower-tier consolidated subsidiary. As always, companies would be well advised to consider the positioning of their intercompany obligations well in advance of any sale or claim of a worthless stock loss.

The third and final rule, the attribute reduction rule, reduces or eliminates the tax attributes of the transferred subsidiary in cases where it is deemed necessary to prevent any duplication of losses. The amount of attribute reduction for this purpose is generally equal to the

*lesser* of (i) the net stock loss on the transferred shares (after the application of the above rules) and (ii) the subsidiary's aggregate inside loss. The aggregate inside loss for this purpose generally is the excess of the subsidiary's net inside attribute amount over the value of all outstanding shares of the subsidiary's stock. Special rules apply to subsidiaries that hold stock in lower-tier consolidated subsidiaries. A *de minimis* rule treats the attribute reduction amount as zero if the aggregate attribute reduction amount is less than five percent of the value of the shares transferred in the transaction.

When applicable, the attribute reduction amount generally is applied to reduce the subsidiary's attributes in the following four categories: (A) capital loss carryovers; (B) net operating loss carryovers; (C) deferred deductions; and (D) basis of assets. By default the attributes in category A are reduced first, in the order of oldest to newest carryovers, followed by the attributes in categories B, C and D in that order. In something of an act of regulatory grace, the Final Regulations permit taxpayers in some cases to specify the ordering of the attribute reduction among categories A-C.

Taxpayers are also allowed to make an irrevocable election to forego an otherwise allowable loss on the subsidiary's stock in order to preserve inside attributes that otherwise would be eliminated under the attribute reduction rule. Note that the attribute reduction is, of course, borne by the departing subsidiary and, by extension, its buyer, in an acquisition. Buyers and sellers should consider whether this election would be appropriate under their particular circumstances by comparing, among other things, the value of the stock loss to the seller versus the value of the inside attributes to the buyer after the application of any loss limitations under section 382 or other provisions. Any agreement reached (or not reached) in this regard should be reflected in the transaction documents executed by buyers and sellers.

Finally, the Final Regulations include a general anti-abuse provision which allows for appropriate adjustments in cases where a taxpayer acts with a view to avoid the purposes of the Final Regulations. The "acts with a view" formulation has appeared in other recent guidance and presumably is intended to set the bar for finding a tax avoidance motive somewhere below the more common "principal purpose" tests. The anti-abuse rule is illustrated with a series of examples which involve, among other things, the use of partnerships and intercompany receivables to avoid or minimize attribute reduction, and the acquisition and liquidation of a target company with a view to reducing a loss company's basis reduction amount.

*By Jeffrey P. Maydew, Chicago*

## LMSB Finally Rolls Out Tier 3 Issues for the Industry Issue Focus Program

During March 2007, the LMSB launched the Industry Issue Focus program ("IIF program"), which purported to take a new approach to coordinating high risk tax issues at a national level. The IIF program was created to help the LMSB meet challenges it faces in applying the tax law in a coordinated approach meant to resolve issues that cross industry lines within the LMSB and resolve these issues consistently. The LMSB also believed that the IIF program would help improve currency (a reference to keeping audits current) and provide greater oversight through a more efficient use of limited resources.

The IIF program consists of three tiers of issues. Tier 1 issues are of "high strategic importance to the LMSB and have significant impact on one or more industries." Tier 2 issues reflect areas of "potential high non-compliance and/or significant compliance risk to LMSB or an industry." The initial Tier 1 and Tier 2 issues were announced in March

2007. Tier 3 issues are “issues of industry importance.” During September 2008, the IRS issued the long-awaited Tier 3 Issues for the IIF program. The Tier 3 issues are issues that are typically industry-related and have been identified as issues that should be considered by LMSB when conducting their risk analyses.

The ten newly identified Tier 3 issues are divided into five industries: communication, technology & media; financial services; heavy manufacturing & transportation; natural resources & construction; and retailers, food, pharmaceuticals & healthcare.

### Communication, Technology & Media

- Carriage/Launch Fees Paid to Cable/Satellite/Television Operators by Programmers/Content Providers. The issue is whether a launch fee payment may be deferred under Rev. Proc. 71-21 and taken into income over the agreement period.
- Amortization of Intangibles – Licensed Program Contract Right. The issue is the time over which license fees for broadcast sporting rights are properly accrued.

### Financial Services

- REMICs. The IRS is looking into the issue of REMIC sponsors’ understatement of reportable gain on the retention and sale of regular interests.
- Premium Deficiency Reserves. The issue concerns a reserve required to be established by health, life, and property casualty companies to book all additional liabilities and expenses associated with any contract that will produce a loss during the subsequent year.

### Heavy Manufacturing & Transportation

- Motor Vehicle Dealerships and Code Section 263A. Many dealerships use a variation of the simplified retail method allowed by section 263A. In 2007, the IRS issued a TAM, which limited the use of the simplified retail method. The IRS is concerned with compliance risks related to the application of the TAM since the dealership industry is “virtually completely non-compliant.”
- Loyalty Programs in Service Industries. At issue is whether revenues received by air carriers as payments for frequent flyer points deferrable under Rev. Proc. 71-21 or Rev. Proc. 2004-34.

### Natural Resources & Construction

- Delay Rentals. At issue is whether delay rental payments are subject to capitalization under section 263A as costs of producing property.
- Code Section 198 Expensing of Environmental Remediation Costs (the Federal Brownfield Tax Incentive). The IRS is concerned with taxpayer compliance with the requirements of section 198, Rev. Proc. 98-47, and Schedule M-3 reporting requirements.

## Retailers, Food, Pharmaceuticals & Healthcare

- Cost segregation studies. At issue is whether an asset is Code Section 1250 or Code Section 1245 property. There has been an increase in claims reclassifying section 1250 property as section 1245 property.
- Vendor allowances. At issue is whether the various types of vendor allowances that can be received by a taxpayer in the normal course of business constitute: 1) gross income under Code Section 61; 2) trade or other discounts reducing the invoice price of merchandise acquired during the taxable year under Treas. Reg. § 1.471-3(b); or 3) reimbursement of an expense.

For Tier 3 issues, the line authority industry executive has unilateral decision making authority including ultimate disposition and resolution. LMSB teams are responsible for familiarizing themselves with the Tier 3 issues.

While only time will tell the full impact that issue focused audits will have on taxpayers and the LMSB, the first year has not gone smoothly. Taxpayers have reported that audits and resolutions of Tier 1 and Tier 2 issues have faced significant delays. The IRS has had to defend the IIF program, explaining that the program is best viewed as a “process of prioritization of work” and is not a “one-size-fits-all approach.” Now that the first Tier 3 issues have been rolled out, it is likely that audits and resolutions of these issues also will be impacted.

*By Jenny A. Austin, Chicago*

## How the Grocer Skinned the CAT: Imposition of Ohio Commercial Activity Tax on Food Sales Held Unconstitutional

*In Ohio Grocers Ass’n. v. Wilkins*, Ohio Ct. App. (Sept. 2, 2008), the Ohio Court of Appeals reversed the Franklin County Court of Common Pleas and held that the imposition of the Ohio Commercial Activity Tax (“CAT”) on gross receipts derived from certain food sales violates the Ohio Constitution. As a general matter, the Ohio Constitution prohibits the imposition of a sales tax or an excise tax on wholesale food sales as well as retail sales of food for off-site consumption. In finding that the CAT was a prohibited excise tax, the Ohio Court of Appeals invalidated the CAT as applied to these sales. The decision, which may be appealed to the Ohio Supreme Court, represents at least a temporary victory for grocers and the food industry.

The CAT is a relatively new tax, implemented by Ohio on a phased-in basis beginning in July of 2005 with a full implementation date of April 1, 2009. The CAT is measured by gross receipts and replaces the Ohio corporate franchise and tangible personal property taxes, which are being phased out as the CAT is phased in. The CAT is imposed on “each person with taxable [Ohio] gross receipts for the privilege of doing business in this state,” with the exception of entities with less than \$150,000 of gross receipts and certain other enumerated entities. OHIO REV. CODE ANN. §§ 5751.02, 5751.01(E)(1). The CAT is imposed at a flat rate of \$150 for the first \$1 million of annual taxable gross receipts, but for taxable gross receipts above \$1 million, the CAT, when fully phased-in, is imposed at the rate of 0.26%. OHIO REV. CODE ANN. § 5751.03. As a general matter, “taxable gross receipts” refers to gross receipts sourced to Ohio, with “gross receipts” defined as “the total amount realized by a person, without deduction for the cost of goods sold or other expenses incurred....” OHIO REV. CODE ANN. § 5751.01(F).

## The Ohio Constitutional Limitations on Taxing Food

The Ohio Grocer's Association and other appellants challenged the constitutionality of the CAT on the grounds that the Ohio Constitution prevented the CAT from being imposed on the sales of groceries. Specifically, the Ohio Constitution provides that "no excise tax shall be levied or collected upon the sale or purchase of food for human consumption off the premises where sold." OHIO CONST., ART. XII, § 3(C). Moreover, Article XII, § 13 of the constitution provides that:

No sales or other excise taxes shall be levied or collected (1) upon any wholesale sale or wholesale purchase of food for human consumption, its ingredients or its packaging; (2) upon any sale or purchase of such items sold to or purchased by a manufacturer, processor, packager, distributor or reseller of food for human consumption, or its ingredients, for use in its trade or business; or (3) in any retail transaction, on any packaging that contains food for human consumption on or off the premises where sold.

Citing these provisions, the Ohio Grocers Association challenged the constitutionality of the CAT as applied to gross receipts derived from the sale of food at wholesale and retail food sales for off site-consumption.

### Characterization of the CAT

The primary issue was the proper characterization of the CAT as either a prohibited excise tax or a permissible franchise tax for the privilege of doing business in the state. The Taxpayers argued that the CAT was equivalent to a sales or transaction tax, because the tax base of the CAT as applied to the Taxpayers was gross receipts derived from the constitutionally protected food sales. Moreover, the Taxpayers argued that, even if the CAT was considered a franchise tax, the CAT would be unconstitutional as applied to the sales of food at issue because a franchise tax is an excise tax.

The Ohio Tax Commissioner ("Commissioner") claimed that the CAT is not an transaction based excise tax but rather is a permissible franchise tax imposed for the privilege of doing business in Ohio. The Commissioner pointed to the statutory language of the CAT in support of its position. More specifically, Ohio law states that the CAT is imposed "on each person with taxable gross receipts for the privilege of doing business in this state." OHIO REV. CODE ANN. § 5751.02(A). Additionally, the statute expressly states that the CAT "is not a transactional tax....[The CAT] is imposed on the person receiving the gross receipts and is not a tax imposed directly on a purchaser. [The CAT] is an annual privilege tax...." *Id.* The Commissioner's position acknowledged that the CAT determined the amount of tax due by using gross receipts as its measurement; however, the Commissioner argued that using gross receipts as a measuring device should not result in the CAT being categorized as a transactional tax. Moreover, the Commissioner argued that the CAT was not a transactional tax because it was not based on each individual sale.

Although the Commissioner prevailed in the trial court, the Appellate Court reversed. As a threshold matter, the court found that a franchise tax is a form of excise tax and that the Ohio Constitution prevented the imposition of excise taxes on the sales of food at issue. Thus, even if the Commissioner was successful in characterizing the CAT as a franchise tax, the CAT would still be unconstitutional as applied to gross receipts derived from these food sales.

In addition, the court analyzed the operational nature of the CAT and determined that it was a transactional tax because it was measured solely by gross receipts aggregated over a specified period of time. The court dismissed the Commissioner's contention that a transactional tax must be imposed on each individual sale. The court reasoned that, "If the legislature is prohibited from collecting a tax on the individual sale, it logically follows the legislature would be prohibited from collecting a tax on the aggregate of those same sales." The court similarly dismissed the statutory imposition language of the CAT, stating, "Though the CAT purports not to be a transactional tax, in its operation when applied to gross receipts, a transactional tax is in essence what it becomes." In support of this categorization, the court cited to *Mosser Const., Inc. v. City of Toledo*, No. L-07-1060 (Ohio Ct. App. Sept. 21, 2007), which similarly characterized the CAT as a transactional tax.

The court also rejected the Commissioner's argument that the CAT was a franchise tax measured by gross receipts. While the court acknowledged instances of permissible franchise taxes measured by tax-exempt property or income, the court distinguished those cases by noting that the tax-exempt property or income was merely one of several factors in determining the tax. In contrast, under the CAT, "the sole factor being used to determine tax liability is gross receipts, which is simply a group of individual sales or transactions." This distinction separated the CAT from other permissible franchise taxes because, as applied to the Taxpayer, the only measure of the tax was receipts derived from transactions that the state was constitutionally prohibited from taxing.

### Impact of the Decision

The impact of the court's decision in *Ohio Grocers* goes beyond grocery stores. Absent reversal, Ohio's constitution would prohibit application of the CAT to gross receipts derived from wholesale sales of food ingredients as well as food related packaging materials. As such, taxpayers making such sales should consider the impact of the decision on their Ohio tax liability. The Commissioner has requested a stay of the appellate court decision pending further review. Further, the Commissioner recently issued guidance instructing taxpayers to continue to pay the tax as imposed and file protective refund claims. Taxpayers impacted by the decision should consider their options in this regard especially in light of the history of states refusing refund the payment of taxes declared unconstitutional.

Finally, in finding that the CAT is a transaction tax, the Ohio court may have aided claims that the CAT's economic nexus standard is unconstitutional. Along with the CAT, Ohio adopted an economic nexus standard whereby out-of-state businesses with limited or no Ohio activities would still become subject to the tax if certain economic thresholds were met, e.g., more than \$500,000 in sales to Ohio customers. If the CAT is akin to a state sales tax, the more likely it is that an out-of-state business must have a physical presence, property or employees, in Ohio before the tax can be imposed under *Quill v. North Dakota*, 504 U.S. 298 (1992).

*By John Paek, New York*

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## California Court of Appeal Allows Only Partial Refund of Unconstitutional LLC Fee

Once again, this time in *Ventas Finance I LLC v. FTB*, California's LLC fee statute has been declared unconstitutional. However, rather than awarding the taxpayer a refund of the entire fee, the California Court of Appeal ordered refunds only to the extent the fee imposed exceeded what constitutionally could have been collected had the Legislature enacted an apportionment formula as part of the original statute. Ventas is in the process of appealing this decision to the California Supreme Court.

Initially, Cal. Rev. & Tax. Code § 17942 imposed a fee on domestic and foreign LLCs doing business in California. The fee was based on "total income" calculated using gross income plus cost of goods sold, approximately gross receipts. The LLC fee was not apportioned, or divided, among the states in which the LLC did business. The fee could range from \$900 for LLCs with annual income of \$250,000, to a maximum fee of \$11,790 for LLCs with over \$5 million in income.

Ventas, like many other companies, challenged the California LLC fee statute. Ventas was registered to do business in California and conducted business activities both within and without California. The parties stipulated that slightly less than ten percent of Ventas' revenue originated from California sources. The issue was originally heard by the California Superior Court which held that the LLC fee statute was indeed unconstitutional. The court further found that the statute could not be reformed by adding apportionment provisions after the fact and thus ordered that the full amount of the unconstitutional LLC fee be refunded. The FTB appealed this decision to the California Court of Appeal. Among other things, the FTB requested judicial reformation of the statute should the ruling that it was unconstitutional be upheld.

The California Court of Appeal affirmed the Superior Court's determination that the statute is unconstitutional. Further, the Court of Appeal rejected the FTB's request for judicial reformation of the statute. The court noted that the legislative history of the statute demonstrated that inclusion of an apportionment formula was specifically considered and rejected by the California legislature. As a result, the Court could not judicially reform the statute or craft a constitutionally permissible one. Nevertheless, the Court of Appeal concluded that a full refund of the LLC fee was not required under federal or state constitutional provisions. The Court of Appeal held that the difference between the amount of tax paid and the amount the taxpayer would have paid if the tax were fairly apportioned is all that is required to cure the Commerce Clause violation. The court reasoned that because the FTB and Ventas already stipulated on the California apportionment percentages, this relief was not unduly burdensome, and the court remanded the case to the trial court for a determination of the correct partial refund amount.

### Request for California Supreme Court Review

On September 19, 2008, Ventas requested review by the California Supreme Court. In its request for review, Ventas asserts that creating a retroactive apportionment regime, the Court of Appeal usurped the legislative function and violated the separation of powers mandated by the California Constitution. Additionally, apportioning the tax under a new apportionment formula supplied by the Court of Appeal arguably constitutes an unconstitutional retroactive tax. The Due Process Clause requires a clear and certain remedy which would not be afforded by retroactively changing the statute to impose a new apportionment formula that was nonexistent during the tax years in question.

## Amendment of Statute

In 2007 (following the first court decisions holding the LLC fee unconstitutional) the Legislature amended the statute to provide for apportionment. In the same bill, the Legislature attempted to limit the remedy available to taxpayers if the earlier unapportioned fee was held unconstitutional. That legislation, much like the result ordered by the Court of Appeal in *Ventas*, limits refunds to the amount paid in excess of an apportioned tax. In considering this change, the Court of Appeal held that, in light of the remedy it ordered, it was not necessary to decide whether the subsequent 2007 legislation could be applied retroactively to the 2001, 2002, and 2003 tax years involved. Consequently, although the prior version of the LLC fee statute itself has been consistently held unconstitutional as originally enacted, the correct measure of refund is yet to be determined.

*J. Pat Powers and Elizabeth M. Ehr, Palo Alto*

## Asia Pacific Tax Conference Offers Engaging Tax Strategy Discussions

This November, Baker & McKenzie's Asia Pacific Tax Practice Group will be holding the 24<sup>th</sup> annual Asia Pacific Tax Conference in Kuala Lumpur, Malaysia. The conference will provide a comprehensive survey of topical regional tax developments, including recent legislative changes in the region, multi-jurisdictional tax planning trends and transfer pricing concerns for multinational companies. To be held on November 13-14, 2008 at the Shangri-La Hotel, the 2008 Asia Pacific Tax Conference brings together over 60 Baker & McKenzie tax attorneys from Asia, Europe, and North America.

Continuing with Baker & McKenzie's tradition to provide clients with timely information on recent developments in tax policies and rules, this year's conference focuses on providing attendees with cutting-edge solutions to recent tax issues. Sessions will feature discussions on recent tax treaty cases, PRC tax developments, equity based compensation, the tax environment in Taiwan, post-acquisition integration, tax costs in supply chain structures, transfer pricing and global tax developments, tax warranties and indemnities, and US tax developments.

Complete agenda and registration details for these and other seminars can be found by visiting the Events section of our website at [www.bakernet.com](http://www.bakernet.com). For additional information or questions, email [Marianne.Shaw@bakernet.com](mailto:Marianne.Shaw@bakernet.com) or call +852 2846 1078.

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